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2024 Judicial Update
Recent Developments in Privacy & Data Law

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1. Privacy as a Value and a Legal Principle.

1.1. Privacy in the US. In the United States, the "right to privacy" is not expressly set forth in the US Constitution, the Bill of Rights or the subsequent Amendments.

1.1.1. ***Griswold* and the Penumbra of Privacy.** The Supreme Court first recognized a constitutional right to privacy in *Griswold v. Connecticut* (1965),[1] a landmark decision that centered around the freedom of individuals to use contraception without interference from the government. The Griswold decision held that the Bill of Rights contained "zones of privacy" emanating from the First, Third, Fourth, and Fifth Amendments. Combined with the Ninth Amendment's implication that not all freedoms are explicitly mentioned in the Bill of Rights and the recognition that due process rights are set forth in the Fourteenth Amendment, Justice William O. Douglas, writing for the majority in Griswold, declared that there is a constitutional right to privacy within the "penumbra," or shadow, of these protections. [2]

1.1.2. **Privacy Implications of the Reversal of *Roe v. Wade* by *Dobbs*.** The constitutional right to privacy recognized in *Griswold* and its progeny is now in question. In 2022, the Supreme Court decided *Dobbs v. Jackson Women's Health Organization*, [3] eliminating the longstanding right to abortion.[4] Writing for a 6-3 majority, Justice Samuel Alito called into question the Court's privacy-based substantive due process doctrine, including protections for everything from contraception in *Griswold* to parental discretion to gay marriage. In his concurrence, Justice Clarence Thomas expressly urged the Court to revisit *Griswold* and other substantive due process cases to see "whether the Privileges or Immunities Clause protects *any* rights that are not enumerated in the Constitution and, if so, how to identify those rights"[5] under the new *Dobbs* test, under which the Due Process Clause of the Fourteenth Amendment only protects rights that, as described by Justice Alito, are "deeply rooted in this Nation's history" and "implicit in the concept of ordered liberty."[6]

1.1.3. **A Separate Constitutional Right to Informational Privacy?** Some commentators have sought to identify an "informational privacy" right, separate and apart from the substantive due process right ("decisional privacy") rejected in *Dobbs*. Justice Alito wrote in *Dobbs* that *Roe v. Wade* had "conflated two very different meanings of the term [privacy]: the right to shield information from disclosure and the right to make and implement

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[1] *Griswold v. Connecticut*, 381 U.S. 479 (1965).
[2] *Id*. at 484.
[3] *Dobbs v. Jackson Women's Health Organization* 597 U.S. 215 (2022).
[4] *Roe v. Wade*, 410 U.S. 113 (1973), overruled by *Dobbs*.
[5] *Dobbs* at 333 (Thomas, J., concurring).
[6] *Id.* at 217.

important personal decisions without governmental interference."[7] As one law review article puts it:

> Although the views of the current Supreme Court majority toward that longstanding protection [of informational privacy] may be less than totally clear, the courts of appeals have largely taken the Supreme Court at its word and developed caselaw percolating through a range of areas detailing the contours of that right to [informational privacy].[8]

Thus, a US citizen's constitutional right to maintain the privacy of their personal information remains alive, but it sits in a legal limbo of sorts.

1.2. Privacy in the EU. The European Union has given the individual right of privacy broad effect and great deference, in contrast to the US, which almost always considers privacy rights against other interests.

1.2.1. **EU's Express Reference to Privacy Rights**. A "right to privacy" is recognized in the UN Declaration of Human Rights and the EU Charter of Fundamental Rights.[9] The European Union views privacy broadly as a fundamental right, the same as life, liberty and property are viewed in the United States.

1.2.1. **Historical Basis for EU Privacy Primacy**. There is an historical basis for the EU's privacy-first-and-foremost approach. As a recent commentator explained it:

> The European Union was founded in the wake of the Second World War among countries whose populations had been terrorized by the total invasiveness of private life by the Nazis, whose massive gathering of information about individuals was used to enable deportations and annihilation throughout occupied Europe as well as Germany. Throughout the Nazi years in Germany, citizens were spied on by trusted party members in apartment buildings and their places of work.[10]

After World War II, the Cold War countries under the influence of the USSR saw the rise to power of incessant surveillance and the pitting of neighbor versus neighbor by the KGB, the Stasi (East Germany's secret police) and other arms of the state. This led to a focus on privacy in the EU. The same commentator compared EU and US attitudes toward privacy:

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[7] *Id.* at 219.
[8] Carmel Shachar & Carleen Zubrzycki, *Informational Privacy After Dobbs*, 75 Ala. L. Rev. 1, 3–4 (2023) (citing *Whalen v. Roe*, 429 U.S. 589 (1977); *Nixon v. Admin. of Gen. Servs*., 433 U.S. 425 (1977) and *Nat'l Aero. and Space Admin. (NASA) v. Nelson*, 562 U.S. 134 (2011)).
[9] Charter of Fundamental Rights of the European Union (2012/C 326/02), Title I, Articles 7 and 8.
[10] Vivian Grosswald Curran, Federal Rule 44.1: "Foreign Law in U.S. Courts Today," 30 *Minn. J. Int'l L.* 231, 270–71 (2021) (internal citations omitted).

> What may seem like an obsessive protection of privacy--including the "right to be forgotten," often the subject of jokes in the United States--is explained in terms of the past in innumerable places on European business sites. In an era of ever-increasing data collection in the United States, one might do well to consider the past state abuses of collected data about European citizenry that inspired Europe's GDPR as a cautionary tale. For the GDPR, data protection is one of the EU citizen's fundamental rights.[11]

The EU had a directive and some privacy guidance in place prior to the 21st century, but the modern world of data privacy started in earnest with the EU adoption of the GDPR.

1.2.2. **EU Enactment of the GDPR.** The EU passed the General Data Protection Regulation (GDPR)[12] in 2016. It became effective on May 25, 2018, codified the EU Right to Privacy, and gave it teeth. The reach of the GDPR is broad, to reflect the serious concerns of EU citizens that gave rise to it.

> Europe's past also explains another aspect of the regulation that causes the wide breadth of possibility for violating it: the GDPR's focus is so overwhelmingly concentrated on the rights of its citizenry to privacy that its reach is immeasurably vast. Thus, it encompasses any company which does business with a citizen of any EU member state; and anyone who either "processes" or "controls" data; and it insists on EU citizens' need to consent to having their data collected; and on their right to withdraw such consent at any time. [13]

The GDPR is enforced by the European Data Protection Supervisor (EDPS) and Supervisory Authorities in each of the EU countries. Fines for violations of the GDPR can run as high as 4% of a company's global revenue, and authorities can order companies to immediately cease the processing of "personal data" (the term typically used in the EU, as opposed to "personal information" in the US).

The GDPR could be the focus of an entirely separate treatise on privacy law. To reduce it to its simplest terms, any company outside the EU that seeks to process or import the personal data of EU residents needs to conform to the GDPR. There is a new EU-US transfer mechanism created in 2023. It is called the EU-US Data Privacy Framework (EU-US DPF)[14] and replaces two prior data transfer frameworks struck down by the European Court of Justice. In most instances, companies adopt the EU's Standard Contractual

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[11] *Id.* (internal citations omitted).
[12] GDPR, officially called Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) [2016] OJ L 119/1.
[13] *Curran, Federal Rule 44.1: "Foreign Law in U.S. Courts Today," 30 Minn. J. Int'l L. at 270–71 (2021)* (internal citations omitted).
[14] See FTC webpage on EU-US DPF at https://www.ftc.gov/business-guidance/privacy-security/data-privacy-framework.

Clauses (SCCs)[15] to transfer EU data to the US. Such adoption requires the US company to abide by EU standards of data protection and agree to the jurisdiction of EU data regulators.

1.3. Privacy Laws in the Rest of the World. By one recent reliable count, "137 countries now have national data privacy laws. This means 70% of nations worldwide, 6.3 billion people or 79.3% of the world's population is covered by some form of national data privacy law."[16] Switzerland and the UK have adopted nearly identical versions of the GDPR. Australia, Japan, South Korea, Brazil, China and a number of other countries have also modeled their privacy legislation on the GDPR, although each has its own context-specific derivations. One privacy scholar focused on China has written that only about half of the countries with such laws are considered "free," but are instead autocratic.[17]

2. United States: Federal Sectoral Privacy Laws

2.1. No Comprehensive Federal Privacy Law. Unlike most other countries, Congress has yet to agree on a comprehensive federal privacy law. The main issues have been preemption of state law and whether there should be a private cause of action for violations of such a law. Nothing is on the horizon, so guidance is to be found in other federal laws, or in the state laws applicable to the residents of a given state.

2.2. Government Sector: The Privacy Act of 1974, 5 U.S.C. § 552a, regulates the collection, use, and disclosure of personal information by federal agencies. The Privacy Act affords individuals certain rights, including the right to access their personal information, correct errors, and limit the disclosure of their information to others.

2.3. Health Sector: The Health Insurance Portability and Accountability Act (HIPAA), P.L. 104-191, 110 Stat 1936 (1996). HIPAA and the implementing regulations adopted by the Department of Health and Human Services, 45 C.F.R. Parts 160 and 164, address privacy and security of protected health information held by covered parties. These parties include physicians, hospitals, other healthcare providers, health plans (such as insurance companies), and healthcare clearinghouses.

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[15] *See* EU Commission webpage at https://commission.europa.eu/law/law-topic/data-protection/international-dimension-data-protection/standard-contractual-clauses-scc_en.

[16] See Alyanna Apacible-Bernardo and Luke Fischer, "Identifying global privacy laws, relevant DPAs," IAPP Privacy Advisor (Mar. 19, 2024 found at https://iapp.org/news/a/identifying-global-privacy-laws-relevant-dpas/ The IAPP Global Privacy Directory is found at https://iapp.org/resources/global-privacy-directory/.

[17] Interview with Mark Jia, Prof. at Georgetown Law, "What's Behind China's Laws to Protect Privacy?, *China File*, (Oct. 16, 2023) found at https://www.chinafile.com/reporting-opinion/notes-chinafile/whats-behind-chinas-laws-protect-privacy.

2.3.1. **HIPAA Definition of "Covered Entities."** HIPAA does not just apply to health care providers. It applies broadly to "covered entities," which are health plans, health care providers, and health care clearinghouses.[18]

2.3.2. **HIPAA Definition of "Business Associates."** HIPAA can apply to data processors, pharmacy benefit managers, accountants, and many other types of organizations that come into contact with this information or provide services to Covered Entities. After passage of the Health Information Technology for Economic and Clinical Health Act (HITECH Act), business associates must comply with all of the HIPAA Security Rule and many parts of the HIPAA Privacy Rule.

2.3.3. **HIPAA Definition of "Protected Health Information" (PHI).** The Privacy Rule defines this health information as "protected health information" or PHI, which includes information related to the past, present, or future physical or mental health or condition, the provision of health care to an individual, or the past, present, or future payment for such health care which is created or received by a covered entity. There are some exemptions from PHI for information that is "de-identified," shared for law enforcement purposes, for research, or to avoid a serious public health threat, but these are narrow and limited exemptions.

2.3.4. **HIPAA General Requirements.** HIPAA requires (with some exceptions) that covered entities: 1) use, request, and disclose only the minimum amount of PHI necessary to accomplish the intended purpose of the use, disclosure, or request (Privacy Rule); 2) implement data security procedures, protocols, and policies at administrative, technical, physical, and organizational levels to protect electronic PHI (Security Rule); 3) comply with uniform standards created for certain electronic transactions (Transactions Rule); and 4) notify individuals if there is a breach of unsecured PHI (and requires that business associates notify covered entities in the event of a breach) (Breach Notification Rule).

2.3.5. **HIPAA Business Associate Agreements.** Covered entities are permitted to disclose PHI to business associates if the parties enter into an agreement that generally requires the business associate to: 1) use the information only for the purposes required or permitted by the covered entity; 2) safeguard the information from misuse; and 3) help the covered entity to comply with its duties under the Privacy Rule. In addition, the Privacy Rule and Security Rule set forth very specific requirements for what needs to be included in these business associate agreements. When a covered entity has knowledge that its business associate has materially breached or violated the applicable agreement, the covered entity is required to take reasonable steps to cure the breach or end the violation and, if such steps are unsuccessful, to terminate the contract.

[18] *See* 45 C.F.R. § 160.103 for key HIPAA definitions.

2.3.6. **HIPAA Breach Notification Requirements.** HHS requires covered entities to notify individuals when their unsecured PHI has been breached. The HIPAA Breach Notification Rule defines a "breach" to be the acquisition, access, use, or disclosure of PHI in a manner that is not permitted by the Privacy Rule and which compromises the security or privacy of the PHI. If there are doubts, there is a presumption of breach; the burden is on the Covered Entity or Business Associate to demonstrate a low probability that the PHI has been compromised. Affected individuals must be notified "without unreasonable delay" and no later than 60 days after discovery of the breach. If a breach exceeds 500 people, HHS and the media must also be notified within this same time frame. HHS must also be notified annually of any data breaches involving fewer than 500 people, regardless of size.

2.3.7. **HIPAA Enforcement.** HIPAA is enforced by the Office of Civil Rights within HHS. This office can initiate investigations into Covered Entities' information handling practices to determine whether they are complying with the HIPAA Privacy Rule. Individuals also have the right to file complaints with HHS about privacy violations. In addition, the HITECH Act gave state attorneys general the right to initiate enforcement actions under HIPAA. **HIPAA does not include a right for individuals to bring private actions**.

2.3.8. **HIPAA Potential Civil and Criminal Liability.** A person who violates HIPAA due to willful neglect and does not correct the violation within 30 days can be fined $50,000 per violation. Penalties are mandatory when willful neglect can be shown. Potential criminal penalties for HIPAA violations include fines of $50,000 to $250,000 and up to ten (10) years in prison. Criminal enforcement via the Department of Justice and civil enforcement occurs through the OCR. As noted above, state attorneys general can now also bring HIPAA actions in accordance with the HITECH Act.

2.4. **Financial Sector: The Gramm-Leach-Bliley Act (GLBA)**, 15 U.S.C. §§ 6801-6810, is intended to restrict the sharing of customers' financial information by requiring financial institutions to give customers notice of their privacy practices, providing a right of a consumer to opt-out of certain types of sharing, and requiring financial institutions to implement appropriate safeguards to protect their customers' "nonpublic personal information."

2.4.1. **GLBA Regulators.** With respect to banks and credit unions, the Consumer Financial Protection Bureau (CFPB), the Office of the Comptroller of Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) are the primary regulators and enforcers of the GLBA. The Federal Trade Commission (FTC) is the primary enforcer of the GLBA for all financial institutions other than those banking entities.

2.4.2. **GLBA "Financial Institutions" are Not Just Banks.** The definition of "financial institution" is quite broad and includes businesses that are significantly engaged in providing financial products or services, such as

check-cashing businesses, mortgage or nonbank lenders, loan brokers, financial and investment advisors, real estate service providers, insurance, debt collectors, and businesses providing retail financing to consumers. Motor vehicle dealers and colleges are just two examples of non -banking financial institutions that now fit the recently expanded definition and must implement and maintain a comprehensive data security system that protects customer information. A business can also be covered under these laws if they collect and maintain financial information for companies that fall directly under these laws. Service providers to financial institutions are subject to examination by the regulators and will generally be expected to contractually agree to comply with the GLBA requirements.

2.4.3. **GLBA General Requirements.** The GLBA requires the financial institution to: 1) notify its customers about its information-sharing practices and provide customers with a right to opt out if they do not want their information shared with certain unaffiliated third parties (GLBA "Privacy Rule"); 2) implement a risk-based written security program to protect nonpublic personal information from unauthorized disclosure (GLBA "Safeguards Rule"); and 3) provide notice of its information sharing to consumers in some situations.

2.4.4. **GLBA Limits on Sharing of Information with Third Parties.** A company can share nonpublic personal information (NPPI) with nonaffiliated companies only if: (i) the individual is first given a right to opt-out of the sharing and does not do so; (ii) the consumer consents to the sharing; or (iii) the sharing falls within an exception that permits sharing without consent or right to opt-out. 15 U.S.C. § 6802(b). A financial institution will generally be required to have a contract in place with the third party that requires the third party to maintain the information as confidential.

2.4.5. **GLBA Data Breach Notification Requirements.** As of April 4, 2022, there is a security incident notification requirement. See Computer-Security Incident Notification Requirements for Banking Organizations and Their Bank Service Providers. Financial Institutions must notify both the regulator and the customer when there has been an unauthorized access to "sensitive customer information."

2.4.6. **GLBA Potential Liability.** GLBA has severe civil and criminal penalties for noncompliance including fines and imprisonment. If a financial institution violates GLBA the institution may be subject to a civil penalty of up to $100,000 for each violation. Officers and directors of the institution may be subject to, and personally liable for, a civil penalty of not more than $10,000 for each violation. Additionally, the institution and its officers and directors may be subject to criminal fines and imprisonment of up to five years. Criminal penalties of up to ten years imprisonment and fines of up to $500,000 (for an individual) or $1 million (for a company), are possible if the acts are committed or attempted while violating another U.S. law, or as part of a pattern of illegal activity involving more than $100,000 in a year.

2.5. Federal Consumer Protection Sector: The FTC Act & Other Laws

2.5.1. **Section 5 of the FTC Act.** Section 5 of the Federal Trade Commission Act (FTC Act) (15 USC § 45) prohibits ‘‘unfair or deceptive acts or practices in or affecting commerce.’’ The Federal Trade Commission and the Consumer Financial Protection Bureau are the primary enforcers of the FTC Act. These agencies seek to regulate subject matter such as geolocation tracking, children’s privacy, data security, credit reporting, financial and health privacy, and spam calls and email. Recent areas on which the FTC has issued studies or guidance include biometric information, social media and video streaming companies’ information practices, and proposed Commercial Surveillance and Data Security Rulemaking.

2.5.2. **The Telecommunications Act of the FCC.** Federal Communication Commission rules issued pursuant to the Telecommunications Act (47 U.S.C. ch. 5 *et seq*.) protect customer proprietary network information (CPNI) in telecom carriers’ possession. This information includes: the location of an active mobile device; the phone numbers called by a consumer; the frequency, duration, and timing of such calls; and any services purchased by the consumer, such as call waiting. Carriers may only use, disclose, or permit access to CPNI as required by law, with customer approval, while providing the carrier’s services or when providing a 911 caller's location information to a 911 call center.

2.5.3. **The Security and Exchange Act of 1934**, 15 U.S.C. §§ 13, 15(d), requires certain nonpublic information regarding cybersecurity practices and incidents to be disclosed by Regulation FD (17 CFR 243.100-101). A publicly traded company must describe the material aspects of any incident's nature, scope, and timing, as well as its material impact or reasonably likely material impact on it. Companies must also generally describe their processes, if any, for assessing, identifying, and managing material risks from cybersecurity threats, as well as the material effects or reasonably likely material effects of risks from cybersecurity threats and previous cybersecurity incidents. A company’s board of directors is obligated to oversee risks from cybersecurity threats and assess management’s role and expertise in assessing and managing material risks from those threats.

2.5.4. **The Video Privacy Protection Act of 1988 (VPPA),** 18 U.S.C. § 2710, was passed by Congress after Judge Robert Bork’s video rental records were published during his confirmation hearings to become a justice of the Supreme Court. It has morphed from a “Blockbuster Video” rental privacy law to new life as a vehicle for private class actions against operators of websites that use pixels or other tools to track what videos an individual streams or views online.

2.5.5. **The Electronic Communications Privacy Act of 1986 (ECPA)**, 18 U.S.C. §§ 2510-2523, commonly referenced together with the Stored Wire Electronic Communications Act, applies to interception of computer and

other digital and electronic communications. The ECPA, as amended, protects wire, oral, and electronic communications while those communications are being made, are in transit, and when they are stored on computers. The Act applies to email, telephone conversations, and data stored electronically.

2.5.6. **The Computer Fraud and Abuse Act of 1986**, 18 U.S.C. § 1030, prohibits intentionally accessing a computer without authorization or in excess of authorization, but fails to define what "without authorization" means. The US Supreme Court has held that one "exceeds authorized access" by accessing off-limit files and other information on a computer system they were otherwise authorized to access.[19]

2.5.7. **Children's Online Privacy Protection Act (COPPA)**, 15 U.S.C. §§ 6501-6506, a law that limits the collection, use, and disclosure of personal information relating to children under age 13. COPPA applies to website operators and other online services and requires those parties to obtain verifiable parental consent before collecting, using, or disclosing personal information from children.

2.5.8. **The Fair Credit Reporting Act (FCRA),** 15 U.S.C. § 1681 *et seq.,* as amended by the Fair and Accurate Credit Transactions Act (FACTA), limits how consumer reports and credit card account numbers can be used and disclosed. FCRA applies to businesses that compile "consumer reports" as well as those who use such reports (lenders and employers) or those who provide consumer credit information to consumer reporting agencies (also known as credit reporting agencies, such as lenders, creditors, and credit card companies)

2.5.9. **The Controlling the Assault of Non-Solicited Pornography And Marketing (CAN-SPAM) Act of 2003**, 15 U.S.C. § 103 *et seq.,* purports to limit the number and types of emails that can be sent to an individual, but it has been largely ineffective, hence the need for spam filters to address the issue.

2.5.10. **The Family Education Rights and Privacy Act of 1974 (FERPA)** (which covers student records), 20 U.S.C. § 1232g, places restrictions on the use and disclosure of K-12 and post-secondary school records.

2.5.11. **The Genetic Information Non-Discrimination Act of 2008**, 42 U.S.C. § 2000ff et seq. empowers the EEOC to enforce this law's prohibition on the misuse of genetic information, which can include information such as the parents or grandparents of an individual, as well as his or her genetic markings.

[19] *Van Buren v. United States*, 593 U.S. 374, 141 S.Ct. 1648 (2021).

2.6. Federal Consumer Protection Sector: The TCPA

2.6.1. **The Telephone Consumer Protection Act of 1991 (TCPA)**, 47 U.S.C. § 227, among other things, limits telephone calls and texts made by an automatic and random telephone dialing system. It allows for private class action suits and is one of the most litigated areas of privacy law.

2.6.2. **TCPA Do Not Call Registry.** The TCPA authorizes the Do Not Call Registry, where people can register their numbers if they do not wish to receive telemarketing calls. Prerecorded messages without the consent of the recipient are prohibited. Fax and cell phone numbers can be registered as well as landlines. Once a consumer has put his or her personal number on the list, telemarketers cannot call (or text) them without express prior permission unless the parties have an established business relationship. A marketing call depends on the circumstances. For example, a retailer's call to follow up on a customer's purchase but also described its "rewards program" was deemed an enticement to make future purchases and a violation of the TCPA.[20]

2.6.3. **TCPA Autodialers.** The TCPA restricts the use of automatic and random telephone dialing system (ATDS or sometimes just "autodialers" for short) prohibits any autodialed calls or texts to a wireless device that charges for usage, unless the consumer has specifically consented to the communication. The Supreme Court has narrowed the definition of ATDS, however, only to include devices that make random calls to a public list using software, and not just a list of people to call from a company's CRM or similar internal or acquired list.[21]

2.6.4. **TCPA Text Messaging.** The TCPA allows individuals and private lawyers to file lawsuits and collect damages for receiving unsolicited telemarketing calls, faxes, pre-recorded calls, auto dialed calls, or text messages. Marketing through telephonic devices, including mobile phones, is covered by the TCPA. Purely informational calls and calls for noncommercial purposes are exempt but dual-purpose calls may be covered.

2.6.5. **TCPA Consent Necessary for Commercial Text Messages.** As texting has proven to be one of the most effective forms of marketing. the TCPA requires prior express written consent for all autodialed and prerecorded marketing calls or text messages made to a cell phone or mobile device and prerecorded calls made to residential land lines for marketing purposes. Electronic or digital forms of signature are acceptable for compliance with this consent requirement. The consent must be "unambiguous," meaning that the consumer must receive a "clear and conspicuous disclosure" that he or she will receive calls that deliver autodialed or pre-recorded telemarketing messages on behalf of a specific advertiser, that his or her consent is not a

[20] *See Chesbro v. Best Buy*, 2012 WL 6700555 (9th Cir. 2012).
[21] *See Facebook, Inc. v. Duguid*, 592 U.S. 395, 396 (2021).

condition of purchase, and he or she must designate a phone number at which to be reached.

3. Privacy in the Various US States.

3.1. California Leads State Privacy Regulation. California has been the leader in enacting privacy protections / regulations amongst the states, just as the EU has led privacy regulation efforts in the world at large. It was the earliest and has been the most comprehensive regulator of privacy. Under the California Constitution, article I, section 1, "All people ... have inalienable rights ... [including] pursuing and obtaining ... privacy." This state constitutional right to privacy encompasses governmental and private conduct.[22] California voters passed the California Consumer Privacy Act of 2018 (effective Jan. 1, 2020) and the California Privacy Rights Act of 2020 (amending the CCPA and effective Jan. 1, 2023).

3.2. California Consumer Privacy Act. Effective January 1, 2020, the California Consumer Privacy Act (CCPA) became the United States' broadest and most stringent privacy law to date. The CCPA regulates the collection, use, and disclosure of personal information from California residents. The CCPA defines personal information broadly and applies it to any business that collects personal information from California residents and (i) has annual gross revenues of $25 million or more; (ii) buys, receives, sells, or shares the personal information of at least 50,000 California residents, households, or devices annually; or (iii) derives a minimum of 50 percent of its annual revenue from selling California residents' personal information.

Under the CCPA consumers have the right to opt out of the sale of their personal information and businesses are required to notify consumers of that right in their online privacy notice and via a conspicuous link on the website reading "Do Not Sell My Personal Information." Notices may also be required at the time of collection of any data if such collection is made at the location and not online. Consumers must be able to actually opt out of the sale of their personal information by clicking a link and businesses are forbidden from discriminating against consumers for exercising this right. The CCPA also gives consumers the right to request the deletion of their personal information. Businesses must honor these requests except for in certain circumstances. The CCPA is enforceable by the California Attorney General and authorizes a civil penalty of up to $7,500 per violation.

The law has a private right of action (including class actions) in the wake of a data breach, provided the business failed to have maintained reasonable data security.

The CCPA private right of action includes statutory damages of up to $750 per incident in the event of a data breach. If 50,000 records of a California resident

[22] *Willard v. AT&T Commc'ns of California, Inc.*, 204 Cal. App. 4th 53, 61, 138 Cal. Rptr. 3d 636, 643 (2012).

are involved in a data breach and the business failed to have reasonable data security in place, a potential claim under the CCPA may exceed $37.5 million. With statutory damages the plaintiff's lawyer does not need to show any actual harm to the individual caused by such data breach.

Final regulations for the CCPA were approved and enforcement by California's Attorney General commenced July 1, 2020, and more are on the way. The first of its kind private right of action and statutory damages allowed in the CCPA has resulted in numerous class action lawsuits and other CCPA related litigation.

The first major enforcement action taken by the California Attorney General under the CCPA resulted in a $1.2 million settlement with Sephora, a French cosmetics brand. Sephora allegedly failed to disclose to consumers it was selling their personal information; failed to honor user requests to opt out of sale via user-enabled global privacy controls; and did not cure these violations within the 30-day period allowed by the CCPA.[23]

3.3. California Privacy Rights Act. The California Privacy Rights Act (CPRA) passed on November 3, 2020. The CPRA expanded the CCPA and created a new and well-funded enforcement agency known as the California Privacy Protection Agency (CPPA). The CPRA aligns the CCPA even more closely with the EU General Data Protection Regulation (GDPR), granting new privacy rights to California consumers and imposing new obligations on companies – for example, requiring service providers to assist "businesses" to comply with their CCPA obligations – a requirement for processors under the GDPR. The CCPA employee and "B2B" exemptions were not extended under the CPRA. The threshold for a "business" to be covered increased from 50,000 to 100,000 consumers or households and "devices" was removed from calculation. The CPRA applies to personal information collected on or after January 1, 2022, with most provisions enforceable on January 1, 2023. A new right to correct was added along with restrictions on "sharing" data.

3.4. Key California Privacy Issues for Franchising.

The first thing a franchisor or franchisee needs to do is determine if it is a "business" governed by the CCPA.[24] Franchises subject to the CCPA need to conduct annual cybersecurity audits, regular risk assessments, draft and insert new contractual language requirements for service providers and contractors, consider whether to recognize Global Privacy Controls (GPC) and employ the principle of data minimization.

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[23] See "Attorney General Bonta Announces Settlement with Sephora as Part of Ongoing Enforcement of California Consumer Privacy Act," Aug. 24, 2022, found at https://oag.ca.gov/news/press-releases/attorney-general-bonta-announces-settlement-sephora-part-ongoing-enforcement.

[24] See CPPA, "Does My Business Need to Comply with the CCPA? Found at https://cppa.ca.gov/pdf/business_comply.pdf.

The CCPA provides that a business that shares common branding with a business covered by the CCPA is also considered to be covered by the CCPA. "Common branding" includes a shared name, service mark, or trademark with another "business" that "controls or is controlled by" it. This issue has not been litigated, but most franchise entities should assume "common branding" under the CCPA will be satisfied.

3.5. California AG and CPPA Enforcement.

3.5.1. **DoorDash Settlement for Lack of Opt-Out Notice and Sharing of Data**. In its second settlement of a suit brought by the California Attorney General under the CCPA and CalOPPA (California's child data protection statute), the AG alleged that DoorDash sold its California customers' personal information without providing notice or an opportunity to opt out of that sale in violation of both the CCPA and CalOPPA.[25] The sale occurred in connection with DoorDash's participation in a marketing cooperative, where businesses contribute the personal information of their customers in exchange for the opportunity to advertise their products to each other's customers. As part of the settlement, DoorDash will pay a $375,000 civil penalty and comply with strong injunctive terms. Specifically, DoorDash must comply with CCPA and CalOPPA, including requirements that apply to businesses that sell personal information; review contracts with marketing and analytics vendors and use of technology to evaluate if it is selling or sharing consumer personal information; and provide annual reports to the Attorney General that monitors any potential sale or sharing of consumer personal information.

3.5.2. **Delay of Agency in Issuing CCPA Regulations**. The state chamber of commerce sued the CPPA in March 2023 for failing to issue the requisite regulations for enforcement of the CCPA, as set forth in Proposition 24, and sought a ban on enforcement by the agency. The Court of Appeals reversed a lower court and held that the CPPA could start enforcement upon publication of its regulations, and CalChamber appealed to the state supreme court, seeking a one-year stay of enforcement after regulations are issued. The case is pending.[26]

3.6. Other States with Comprehensive Data Privacy Laws. Apart from California, fourteen other states currently have comprehensive data privacy laws: Virginia, Connecticut, Colorado, Utah, Iowa, Indiana, Tennessee, Oregon, Montana, Texas, Delaware, Florida, New Jersey, and New Hampshire. This state patchwork approach to privacy legislation imposes potential compliance and liability risks for companies with multi-state operations. A discussion of a few key state privacy laws follows.

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[25] *The People of the State of California v. DoorDash, Inc.*, No. CGC-24-612520, 2024 WL 729652 (Cal. Super. Feb. 21, 2024).

[26] *California Priv. Prot. Agency v. Superior Ct. of Sacramento Cnty.*, 99 Cal. App. 5th 705, 318 Cal. Rptr. 3d 90 (2024), review filed (Feb. 20, 2024).

3.6.1. **Virginia.** The Virginia Consumer Data Protection Act (VCDPA) became effective January 1, 2023.The Virginia law differs from the California approach and adds a few operational challenges for businesses, including:

- A broader affirmative consent or opt-in requirement to process sensitive personal data.
- A broader opt-out right of processing personal data that covers not only sales of personal data, but also targeted advertising and profiling decisions that produce legal or similarly significant effects.
- Similar to the GDPR, mandatory data protection assessments are required for sales, targeted advertising, and profiling, including profiling that presents a reasonably foreseeable risk of unfair or deceptive treatment.
- The roles of controllers and processors are defined with specific processor role-based requirements and obligations to provide assistance and adhere to the controller's instructions and to demonstrate compliance with processor obligations.

In contrast to the CCPA, personal data under the VCDPA excludes employee, business-to-business data, de-identified data, and publicly available information. "Sale" of data under the VCDPA is narrower than the CCPA and is limited to the exchange of personal data for monetary consideration by a controller to a third party.

The VCDPA does not include a private right of action. The Virginia attorney general can, however, seek fines for failure to cure a violation of up to $7,500 per violation.

3.6.2. **Colorado.** Colorado was the third US state to pass a comprehensive data privacy law-the Colorado Privacy Act (the "CPA"). The CPA became effective July 1, 2023. The CPA borrows in part from the European Union's GDPR, but more significantly from both the California Consumer Privacy Act ("CCPA", including as amended by the California Privacy Rights Act ("CPRA")), and the Virginia Consumer Data Protection Act ("VCDPA").

The Colorado Privacy Act is the only state privacy law so far that applies to non-profit entities.

The definition of "sale" in the CPA is nearly identical to the CCPA definition and includes any exchange for monetary or other valuable consideration. The VCDPA defines "sale" more narrowly, including only exchanges for monetary consideration.

Under the CPA, consumers may opt out of the processing of their personal data for: (i) targeted advertising; (ii) the sale of personal data; and (iii)

profiling in further of decisions that produce legal or similarly significant effects concerning a consumer (provision or denial of financial, lending, housing, insurance, education, criminal justice, employment, healthcare, or essential goods or services).

The CPA requires that controllers provide a “clear and conspicuous” method to exercise the right to opt-out of the sale of personal data or targeted advertising, which must be in the controller’s privacy notice as well as in a readily accessible location outside the privacy notice. Controllers may also allow users to opt-out through a universal opt-out mechanism that meets technical specifications established by the Attorney General (this becomes mandatory on July 1, 2024).

The CPA states that the following does not constitute “consent”: (a) acceptance of a general or broad terms of use or similar document that contains descriptions of personal data processing along with other, unrelated information; (b) hovering over, muting, pausing, or closing a given piece of content; and (c) agreement obtained through dark patterns (a user interface designed or manipulated with the substantial effect of subverting or impairing user autonomy, decision-making, or choice).

The CPA does not create a private right of action for privacy violations. Enforcement is exclusively with the Attorney General and District Attorneys. A violation of the CPA is considered a deceptive trade practice under the Colorado Consumer Protection Act.

Until January 1, 2025, prior to any enforcement of the CPA, controllers must be given a 60-day cure period (where a cure is deemed possible by the Attorney General or District Attorney). The CCPA and the VCDPA also provide for cure periods, though those are not set to sunset as is provided under the CPA.

3.6.3. **Connecticut.** The Connecticut statute became effective July 1, 2023. This law applies to entities that either control and/or process personal data of 100,000 consumers or more per year, or control and/or process personal data of 25,000 consumers or more per year if that entity derives more than 25% of its gross revenue from selling personal data. The Connecticut law gives consumers the right to know whether a business collects data about them, as well as to request corrections to or deletion of their personal data controlled by the business. The law also gives consumers the right to opt out of data collection and processing for the purposes of targeted advertising, sale, or automated decision-making based on data profiling—all opt-outs that are similar to provisions in other states’ comprehensive data privacy laws.

The Connecticut law creates affirmative obligations for covered businesses to limit data processing to what is “reasonably necessary” for their purposes, provide a way for consumers to revoke their consent to data processing, and

protect consumers' data with adequate cybersecurity practices. There is no private right of action for privacy violations. The law is enforced by the Connecticut Attorney General.

3.6.4. **Massachusetts.** Massachusetts has long had rigorous data security laws. Massachusetts requires any company that owns or licenses personal information from residents of the state to develop, implement, and maintain a comprehensive written policy that creates proper administrative, technical, and physical safeguards for consumer information. Massachusetts follows a "sliding scale" approach, allowing a smaller business with limited customer information to develop a policy that works to protect their data. The regulations require encryption of any data relating to a Massachusetts resident transmitted across a public network, as well as encryption (not just password protection) of any customer data on a portable device.

Massachusetts data privacy laws and regulations require all persons that own or license personal information of Massachusetts residents to create a Written Information Security Program (WISP):

> [D]evelop, implement and maintain a comprehensive information security program that is written in one or more readily accessible parts and contains administrative, technical, and physical safeguards that are appropriate to (a) the size, scope, and type of business of the person obligated to safeguard the personal information... (b) the amount of resources available to such person, (c) the amount of stored data, and (d) the need for security and confidentiality of both consumer and employee information.[27]

These Massachusetts regulations require policies that include training of employees, identifying media and records that contain personal information, monitoring, and verifying and requiring that third party service providers comply with the Massachusetts regulations.

Specific technical safeguards are identified such as secure authentication protocols, secure access control measures, and encryption of personal information stored on laptops and mobile devices or any files or records that contain personal information and that may be transmitted across a public network.

An out-of-state business may have to pay attention to these Massachusetts data security laws and regulations if they collect any personal information of a Massachusetts resident.

Many businesses have used the Massachusetts WISP as a model to create a written data security program that not only complies with Massachusetts law but can be used to respond to customer requests for such written data

[27] 201 Mass. Code Regs 17.03(1).

security policies and to require vendors handling data to have the same or similar programs in place.

3.6.5. **New York.** On March 21, 2020, the data security provisions of New York's Stop Hacks and Improve Electronic Data Security Act ("SHIELD Act") went into effect. The SHIELD Act requires any person or business owning or licensing computerized data that includes the private information of a resident of New York ("covered business") to implement and maintain reasonable safeguards to protect the security, confidentiality and integrity of the private information. Violations of the SHIELD Act are considered deceptive acts or practices and may be enforced by the New York attorney general. Covered businesses may be liable for a civil penalty of up to $5,000 dollars per violation.

The New York State Department of Financial Services (DFS) previously (in 2017) issued sweeping new cybersecurity regulations with an unprecedented level of accountability for senior management. The regulations impact financial institutions, insurance companies, health plans, and charitable institutions, and can affect organizations outside of New York.

Under the new rules, covered entities must appoint a qualified staff member as Chief Information Security Officer (CISO) to implement and enforce a comprehensive cybersecurity program and policy. The CISO must perform periodic Risk Assessments to assess the confidentiality, integrity, security, and availability of the organization's information systems and nonpublic information.

The CISO must then develop a thorough cybersecurity program which must, at a minimum: (1) identify internal and external cyber risks; (2) use defensive infrastructure and the implementation of policies and procedures to protect information systems and nonpublic information; (3) detect cybersecurity events; (4) respond to, detect, and mitigate the effects of cybersecurity events; (5) recover from cybersecurity events; and (6) fulfill regulatory reporting requirements.

Based on the mandatory Risk Assessment, the CISO must also develop a comprehensive cybersecurity policy for the organization, detailing areas such as data governance, access controls and identity management, systems and network security, and incident response. While these regulations are somewhat flexible, in that they allow for modification based on the particular risks faced by any given organization, they are also extensive and highly detailed. Out of state companies that may at any time be regulated by the New York DFS should carefully monitor these regulations and stay up to date with any newly issued guidance.

3.6.6. **Utah.** The Utah Consumer Privacy Act (UCPA) became effective December 31, 2023. Its definitions are similar to those in Colorado and Virginia. The

law applies to businesses that are either a “processor” or a “controller” of personal data— borrowing terminology from the European Union’s GDPR.

Unlike either the GDPR or the Colorado and Virginia laws, however, fewer businesses are covered by the UCPA even if they otherwise would qualify as a “controller” and/or “processor.” Only businesses that have an annual revenue of $25 million or more and reach certain data-level thresholds are covered by the UCPA. A business can reach these thresholds either by controlling/processing the personal data of 100,000 or more consumers per year, or by both deriving over 50% of its gross revenue from the sale of personal data and controlling/processing the data of 25,000 or more customers.

The enforcement mechanism of the UCPA is unique. The Division of Consumer Protection (“DCP”) (contained within the Utah Department of Commerce) has the power to investigate any consumer complaints about potential violations of the law. After investigation, if the Division of Consumer Protection deems the claim legitimate then it must refer the matter to the Utah attorney general. The attorney general’s office then conducts a second review and may either concur with the findings of the DCP or dismiss the consumer’s complaint as lacking merit. Although this might lead to a protracted review process, the existence of two levels within the UCPA’s enforcement mechanism might also lead to fewer complaints in which a violation is determined to have occurred. The UCPA does not create a private cause of action.

3.7. Illinois Biometric Information Privacy Act (BIPA). Enacted in 2008, this Illinois law has given rise to many class action lawsuits against manufacturers of scanners and scanning software, employers and others utilizing biometric information like fingerprints and retinal scans to identify persons. the law requires that entities obtain an individual’s consent before collecting, obtaining, or disclosing that individual’s biometric information. It also requires entities to develop, publicly disclose, and comply with a written data retention and deletion policy. BIPA allows for private actions and statutory damages of $1,000 for each negligent violation and $5,000 for each intentional or reckless violation (or actual damages if they exceed these amounts). The Illinois Supreme Court has held that a violation occurs with each scan, not just with each person scanned.[28]

3.8. State-Mandated Privacy Impact Assessments (PIAs). Consumer privacy laws in California, Colorado, Connecticut, Virginia, Montana, Indiana and Tennessee now require a Privacy Impact Assessment for information processing practices which create a risk of harm to the consumer. Over the next year, most companies will face a mandatory requirement to have a PIA on file, so preparing one now or soon would be the best course of action.

[28] *Cothron v. White Castle System, Inc*., 2023 IL 128004 (Ill. 2023).

3.8.1. **PIAs in California.** Under the California CCPA, a company must conduct this risk assessment when its processing activities present a "significant risk to consumers' privacy or security." Businesses must consider the size and complexity of the business, as well as the nature and scope of the processing activities in determining whether there is significant risk to the security of the information.

3.8.1. **PIAs in Other States.** Other states follow a similar analysis, typically for "heightened risk," in determining whether a PIA is required. Examples include when the company uses personal data for targeted advertising; sells personal data; engages in improper profiling, or processes sensitive data, which is usually defined as data which could reveal a consumer's race, ethnicity, religious beliefs, mental or physical health diagnosis, sexual orientation, or citizenship or immigration status; genetic data or biometric data that is processed to uniquely identify an individual; personal data collected from child; or precise geolocation data (except for Colorado and Tennessee).

4. Privacy and Data Litigation of Note

4.1. United States Supreme Court Data Cases.

4.1.1. *Carpenter*[29] held that a cell phone user retained Fourth Amendment rights in his cell phone location data, even though that data was disclosed to his cell phone companies. Under the Stored Communications Act, the government may require the disclosure of telecommunications records when "specific and articulable facts show that there are reasonable grounds to believe" that the records sought "are relevant and material to an ongoing criminal investigation."[30] Notwithstanding this language, the *Carpenter* Court held law enforcement was required to obtain a warrant to retrieve cell phone location information from the carrier about the individual, which it had failed to do.[31]

4.1.1. Section 230 of the 1996 Communications Decency Act grants legal immunity to Internet platforms for content posted by users. When plaintiffs argued that Twitter (now X) aided and abetted ISIS in an attack on their family members, it urged the Court to find that Twitter violated federal antiterrorism statutes by allowing content to remain online. The Supreme Court held that the failure to allege that the platforms here do more than transmit information by billions of people—most of whom use the platforms for interactions that once took place via mail, on the phone, or in public areas—was insufficient to state a claim that defendants knowingly gave substantial assistance and thereby aided and abetted ISIS' acts.[32] Section 230 remains a hot topic in Congress

[29] *Carpenter v. United States*, 585 US ___ (US 2018). [30] *Id.* at 302(18 USC 2703(d)).
[30] *Id.* at 302(18 USC 2703(d)).
[31] *Id.* at 319.
[32] *Twitter, Inc. v. Taamneh*, 598 U.S. 471, 143 S. Ct. 1206, 215 L. Ed. 2d 444 (2023).

with respect to the obligation of social media platforms to monitor online conduct, as it provides broad immunity to such companies at present.

4.2. Federal Standing in Data Breach Class Actions. Data breach plaintiffs in federal court must establish that they have suffered a cognizable harm under Article III of the US Constitution. The bar has been lowered over the years so that plaintiffs can now sometimes meet the standard by spending time and money searching for evidence of (or just be anxious about) identity theft associated with the data breach.[33]

4.3. FTC Enforcement of Section 5

4.3.1. Avast Settlement for Selling Web Browsing Data. In the February 2024 Avast settlement[34], the Federal Trade Commission is requiring software provider, Avast, to pay $16.5 million and prohibited the company from selling or licensing any web browsing data for advertising purposes to settle charges that the company and its subsidiaries sold such information to third parties after promising that its products would protect consumers from online tracking. In the Consent Order, Avast must not sell or license any browsing data from Avast-branded products to third parties for advertising purposes; must obtain affirmative express consent from consumers before selling or licensing browsing data from non-Avast products to third parties for advertising purposes; must delete the web browsing information transferred to third-parties and any products or algorithms derived from that data; notify affected consumers; and implement a comprehensive privacy program that addresses the misconduct highlighted by the FTC.

4.4. Claims for Collection by Pixel, Web Beacon and Session Recording. These types of claims are growing exponentially, with statutory damages and attorneys' fees often available. Businesses should review the types and configurations of the mechanisms used to track users' visits to a website and the identity of the user's device, identity, precise location, or keystrokes.

4.4.1. **Wiretapping and Invasion of Privacy Claims.** In a recent case brought against a national pizza franchisor, the plaintiffs claimed that defendant used session replay software which enabled it to see the screens of plaintiffs while they were on the franchisor's website. The federal district court refused to dismiss a cause of action for violation of section 631 of the California Penal Code (California Invasion of Privacy) and dismissed a claim for violation of

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[33] *In re_Marriott Int'l, Inc., Customer Data Sec. Breach Litig.*, 341 F.R.D. 128, 172 (D. Md. 2022) (There are different schools of thought on whether an as-yet-unrealized threat of future injury is sufficient to establish the "concrete injury" needed to sustain Article III standing); *Whalen v. Michaels Stores, Inc.*, 689 F. App'x 89, 90-91 (2d Cir. 2017) (no cognizable injury when credit card issuers would cover improper charges); *Lewert v. P.F. Chang's China Bistro, Inc.*, 819 F.3d 963, 966 (7th Cir. 2016) (the mere threat of future harm was sufficient because plaintiffs "should not have to wait until hackers commit identity theft or credit card fraud in order to give the class standing.").

[34] *In the Matter of Avast Ltd., A United Kingdom Ltd. Liab. Co., Avast Software S.R.O., A Czech Republic Ltd. Liab. Co., & Jumpshot, Inc., A Delaware Corp..*, No. 202-3033, 2024 WL 863335 (MSNET Feb. 22, 2024).

section 632.7 of the California Penal Code (California Wiretapping), with leave to amend.[35]

4.4.2. **Meta Pixel and other Tracking Cases.** These cases continue to fill the state and federal dockets and have gone both ways on motions to dismiss.[36]

4.5. Cyberinsurance Coverage Disputes. The cyberinsurance industry is still working through underwriting and coverage questions. Exclusions and coverage terms are not uniform, so *caveat emptor*. For example, the Ohio Supreme Court held that a ransomware attack via malware that disabled an insured's system did not qualify as "direct physical loss or physical damage" because the attack was upon software, which does not have a physical existence and "nothing more than a set of instructions that a computer follows to perform specific tasks."[37] In many instances, insurers will prefer to pay a ransom for decryption, because it will be less expensive and cumbersome than rebuilding the system from scratch. Cyberinsurers are now more likely to insist upon a minimum level of data security and backups of data held apart from the regular environment.

5. Franchise Data Litigation of Interest

5.1. Return of Customer Data to Franchisor. Courts will look to the franchise agreement to see how the term "customer data" is defined and who controls it. In one example, the District Court limited an injunction for return of data by a former vape store franchisee to only certain "customer sales data" up to a certain date under the agreement. The court found that under the agreement, the plaintiff franchisor did not own the remaining customer information related to the business, including the names of current customers or those listed as having "liked" social media sites.[38] With respect to the format, the agreement should require return of data in a usable computer format, to avoid receiving only paper or pdfs of the data.[39]

5.2. Ransomware as a Basis to Terminate Franchise. At least one district court has held that a ransomware attack on a franchisee was not a valid reason under the agreement for the franchisor to terminate the franchise.[40] This is determined on a case-by-case basis, however, and depends on the language of the agreement.

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[35] *Kauffman v. Papa John's Int'l, Inc.*, No. 22-CV-1492-L-MSB, 2024 WL 171363, at *10 (S.D. Cal. Jan. 12, 2024).
[36] *See Cousin v. Sharp Healthcare*, No. 22-CV-2040-MMA (DDL), 2023 WL 4484441 (S.D. Cal. July 12, 2023) (dismissing claims for breach of fiduciary duty, California Confidentiality of Medical Information Act and California Invasion of Privacy Act); *Pileggi v. Washington Newspaper Publ'g Co.*, LLC, No. CV 23-345 (BAH), 2024 WL 324121, at *1 (D.D.C. Jan. 29, 2024) (dismissing VPPA claims); *but see Doe v. FullStory, Inc.*, No. 23-CV-00059-WHO, 2024 WL 188101 (N.D. Cal. Jan. 17, 2024) (allowing CIPA claims).
[37] *EMOI Servs., L.L.C. v. Owners Ins. Co.*, 2022-Ohio-4649, 170 Ohio St. 3d 78, 82, 208 N.E.3d 818, 823
[38] *AMV Holdings, LLC v. Am. Vapes, Inc.,* No. 519CV00037KDBDCK, 2019 WL 3406315, at *10 (W.D.N.C. July 26, 2019).
[39] *See Clear Spring Prop. & Cas. Co. v. Victory Ins. Co.*, No. 21-CV-01162, 2021 WL 4502219, at *8 (N.D. Ill. Oct. 1, 2021).
[40] *Franlink Inc. v. BACE Servs., Inc.*, 50 F.4th 432, 436 n.1 (5th Cir. 2022).

5.3. Data Breach Class Actions.

5.3.1. **Class Action Waivers.** In 2023, the Fourth Circuit vacated certification of consumer class action against a hotel franchisor and remanded for the District Court to first determine the import of a class action waiver signed by every putative class member.[41] Upon remand, the District Court held that the franchisor had waived its right to enforce the provision because it agreed to multi-district litigation in another forum.[42] Arbitration clauses, jury waivers and class action waivers can be enforceable, if carefully drawn with solid evidence of consent.[43]

5.3.2. **Consolidation of Data Breach Suits to Include Franchisees.** After a cyberattack on a defendant franchisor's computer systems in January 2023, different plaintiffs filed a number of data breach suits, mostly against the franchisor alone but some against operators of franchises. The Court granted a motion to consolidate all of the lawsuits, even if the franchisees had no notice of the motion.[44]

5.3.3. **No Negligence *Per Se* under the FTC Act.** After an August 2022 data breach of an operator of numerous fast-food franchises, a proposed class of affected employees sued for negligence and negligence per se based on the FTC Act. The District Court allowed the damage theories at the dismissal stage, but held that the FTC Act was too general to support a claim of negligence *per se*.[45]

5.3.4. **No Article III Injury without Traceability.** After an August 2022 data breach of a tax preparation franchisee, customers sued for loss of their information. The District Court dismissed the case, finding allegations of "an attempted Best Buy transaction in another state and the receipt of multiple phone calls from loan companies," did not state concrete injuries and were not fairly traceable to the defendant or the information provided by plaintiffs.[46]

5.4. Post-Breach Shareholder Derivative Action: Approval of Settlement. After a point-of-sale data breach at several franchisee locations, shareholders inspected franchisor's corporate books and records under a protective order to examine whether the cyberbreach was attributable to corporate mismanagement or wrongdoing by the franchisor's officers and directors. The

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[41] *In re Marriott Int'l, Inc.*, 78 F.4th 677, 685 (4th Cir. 2023).
[42] *In re Marriott Int'l Customer Data Sec. Breach Litig.,* 345 F.R.D. 137, 142 (D. Md. 2023).
[43] *See Falcon, et al v. Televisaunivision Digital, Inc.*, No. 823CV02340TPBUAM, 2024 WL 1492831, at *4 (M.D. Fla. Mar. 29, 2024) (arbitration clause enforceable when"Terms of Use" hyperlinks were not buried at the bottom of webpage and users were informed they must agree to the site's terms to proceed.
[44] *Stinson v. Yum! Brands, Inc.,* No. 3:23-CV-00183-DJH, 2023 WL 8724007, at *1 (W.D. Ky. Nov. 15, 2023), report and recommendation adopted, No. 3:23-CV-183-DJH-LLK, 2024 WL 448791 (W.D. Ky. Jan. 19, 2024).
[45] *Allen v. Wenco Mgmt., LLC*, No. 1:23 CV 103, 2023 WL 6456571, at *1 (N.D. Ohio Sept. 29, 2023).
[46] *Deevers Stoichev v. Wing Fin. Servs., LLC*, No. 22-CV-0550-CVE-JFJ, 2023 WL 6133181, at *7 (N.D. Okla. Sept. 19, 2023).

Sixth Circuit affirmed the District Court's approval of the settlement, including its resolution of a dispute amongst plaintiffs' attorneys over $3 million in fees.[47]

5.5. Post-Breach Credit Card / Bank Action against Franchisor. After a data breach at fast food franchisor restaurants across the country, Visa and Mastercard assessed roughly $20 million in fees on third-party Bank of America, the sponsor for the franchisor's payment card networks. The North Carolina Superior Court ruled on Motions for Leave to File Select Materials Under Seal to protect confidential information, which it both granted and denied in part. Just a reminder that these parties will look for redress after a breach causes losses on credit cards.

5.6. Post-Breach SEC Act Misrepresentation Suit. A multiemployer pension plan filed class action on behalf of those who purchased hotel franchisor's stock, claiming its SEC disclosures contained false and misleading statements and omissions related to a data breach. The District Court dismissed because plaintiff failed to adequately allege a false or misleading statement or omission, a strong inference of scienter, and loss causation. The Fourth Circuit affirmed.[48]

5.7. Human Trafficking Claim – Hotel Franchisor as Data Controller. In a Trafficking Victims Protection Reauthorization Act ("TVPRA") claim, the District Court denied a franchisor hotel's motion to dismiss because it found plaintiff sufficiently alleged franchisor exercised day-to-day control over the franchise property by requiring franchisees to use franchisor's property management system, reservation system, centralized data collection system, and Wi-Fi and security vendors, among other requirements. The court held plaintiff pleaded control over the franchisee property for purposes of an agency relationship and vicarious liability.[49] In most instances, franchisors will want such requirements, which may be a factor in the "control" determination.

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[47] *In re Wendy's Co. S'holder Derivative Action*, 44 F.4th 527 (6th Cir. 2022).
[48] *In re Marriott Int'l, Inc., Customer Data Sec. Breach Litig.*, 543 F. Supp. 3d 96, 107 (D. Md. 2021), aff'd sub nom. In re Marriott Int'l, Inc., 31 F.4th 898 (4th Cir. 2022).
[49] *G.G. v. RED ROOF INNS, INC. AND RED ROOF FRANCHISING, LLC*, No. 2:22-CV-3766, 2024 WL 1347401, at *8 (S.D. Ohio Mar. 29, 2024).

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2024 Judicial Update

What You Should and Shouldn't Do: Fraud and Disclosure

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The dictionary definition of "fraud" is the "intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right."[1] Deceit and trickery are listed as synonyms. While this portion of this paper will cover some sensational cases from the last year that most will agree involved deceit and trickery, other cases and enforcement actions included stand for a more mundane (and hopefully not surprising) truth: franchisors cannot rest on their laurels, content that they are not liars and cheats - they also need to ensure they are aware of, and follow franchise laws, taking care not to inadvertently mislead prospective franchisees. The paper will also discuss that misleading and potentially deceitful behavior can be found among prospective franchisees as well as among franchisors, and will end with information about more recent regulatory developments as well as likely future ones.

1. Fraud: What Franchisors Absolutely Shouldn't Do

1.1 *United States v. Burgerim Group USA, Inc.*

The name Burgerim has been hard to avoid in franchise circles for several years. The story started in the mid-2010s when the franchisor in question rapidly sold hundreds of franchises. In spite of what may at first glance seem as instant success, in 2019, the Securities Commissioner of Maryland issued a stop order against Burgerim Group USA, Inc. ("Burgerim") suspending and revoking its franchise registration in Maryland.[2] That stop order stated that Burgerim's FDD included false or misleading statements or omissions of material facts in violation of Section 14-221 of the Maryland Franchise Law. In particular, the stop order stated that the franchisor failed to include contact information for current and former franchisees, and that while it had started insolvency proceedings, it failed to amend its FDD to disclose this information. According to the Maryland stop order, the 2018 FDD reflected that there were 452 franchise agreements signed for locations not yet opened, and the franchisor projected 351 locations to open in 2019.

Washington followed suit in 2020 and issued an order revoking Burgerim's registration to sell franchises in the state.[3] Indiana also issued a stop order, revoking the franchisor's registration to sell franchises.[4]

The California Commissioner of Financial Protection and Innovation was next, and on February 16, 2021 issued a Desist and Refrain Order against Burgerim, several of its affiliates, and its owner, Oren Loni.[5] The California order goes into detail about the sales

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[1] https://www.merriam-webster.com/dictionary/fraud.

[2] *In the Matter of: Burgerim Group USA, Inc.*, Case No. 2019-0213, available at https://www.marylandattorneygeneral.gov/Securities%20Actions/2019/Burgerim_USA_stop_order_Final_122719.pdf.

[3] *In the Matter of: Bugerim Group USA, Inc., State of Washington, Department of Financial Institutions, Securities Division*, Order No. S-20-28236-20-FO01, entered February 13, 2020, available at https://dfi.wa.gov/documents/securities-orders/S-20-2836-20-FO01.pdf.

[4] *In the Matter of: Burgerim Group USA, Inc.*, Cause No. 20-0008 SO, dated February 24, 2020, available at https://securities.sos.in.gov/admin-actions-search/.

[5] *In the Matter of: The Commissioner of Financial Protection and Innovation v. Burgerim Group USA, Inc., Burgerim Group, Inc., Food Chain Investments USA, LLC, and Oren Loni*, File Or. Ids.: 170427 and 237772, available at https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/02/Citations-DR-Burgerim-Group-USA-Inc..pdf.

practices of Burgerim and the shortcomings of its disclosure. Among other things, prospective franchisees were told not to worry about the funds needed to open a franchise as the franchisor would be there to support them every step of the way. They were also told that franchisees could cancel the franchise agreement at any time for a refund. By July 2019, at least 1,550 franchises had been sold and initial fees of over $57 million had been collected.[6] Franchisees used their retirement savings or credit cards to pay for the initial fees.[7] For the franchisees, after signing the franchise agreement the theretofore rosy picture quickly changed. Franchisees were told that their previously approved credit was insufficient and that they needed to clean up their credit; that they needed to pay broker fees of up to $10,500; or that they should take out second home mortgages or lines of credit to finance their franchise. As is common with franchisors experiencing very rapid growth, the Burgerim real estate department was unable to provide or approve suitable locations for the franchisees.[8] To make things even worse, franchisees' construction estimates were also coming back as substantially higher than the range provided by Burgerim.

At the same time as Burgerim was signing a lot of new franchise agreements, it was also issuing a large number of refunds. Between 2017 and 2019, 287 refunds were issued.[9] While refunds apparently were paid out in the beginning of that period, towards the end, franchisees were issued post-dated refund checks. Then checks started to bounce.[10] In October 2019, Mr. Loni fled the U.S.[11]

According to the California order, there was a long list of inaccuracies in the Burgerim FDD. The shortcomings and inaccuracies include: failure to disclose affiliates; failure to disclose several persons with management responsibility relating to the sale or operation of franchises; failure to disclose at least one bankruptcy; inaccurate disclosures regarding refundability of fees; failure to disclose pre-opening support by franchisor; failure to disclose public figures used in the marketing of franchise sales; stating that FPRs were not made to prospective franchisees, when in fact they were; and misrepresentation of the number of franchises sold.[12]

The Burgerim saga seems to finally have come to an end in the last year. The FTC brought an action against Burgerim Group USA, Inc., Burgerim Group, Inc. (jointly, the "Entity Defendants") and Oren Loni in the United State District Court Central District of California for violation of Section 5(a) of the FTC Act, violation of Sections 436.3, 436.5, and Subpart D of Section 436.6, 436.9(a) and (c) of the FTC Franchise Rule,[13] demanding a permanent injunction against the defendants, monetary relief and any other relief the court would determine to be proper.[14]

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[6] *Id*. at 4.
[7] *Id.*
[8] *Id.* at 5.
[9] *Id.*
[10] *Id.*
[11] *Id.* at 6.
[12] *Id.* at 6-12.
[13] 16 C.F.R. 436 (2007).
[14] Complaint, *United States v. Burgerim Grp. USA, Inc.*, Case No. 2:22-cv-00825 (C.D. Cal. Filed Feb. 7, 2022).

The complaint in large part reiterates the underlying facts included in the Maryland and California orders. Being as it is a summary of what has come before, it provides an excellent guide to behaviors that are likely to lead to problems. Franchisors should take care not to do any of the following:

- Don't sell franchises to prospects that have no prior experience operating a business, or a business of the kind involved in the franchise;
- Don't include statements on your website such as "[a]ll you need is the will to succeed … We'll help you customize your location, hire a small team, and generate wealth;"
- Don't make financial performance representations when there is no FPR in your FDD (or tell prospects that they will break even in two weeks or less);
- Don't make unrealistic promises about the ease of obtaining financing;
- Don't make unrealistic promises about finding first-rate locations for the prospective franchisees;
- Don't omit conditions for obtaining a refund of franchise fees from your FDD;
- Don't omit from your FDD disclosure of franchisor's principals who have management responsibility for the sale or operation of franchises;
- Don't omit names and addresses of franchisees who have left the system from the FDD.

The U.S. government and Loni entered into an agreed upon order for permanent injunction and monetary judgments for civil penalties and consumer redress on November 20, 2023.[15] Pursuant to the order, Loni is permanently enjoined from advertising, marketing, promoting, or offering for sale, selling or assisting others in the same activities of any franchise.[16] He is also enjoined from misrepresenting, or assisting others in misrepresenting: any material aspect of the terms of any refunds, cancellations, exchange or repurchase policy; with respect to the sale of any franchise, business venture, business opportunity, or other offer to earn income: any income, profits, or sales volume achieved by existing or past purchasers or operators; any income, profits, or sales volume likely to be achieved; the length of time in which a purchaser is likely to recoup the purchase price or initial investment costs; the number or identity of current or former purchasers; the nature, scope, or amount of any training provided to any purchaser; the amount, nature or degree of assistance that will be provided; and any other fact material to consumers.[17] The monetary judgment – $5,000,000 as a civil penalty, and $38,849,351 for consumer redress – was suspended against the payment of a $1,000 bond, subject to certain conditions.[18] The condition to the suspension was that the sworn financial statement of

[15] *U.S. v. Burgerim Group USA, Inc. et. al*, Order for Permanent Injunction and Monetary Judgments for Civil Penalty and Consumer Redress as to Defendant Oren Loni, No. CV 22-825-DMG (PDx), November 20, 2023, U.S. District Court Central District of California.
[16] *Id.* at 3.
[17] *Id.* at 3-4.
[18] *Id.* at 4.

Loni was truthful and complete. Loni also had to relinquish dominion of all in all assets transferred under the order.[19]

The Entity Defendants were not active participants in the litigation against them. They were properly served with the complaint, but did not respond or appear. On December 22, 2023, the U.S. government filed a motion for default judgment against the Entity Defendants. The court held a hearing on January 19, 2024, at which they failed to appear. On that day, the court issued a default judgment against the Entity Defendants.[20] The court permanently restrained and enjoined the Entity Defendants from the same activities as Loni, but also added a permanent ban on advertising, marketing, promoting, or offering for sale, selling or assisting others in the same activities, of any franchise. The Entity Defendants, as well as their officers, directors, agents, employees, attorneys and all other persons in active concert with any of them in connection with the offer and sale of any product or service were also restrained and enjoined from misrepresenting any material aspect of the terms of any refunds, cancellations, exchange or repurchase policy; with respect to the sale of any franchise, business venture, business opportunity, or other offer to earn income: any income, profits, or sales volume achieved by existing or past purchasers or operators; any income, profits, or sales volume likely to be achieved; the length of time in which a purchaser is likely to recoup the purchase price or initial investment costs; the number or identity of current or former purchasers; the nature, scope, or amount of any training provided to any purchaser; the amount, nature or degree of assistance that will be provided; and any other fact material to consumers. The court also ordered a civil penalty of $7,750,000 to be paid to the U.S. government, and entered judgment of $48,476,689 for consumer redress.

Is this the end of the story of Burgerim? Though certainly there shouldn't be any additional BurgerIm franchised locations opening in the U.S., some previously opened ones still operate. It is unclear what will happen when those locations' franchise agreements come up for renewal, and whether Burgerim would be able to renew the agreements at that time.

1.2 *Park 80 Hotels, LLC et al. v. Holiday Hospitality Franchising, LLC*

Another interesting case from the last year is based on facts much less sensational than the Burgerim matter, but its holding regarding fraud claims is relevant to all franchisors. The matter relates to a class action brought against the franchisor of the Holiday Inn brand, Holiday Hospitality Franchising, LLC.[21] The plaintiffs had filed a consolidated class action complaint alleging that the franchisor had breached twelve express and implied duties under the franchise agreement and that it had also violated the duty of good faith and fair dealing in eight ways.[22] The court dismissed, as a matter of law, all but one of the plaintiffs' claims. A key consideration in the court's decision was

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[19] *Id.*

[20] *United States of America v. Burgerim Group USA, Inc., Burgerim Group, Inc., and Oren Loni*, Default Judgment and Final Order for Permanent Injunction and Monetary Judgments for Civil Penalty and Consumer Redress, No. 2:22-CV-00825-DMG, January 19, 2024, U.S. District Court Central District of California.

[21] *Park 80 Hotels, LLC et al. v. Holiday Hospitality Franchising, LLC*, 2023 WL 5523617 (August 4, 2023, U.S. Dist. Ct. N.D. Georgia).

[22] *Id.* at 1.

the integration clause in the franchise agreement. As required by the FTC Franchise Rule, the integration provision carved out representations made in the franchisor's FDD.[23] Specifically, the integration clause read:

> This is the entire agreement between the [P]arties pertaining to the licensing of the Hotel and supersedes all previous negotiations and agreements between the parties pertaining to the licensing of the Hotel as a Holiday Inn brand group hotel … Nothing in the preceding sentence is intended, however, to disclaim any representations [Defendants] made in the franchise disclosure document that [Defendant] provided to [Plaintiffs] …

The court concluded that the FDD is not part of the parties' franchise agreement, and therefore, breach of contract claims based on what was stated in the FDD were precluded.[24] Plaintiffs sought reconsideration of this part of the court's opinion. Plaintiffs identified three out-of-state federal district court cases, and a California state court case that allowed breach of contract claims based on the content of the franchisor's FDD.

The court concluded that its initial analysis was correct and went through a detailed analysis of how this decision was arrived at. For purposes of this paper, two aspects of the court's reasoning are particularly important. First, it distinguished two of the cases relied on by plaintiffs had integration clauses that expressly stated that the franchise disclosure documents were part of the franchise agreement.[25] Second, and important for this discussion of fraud and disclosure, the court found that even though inconsistent statements in the FDD could not be brought as breach of contract claims, franchisees could seek recourse on the basis of fraud in the inducement claims.

2. Administrative Actions: What Franchisors Also Shouldn't Do

The cases discussed above allege fraud by the parties. However, as mentioned in the introduction to this paper, franchisors cannot content themselves with not committing outright fraud. Franchise disclosure laws set a much higher bar. That bar can be enforced not only by disgruntled franchisees, but also by the states' agencies. Some states put significantly more resources towards enforcement than other states, but in each state, whether they only had a few enforcement actions against franchisors in 2023, or if there were dozens, a pattern emerges. There appear to be two main issues. First, ignorance of franchise laws, leading to the failure to identify a business' offering as a franchise, resulting in the offer and sale of "accidental franchises." Second, even when a business realizes its offering is a franchise, failure to register that franchise with the appropriate state before offers and sales begin, is also an issue. While franchisors and their counsel may wish to take a practical approach to these types of violations – "the franchisee is happy, so it's not an issue" – often they are still violations of the state franchise statutes and it is the responsibility of state franchise examiners to ensure that consumers in their states receive the protection afforded them under state law.

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[23] *Id.*

[24] *Id.* at 2.

[25] *Id.* at 5 (citing *Ayu's Glob. Tire, LLC v. Big O Tires, LLC*, No. B236930, 2013 WL 2298585, at 4 (Cal. Ct. App. May 24, 2013) and *Martrano v. Quizno's Franchise Co., LLC*, No. 08-0932, 2009 WL 1704469 at 4 (W.D. Pa., June 15, 2009)).

The enforcement actions discussed below cover both accidental franchises and the failure to register with state agencies, but in addition also highlight other types of issues that have led to enforcement actions.

2.1 California

The California Department of Financial Protection and Innovation[26] has for many years had a very active enforcement division. In the last year, a large number of enforcement actions were brought by the Department, and the following is a summary of some of the enforcement actions that demonstrate both the general trends of the actions brought, and also some of the more unusual remedies that the Department sometimes requires.

A common issue in California was the sale unregistered franchises. Sometimes the issue was that the franchisor sold "licenses" that fall under the definition of a franchise under the California Franchise Investment Law ("CFIL"), and in other instances the issue was the failure to properly register the franchise offer before undertaking sales.

The former was the issue addressed by the consent order that the Department entered into with Culichitown Management Group, Inc., the franchisor of the Mexican restaurant concept Culichi Town Restaurants.[27] Between 2017 and 2021 the franchisor entered into 11 "License Agreements" with California franchisees. Though it is not spelled out in the order, it appears that the franchisor either was not familiar with franchise laws at all, or believed that its business model did not fit within the definition of a franchise. The prospective franchisees were not provided with an FDD, and no FDD was registered with the Department. The order requires the franchisor to desist and refrain from the violations listed in the order, and to pay a penalty of $1,100. It also requires the franchisor to offer rescission to its franchisees. The franchisees were to be offered the opportunity to rescind their license agreement, cease operations under the Culichi Town brand, and receive a full refund of fees, or to enter into a new franchise agreement with the franchisor. The order specifies that the franchise agreement will be for a 10 year term, no initial fee or initial training will be required, and that the franchisee would receive a $950 credit towards royalty payments. The penalty required under this order is low, given the large number of sales, and it may be speculated that it is the offer of a royalty credit to the franchisees that motivated the low penalty.

The action against the franchisor of the Flip Flop Shops franchise system shows that it is not enough to generally comply with franchise law, but that details matter. It is important for franchisors to keep track of the information necessary for proper FDD preparation, and likewise to keep track of the status of pending state applications. The franchisor for the Flip Flop Shops brand was sold in 2018, and shortly thereafter, the new franchisor filed its initial registration in California.[28] Five years later, upon the 2023

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[26] Throughout this paper, the state departments of the various states are referenced as the "Department" in the sections of the paper addressing the state in question.

[27] *See* Consent Order, *Comm'r of Fin. Prot. & Innovation v. Culichitown Management Group, Inc. and Roman Misael Guerrero Elenes*, March 9, 2023, https://dfpi.ca.gov/enf-c/culichitown-management-group-inc/.

[28] *See* Consent Order, *Comm'r of Fin. Prot. & Innovation v. Flip Flop Shops, LLC*, Fil. Org. ID: 295447, July 19, 2023, https://dfpi.ca.gov/enf-f/flip-flop-shops-llc/.

renewal of its application to sell franchises in California, the franchise examiner discovered that back in 2016 the franchisor's predecessor has been named as a defendant in a civil lawsuit alleging fraud, unfair or deceptive practices, and other unfair business practices. The franchisor had correctly identified its predecessor in the FDD, but had failed to disclose the litigation. Not disclosing the litigation was a violation of Section 31200 of the CFIL.

The Department treats each application to register to sell franchises as a separate violation, and since the franchisor had submitted six applications between 2018 and 2023 the Department concluded that there had been six violations of Section 31200 of the CFIL.

In addition, the franchisor had failed to disclose two lawsuits it had itself filed in 2022 against former franchisees. Therefore, there was a total of eight violations of Section 31200.

Since 2018 the franchisor had sold at least 10 franchises in California. Because the prospective franchisees had been disclosed with the incomplete FDD, and it is unlawful to make material misrepresentations or omissions in the sale of franchises under Section 31201 of the CFIL, those sales resulted in another 10 violations.

Finally, the franchisor had also sold a franchise in California while the application to sell franchises was pending. This sale was a violation of Section 31110 of the CFIL requiring franchisors to be registered before selling franchises; of Section 31119 of the CFIL requiring franchisor to provide prospective franchisees with their then current FDD at least 14 days before the sale; and of Section 31200 of the CFIL for failing to disclose this sale at the time it renewed its application in 2023.

The franchisor and the Department entered into a consent order that includes many of the remedies typically sought by the Department. The franchisor agreed to desist and refrain from further offers and sales of franchises in violation of CFIL, to desist and refrain from selling franchises without providing the prospective franchisee with its current FDD at least 14 days before entering into a franchise agreement, and to desist and refrain from making untrue statements of material facts in its franchise applications. The franchisor agreed to pay administrative penalties of $52,500 and to prepare, and file with the Department for approval, Notices of Violation to be sent to its franchisees. In addition, the order also required a number of employees of the franchisor to participate in 8 hours of remedial education. Those required to participate included those with management responsibility for the franchisor's sale of franchises and all persons assisting in preparing franchise materials, and those certifying the accuracy of the franchisor's FDD. The training must be by a franchise law specialist approved by the Department.

Franchise systems need to make sure that they not only understand franchise law in general, but that they also understand the law in each state in which they operate. California has some unusual statutory provisions, including regarding the negotiation of franchise agreements. The franchisor Escapology, LLC experienced that being registered to sell franchises is not necessarily enough to comply with California law. California's negotiated sale provisions in the CFIL and the related regulation has to be complied with when a franchisor negotiates the form of agreements contained in the

FDD.[29] Escapology had failed to do so on two occasions. In the course of investigation, it was also determined that the franchisor did not have a copy of the FDD receipt for one of those sales. Because of the multiple issues, the consent order includes a long list of CFIL violations: failure to timely provide an FDD to a prospective franchisee under Section 31119 of the CFIL; failure to comply with the negotiated sale provisions of the CFIL; making an untrue statement of material fact or willfully omitting a material fact to be stated to the Commissioner when filing an FDD on at least two occasions under Section 31200 of the CFIL; selling franchises using an FDD that omitted to state that the franchisor had sold negotiated franchises in violation of Section 31201 of the CFIL; and the failure to maintain a complete set of books and records as required under Section 31150 of the CFIL. The consent order requires Escapology to desist and refrain from further violations and to pay an administrative penalty of $12,500.

While state examiners usually take action against franchisors, those involved in franchise sales and the operation of franchise systems should remember that they too may be subject to state franchise laws. This is something that John Hewitt, the founder of the Liberty Tax Services franchise system experienced.[30] Hewitt served as the CEO of Liberty from 1997 until 2017, and as the chair of its board until 2018. He was also the controlling shareholder. About 16 months after Hewitt left his various roles with Liberty, the Department of Justice entered into a consent order with Liberty, enjoining the franchisors from several different practices, and also agreeing not to hire Hewitt, or to engage him as an executive, advisor, consultant, franchisee, area developer, or member of its board. Even though Hewitt was not a party to the order with the Department of Justice, the Commissioner determined that he should be required to disclose that order in any franchise disclosure document filed by any franchisor in which Hewitt maintains management responsibility.

2.2 Minnesota

In 2023, the Minnesota Commerce Department brought enforcement actions that resulted in some type of penalty against six different companies. All cases involved the sale of unregistered franchises to Minnesota prospects, in violation of Minnesota franchise law.[31] Many of the actions resulted in a simple letter called “Civil Penalty and Agreement” in which the franchisor admits to the violation of the statute; that the franchisor will register before making any additional offers; that rescission will be offered and evidence thereof provided to the Department; and that the enforcement action will be disclosed in the franchisor’s FDD for the next two years.[32] A civil penalty of $1,000 is also imposed.

In other cases, the Department has entered into consent orders with the franchisor. For example, a consent order was entered into with Vend Tech International Inc. in which

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[29] CAL. CORP. CODE §§ 31109.1 and 31123, and CAL. CODE REGS. Tit. 10 §310.100.2.

[30] *See* Consent Order, *Comm’r of Fin. Prot. & Innovation v. John T. Hewitt*, August 15, 2022, https://dfpi.ca.gov/enf-h/hewitt-john-t/.

[31] MINN. STAT. §§ 80C.01 through 80C.22. The orders do not specify which specific section of the statute that the violations refer to.

[32] *See, e.g.* Civil Penalty and Agreement with Advanced Mobile IV, LLC, dated May 1, 2023, and Civil Penalty and Agreement with Mochinut, Inc. dated May 26, 2023, both available on https://www.cards.commerce.state.mn.us.

the company's offering was, in the determination of the Department, a franchise. The company ceased its offers in Minnesota before the commencement of the matter. The company agreed not to offer any franchises in Minnesota before it had registered pursuant to Minnesota franchise laws, and similar to the civil penalties and agreements discussed above, the company was required to disclose the action in its FDD for the next two years. A $4,000 civil penalty was imposed.[33]

2.3 Washington

Washington state actively enforced the Washington franchise law in 2023, resulting in 19 enforcement actions.[34]

Franchisors should take care not to make unlawful financial performance representations in the sales process and should also pay attention to the details of the consent orders they enter in to. The Consent Order that the Department entered into with F45 Training Incorporated on December 4, 2023 provides an example of what franchisors should not do in both of those regards.[35] It was the second consent order against this franchisor and most of the facts laid out in the Consent Order were addressed by that first order entered already on October 18, 2022. According to the Consent Order, in spite of the franchisor's FDD stating that it did not provide FPRs, the franchisor did just that. It stated in advertising, web videos, and in other communications that franchisees could quickly achieve high profits as an F45 franchisee. The franchisor stated to prospective franchisees that nearby franchised units were "successful," apparently omitting that success did not equal profitability.

The Consent Order also discloses that other violations occurred. The franchisor paid public figures connected to the NBA to promote franchises, but did not disclose those payments in its FDD. When the franchisees formed an independent franchisee association, the franchisor terminated the franchise of the franchisee identified as the leader of the association. This is a violation of the Section 19.100.180 of the Washington Investment Protection Act, also known as the Franchisee Bill of Rights.

The violations discussed above had already been addressed in the first consent order with this franchisor. Pursuant to the Consent Order, the franchisor had agreed to cease and desist from further violations of the Washington franchise act and had to send an offer to rescind the franchise agreement of each franchisee who had entered into a franchise agreement before December 31, 2019. It was also required to pay the Division's investigative costs of about $15,500. While this should have been the end of the franchisor's problems, it was not.

One of the things the franchisor was required to do in response to the first consent order was to disclose that consent order in its FDD. While the franchisor disclosed the consent order, the information disclosed was not accurate. First, it disclosed that the order had been entered before the order was actually entered into. It disclosed that the order was entered into on May 11, 2022, when in fact it was not entered into until October

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[33] *Id.*

[34] Copies of all enforcement actions are available at https://dfi.wa.gov/securities-enforcement-actions/securities2023.

[35] [35] Consent Order as to F45 Training Incorporated, Order No. S-23-3434-23-CO01, available at https://dfi.wa.gov/securities-enforcement-actions/securities2023.

18 of that year. Arguably, this may not have been that much of an issue, had the franchisor not started to disclose this information to Washington franchisees already in August 2022. The disclosure also stated that the franchisor denied the allegations of non-compliance with regard to the Washington Investment Protection Act. However, as part of that consent order, the franchisor stated that the franchisor neither admits nor denies the allegations. Failing to properly disclose the previous consent order was a violation of Section 19.100.170(1) of the Washington Investment Protection Act. The Division required the franchisor to pay additional investigative costs of $2,675.

American Shaman Franchises Systems, Inc. also got in trouble in Washington State both for selling its franchises for industrial hemp and other plant-based products without being registered and for omitting material information from its disclosure document when it did register.[36] American Shaman sold franchises to at least two Washington residents before registering. In 2019, after selling those franchises, it did register to sell franchises in Washington. However, at that point it omitted to include information about the personal bankruptcy of its director of franchise development. The Consent Order states that the actions of American Shaman constituted the offer and sale of unregistered franchise in violation of Section 19.100.020 of the Washington Investment Protection Act, and further that the failure to include the bankruptcy information was an omission of material facts, in violation of Section 19.100.170 of the statute.

In Washington, both franchisors and franchise brokers need to pay attention to the Washington franchise regulations. ZGrowth Partners is a franchise broker that entered into an agreement with franchisor Madabolic Franchise Systems, LLC. Apparently, eager to start selling franchises in Washington and elsewhere, Madabolic routed website inquiries from prospective franchisees to ZGrowth personnel, since at least April 2022. It is unclear from the consent orders relating to this matter if Madabolic was aware that ZGrowth were reaching out to Washington residents when the franchisor was not registered in the state before the franchisor's Washington state registration was approved in November 2022, and it is likely unknown whether Madabolic was aware either that ZGrowth and its CEO Rick Del Sontro did not file applications to register as franchise brokers in Washington until August 2023, or that Mr. Del Sontro had been involved in arbitration since 2020, which arbitration concluded in January 2023 finding that Mr. Del Sontro had meaningfully participated in fraudulently inducing a prospective franchisee of another franchise system to enter into a franchise agreement.

The Division entered into two separate consent orders, one with ZGrowth and Mr. Del Sontro, and one with Madabolic.[37] After laying out the facts set forth in the previous paragraph, the order against the franchise brokers denies the broker registrations and imposes liability for the investigative cost of $2,000. The order against the franchisor finds that the franchisor has violated the Washington Investment Protection Act through offering and selling franchises in the state of Washington before being registered. As mentioned

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[36] Consent Order *In re American Shaman Franchise Systems, LLC f.k.a. American Shaman Franchise Systems, Inc., d.b.a. CBD American Shaman*, Order No. S-19-2786-23-CO01, https://dfi.wa.gov/securities-enforcement-actions/securities2023.

[37] Consent Order In re ZGrowth Partners, LLC and Rick Del Sontro, Order No. S-23-3612-23-CO01, and Consent Order as to Madabolic Franchise Systems, LLC, Order No. S-23-3612-23-CO02, https://dfi.wa.gov/securities-enforcement-actions/securities2023.

above, it is unclear from the orders how much the franchisor knew about its broker's activities. However, the orders state that two franchise applications from Washington residents were submitted in August 2022. The franchisor was not registered in the state until November of that year.

A more common story is told by the Consent Order entered into with Von's Chicken California and Chul Soo Han.[38] This matter involved what was likely an unwitting sale of a franchise by a party unfamiliar with federal and state franchise laws. B.A.G. Von's Co. Ltd. is a South Korean corporation and the owner of the Von's Chicken and related trademarks. It set up two companies in California, through which it offered two "licenses" to Washington residents. The franchisees signed a "license agreement," which was the only document offered to them before the sale. No franchise disclosure document was provided and none of the Von's entities was registered to sell franchises in Washington. The license agreements licensed the use of the Von's trademarks, required the franchisee to pay an initial fee of over $25,000, and referred to the proprietary system that had been developed for the operation of oven baked chicken restaurants under the marks. Franchisees also received a week of training prior to opening. The investigation undertaken by the Division discovered that the sale to one of the two franchisees was exempt, due to the franchisee's high net worth. The other sale, however, was a sale in violation of the Washington Investment Protection Act. All respondents agreed to cease and desist from offering and selling franchises in Washington in violation of the law, and they were required to pay the investigative costs of $2,000.

The reader may have noticed that no penalties or fines were imposed by the Division in any of these matters. This is simply because the Washington Investment Protection Act does not give the Division the power to impose such fines or penalties. The only monetary penalty the Division can enforce is the investigative cost, which is calculated based on the number of hours that the state examiner devotes to the investigation.

2.4 Wisconsin

Franchise registration in Wisconsin is a very simple matter that does not require any interaction with state examiners. Therefore, it may be surprising to franchisors to discover that the Wisconsin Department of Financial Institutions has examiners dedicated to enforcement of the Wisconsin Franchise Investment Law. In 2023, for example, an action was taken against Teddy Bear Mobile, Inc.[39] Similar to many of the enforcement actions listed above, the violation by Teddy Bear Mobile consisted of selling an unregistered franchise in Wisconsin in violation of Sec. 553.1 of the Wisconsin Franchise Investment Law.

> The Department entered into a Consent Order to Cease and Desist and Imposing Administrative Assessment with Teddy Bear Mobile. The consent order prohibits the franchisor as well as its agents, servants, officers, employees, successors,

[38] Consent Order In re Von's Chicken California and Chul Soo Han, Order No. S-23-3500-23-CO01, https://dfi.wa.gov/securities-enforcement-actions/securities2023.

[39] *See* Consent Order to Cease and Desist and Imposing Administrative Assessment, *In the Matter of Teddy Bear Mobile, Inc.*, DFI Case No. S-246870 (FX), executed on August 3, 2023, https://dfi.wi.gov/Pages/Securities/RegistrationOfProfessionals/EnforcementAdministrativeOrders.aspx.

affiliates, and every entity and person directly or indirectly controlled or organized by or on behalf of the franchisor to cease and desist from making or causing to be made any offer or sale of franchises to persons in Wisconsin without first registering. It also assessed an administrative assessment of $5,000 on the franchisor. Interestingly, the consent order does not require the franchisor to offer rescission to the franchisee.

3. What Prospective Franchisees Shouldn't Do

Bad behavior is not limited to franchisors, as franchisor Smash Franchise Partners, LLC ("Smash") experienced.[40] The franchisor offers "Smash My Trash" franchises involving smashing trash in dumpsters, using a rotating drum attached on an arm to a Smash-branded truck. This technique allows customers to pack more trash into each dumpster, and the customer can save money on trash pick-up fees. Todd Perri was an engineer and entrepreneur who approached Smash Franchise Partners about their offer. Even though Perri decided not to buy a franchise, he continued to show interest and gather information about the mobile trash compaction business.[41] Perri formed his own company, Dumpster Devil LLC, that offered trash compaction, just like the Smash My Trash franchise system.[42] On the company's website, there was a comparison between the equipment and economic return offered by Smash, and the one offered by Dumpster Devil.[43]

The franchisor filed suit against Perri, his business partner, and against Dumpster Devil and sought a preliminary injunction to force Dumpster Devil to stop operating. A large number of theories were invoked: breach of a non-disclosure agreement; unjust enrichment; misappropriation of trade secrets; conversion; unfair competition; fraud; deceptive trade practices; and trademark infringement.[44] The preliminary injunction was denied, but also held that the franchisor had demonstrated a reasonable likelihood of success on the merits of its claims that Perri had committed fraud, misrepresenting his interest in a Smash franchise, and also for claims under the Delaware Uniform Deceptive Trade Practices Act ("DUDTPA").[45] After the order on the injunction the franchisor dropped its claims, other than the fraud claim and the DUDTPA claim.[46]

The story told by the court will sound familiar to anyone in the franchise community. Smash was a relatively new franchisor when put in touch with Perri through a franchise broker, eager to sell franchises. The broker gave Perri an overview of Smash My Trash, provided him with access to the franchisor's YouTube channel, a pitch deck, and other information about the franchise system and the industry it operated in.[47] Perri received the Smash My Trash FDD which included both the estimated investment and a financial performance representation. The prospective franchisees would participate in a Unit

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[40] *See Smash Franchise Partners, LLC v. Kanda Holdings, Inc., Todd Peri, and Dumpster Devil, LLC*, 2023 WL 4560984, July 14, 2023, Court of Chancery of Delaware, at *1.
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.* at 4.

Economics Call and a worksheet with economic data.[48] It was not until prospects were invited to participate in the franchisor's discovery day that they were asked to sign NDAs. After the discovery day, prospects could also participate in weekly "Franchisee Forum Calls" hosted by existing franchisees. The franchisees would talk about operating their business and answer questions. There were also "Founder Calls" with the founder of Smash, who talked about the company's history and future plans. The court pointed out that it is only after a franchise agreement is signed that the franchisor actually trains the franchisee in operation of the franchised business.[49]

The opinion sets forth in great detail Perri's pre-sale interactions with Smash and its representatives,[50] but to summarize: Perri went through the entire process described above, and signed an NDA in advance of attending the discovery day. Then he called his friend and future business partner, Kevin McLaren. McLaren, who had had a bad experience with another franchise in the past, now operated, amongst other things, a roll-off dumpster business. He warned Perri off from becoming a Smash My Trash franchisee. They then discussed starting their own mobile trash compacting business and the impact on that venture of Smash seeking a patent for the key equipment used in the franchised business. Perri decided to explore both the Smash My Trash path, in case Smash had enforceable patent rights, and at the same time look into starting his own business with McLaren.[51] Perri then participated in some of the calls described above, and informed Smash's broker that he had purchased a ticket to come attend the upcoming discovery day. However, he quickly cancelled the ticket. Two days after registering for discovery day, Perri registered the domain, DumpsterDevil.com. He continued to participate in calls for prospective franchisees. He also asked McLaren to reach out to Smash's European manufacturer of the trash smashing equipment to inquire about purchasing direct, as he didn't want the manufacturer to report back to Smash that he himself had reached out. He cancelled his discovery day participation because his dog got sick, but Perri participated in six Franchisee Forum Calls, and five Founder Calls in total. When informed that another prospect was interested in the same territories that he had expressed interest in, he told Smash that he remained interested. At about the same time, he flew up to Canada to meet with an alternative equipment manufacturer and presented the intended Dumpster Devil business to the manufacturer. The presentation included many of the hallmarks of the Smash My Trash franchise system, except that Perri was going to try to avoid franchise regulation. The court notes that "Perri hoped that by not offering franchises, Dumpster Devil could beat competitors like Smash to the markets where a franchisor had to file for franchise approval."[52] The presentation relied on information Perri had received from Smash, but almost all of it early on, at a time that the court still deemed that he was considering becoming a franchisee.[53] When Dumpster Devil's website went live, about 2 months after Perri had been attending the prospective franchisee calls, an entire subpage was devoted to comparing it to Smash My Trash.[54]

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[48] *Id.* at 5.
[49] *Id.*
[50] *Id.* at 3-15.
[51] *Id.* at 6-7.
[52] *Id.* at 13.
[53] *Id.*
[54] *Id.* at 14.

Perri and McLaren purchased Google Adwords advertisements for their website, including for the name "Smash My Trash," focusing on key geographic areas pursued by Smash.[55] Smash filed suit against Perri, McLaren and Dumpster Devil about a month later.

The court summarily addressed Smash's common law fraud claim, concluding that fraud claims alleging misappropriation of information are preempted by the Delaware Uniform Trade Secrets Act ("DUTSA").[56] This would have been the case whether or not the misappropriated information qualified as a trade secret, even though a plaintiff would only have claims under DUTSA *if* the information qualified as a trade secret under that act.[57] In spite of the fraud claim being preempted, the court went on to analyze the fraud claim, concluding that had it not been preempted it would still have failed, because Smash had not proven causation between the fraudulent misrepresentations by Perri and the damages sought.[58] Much of the information that Smash claimed Perri obtained fraudulently was obtained before the court concluded that he was acting with intent to mislead. Further, much of the information was publicly available through the Smash My Trash FDD. Other information that Perri obtained Smash conceded was not confidential.

Smash's second claim was under DUDTPA,[59] claiming that the defendants had engaged in a deceptive trade practice by disparaging Smash My Trash's goods, services or business by false or misleading representations of facts on the Dumpster Devils website.[60] The evidence at trial showed that several of the statements on Dumpster Devils' website were false or misleading. However, the court concluded that the defendants had made the statements in good faith, thereby limiting the remedies available to plaintiff. The permanent injunction sought by Smash to stop Dumpster Devil from using the misleading statements on its website were denied (because they had already been removed) and the court did not find that Smash had proven damages. In the end, even though the court found that the defendants had violated DUDTPA, no relief was granted to the plaintiff, and each party bore its own costs.[61]

4. Recent Regulatory Changes: What Franchisors Should Do

4.1 California

The NASAA Electronic Filing Depository (NASAA EFD, or sometimes colloquially referred to as "FRED") has been live for several years now and most states require franchise registration now allow filing through the platform. California has been using a hybrid version of NASAA EFD for several years – it allowed filers to file through the EFD, but then handled any comments on the filing through its own service portal, DOCQNET. This hybrid solution had some issues, with comment letters and responses occasionally being overlooked and lingering. This year, the California Department of Financial Protection and Innovation has instead encouraged filers to complete their filings through

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[55] *Id.*
[56] *Id.* at 16.
[57] *Id.* at 17.
[58] *Id.* at 19-23.
[59] 6 DEL. C. §2532(a)(8).
[60] *Smash Franchise Partners, LLC,* 2023 WL 4560984, at *24.
[61] *Id.* at 30.

DOCQNET only. The Department is working on rolling out a new online filing platform – FRANCIS - which is currently in beta testing.

4.2 Utah

Utah, a business opportunity state that requires franchisors to file annual notice filings in order to claim an exemption under its business opportunity statute, has updated its online filing system. Franchisors who had previously registered through the old website have received email notifications with an individualized registration code necessary to set up an account and register through the new system.

4.3 Washington

While the changes in California and Utah relate to logistics, some of the changes franchisors have experienced with respect to their disclosures are substantive. States' enforcement priorities may change, and from time to time, state regulators pick up on an issue in their review of FDDs filed for registration that has previously not been addressed, or addressed differently. In the last several years, Washington State has taken a stricter view of how its Franchise Investment Protection Act impacts franchise agreements. Many franchisors have seen significantly longer comment letters in response to their filings, than what was common just a few years ago. One relatively recent development has been the interpretation by the Washington franchise examiners of the FTC Franchise Rule guidance relating to real estate estimates in Item 7 of the FDD. Real estate cost is a required disclosure, but the FTC Franchise Rule states that "[i]f real property costs cannot be estimated in a low-high range, [the franchisor may] describe the approximate size of the property and building and the probable location of the building (for example, strip shopping center, mall, downtown, rural, or highway)."[62] Real estate cost are especially difficult for franchisors to estimate given the significant variations in real estate cost across the U.S. Consequently, many franchisors have been taking advantage of the "pass" given by the FTC. This is particularly common in some industries, such as in hospitality. This past year, Washington state examiners have required franchisors to estimate the real estate cost, presumably on the basis that while real estate cost may be difficult to estimate, the *can* still be estimated.

This particular comment has caused franchisors quite a bit of concern. Real estate costs can vary dramatically and can skew Item 7 total figures, both on the low and high end of the estimate provided. In the author's experience, in a recent situation the estimated real estate cost for the franchisor's target markets in the state of Washington alone, varied between about $350,000 to about $3,200,000. If the franchisor would have looked at real estate cost in key markets in the country as a whole, it is likely the spread would have been even more significant.

[62] 16 CFR §436.5(g) (2007).

5. Upcoming Legal Changes: What Franchisors and Brokers Should Do In the Future.

5.1 California – Pending Franchise Broker Registration

On January 10, 2024, California Senator Tom Umberg introduced a bill that would make California the third state that would require registration of franchise brokers.[63]

The bill would amend the California Franchise Investment Act to include provisions regulating brokers, or "third-party franchise sellers" as they are termed in the bill. Third-party franchise sellers are persons who directly or indirectly engage in the business of offering or selling franchises. Franchise brokers, broker networks, broker organizations and franchise sales organizations are listed as examples of third-party franchise sellers. Specifically excluded are franchisors, subfranchisors, area representatives and their respective officers, directors, employees; and employees of wholly owned affiliates of franchisors and subfranchisors; and franchisees of the franchise being presented to the prospective franchisee, unless the franchisee is operating a franchised broker business.[64]

Third-party franchise sellers would be required to register before they can effect a franchise sale in California.[65] The initial registration fee would be $250, the renewal fee $150, and the amendment fee $50.[66]

The proposed bill would lead to changes not only relating to franchise brokers. For example, the text proposed as of the date of this paper would require that every franchise seller who is not a third-party franchise seller be listed in Item 2 of the FDD.[67]

The third-party franchise seller would have to file an application form, accompanied by a disclosure document – the Uniform Third-Party Franchise Seller Disclosure Document - containing the following information:[68]

"(a) A third-party franchise seller cover page that contains standardized language regarding third-party franchise sellers, including, but not limited to, all of the following:

(1) The types of sellers.

(2) The third-party franchise sellers' role in the franchise sales process.

(3) Services a third-party franchise seller might provide.

(4) Different ways a third-party franchise seller might be compensated for its services.

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[63] CA S.B. 919. New York and Washington state also require registration of franchise brokers. In the past, Illinois has also required franchise broker registration.
[64] Suggested CAL. CORP. CODE § 312020 (a).
[65] *See* suggested revisions to CAL. CORP. CODE § 31210.
[66] Suggested revisions to CAL. CORP. CODE §31500.
[67] *See* suggested revisions to CAL. CORP. CODE §31210. The FTC Franchise Rule only permits the inclusion in Item 2 of the FDD of persons holding certain offices or titles and those with management responsibility for the sale or operation of franchises. Many franchise sellers do not have this level of responsibility and would therefore potentially put franchisors in a difficult position – whether to strictly follow the FTC Franchise Rule, or to comply with CFIL.
[68] Suggested CAL. CORP. CODE §31528.

(5) Examples of questions a prospective franchisee might ask a third-party franchise seller.

(b) All of the following information about the third-party franchise seller:

(1) Legal name.

(2) Trade name.

(3) Year and state of incorporation.

(4) Principal place of business.

(5) Owners.

(6) Directors and officers.

(7) Contact information.

(c) The third-party franchise seller's professional experience during the last five years.

(d) Administrative, civil, or criminal actions alleging that the third-party franchise seller, or an owner, officer, or director of the third-party franchise seller, violated any franchise, antitrust, or securities law, or committed fraud, unfair or deceptive practices, or similar violations, whether pending or resolved, within the last five years.

(e) The industries of the brands the third-party franchise seller represents and how many brands within each industry the third-party franchise seller represents.

(f) A description of the services performed by the third-party franchise seller.

(g) How the third-party franchise seller is compensated, including, but not limited to, how the amount of any consideration the third-party franchise seller receives is calculated.

(h) Whether a broker network, broker organization, or franchise sales organization may receive any additional consideration.

(i) The name and contact information for all franchisees to whom the third-party franchise seller sold a franchise anywhere in the United States or its territories during the last calendar year, including, but not limited to, the total number of units sold to each franchisee."

The Commissioner of the Department of Financial Protection and Innovation may require filing of additional documents.[69]

The registration appears to be a notice filing, to be effective 5 days after filing. It would remain effective for one year.[70] Similar to the registration required by franchisors, the third-party franchise seller registration must be amended in the case of material

[69] Suggested CAL. CORP. CODE §31528.
[70] Suggested CAL. CORP. CODE § 31528.

change.[71] Examples of material changes include changes to litigation history, changes to services provided, and changes to compensation.[72]

The third-party franchise seller will have to provide the disclosure to prospective franchisees before engaging with them about a franchise opportunity, but there are otherwise no timing requirements regarding the disclosure.[73]

A third-party franchise seller who is not properly registered, or otherwise violates the rules commencing with 31520 or 31200 will be liable to the franchisee for damages.[74] However, if the violation is willful, the franchisee may also sue for rescission. Given that rescission will affect the franchisor, CFIL will also allow the franchisor to sue the third-party franchise seller for damages or assert indemnity.[75]

The Commissioner has the power to issue a stop order or deny effectiveness of any registration if the Commissioner finds that that the third-party franchise seller has not complied with the CFIL regulation relating to brokers.

As of the date of this paper, the bill had been re-referred to the Rules Committee and there is no information on if and when the bill would become law.

5.2 NASAA – Pending National Broker Registration Act

The regulation of brokers is a hot topic this year, and in addition to the pending bill in California, the North American Securities Administrators Association is also considering a model act for broker registration. As with other model acts, the intention of this model act is to provide states that are considering regulation of franchise broker a template act to start from. It is likely that by the time this paper is published, the draft model act will be out for public comment.

6. Practical Take-Aways

Franchisors should not take disclosure obligations arising under state franchise laws lightly and should ensure that not only management, but also the people who are in touch with prospective franchisees understand, their obligations and the do's and dont's of franchise disclosure. Many of the enforcement actions discussed in this paper could possibly have been avoided with better understanding amongst franchise sellers of what the rules are. While the penalties imposed through the enforcement actions may seem minor in proportion to what a franchisor may gain, many of the consequences are not readily apparent from the enforcement actions themselves. The investigation required in connection with an enforcement action can be costly and time consuming for the franchisor and its staff; the franchisor will likely have to engage outside counsel to help address the issues and pay their legal fees; and last, when rescission offers must be made, the consequences of the action may go far beyond what is obvious from the order itself.

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[71] Suggested CAL. CORP. CODE §31522.
[72] Suggested CAL. CORP. CODE §31522.
[73] Suggested CAL. CORP. CODE §31527. The disclosure can be through electronic means.
[74] Suggested revisions to CAL. CORP. CODE §31300.
[75] Suggested revisions to CAL. CORP. CODE §31300.

International Franchise Association
56th Annual Legal Symposium
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2024 Judicial Update
International Updates in Franchise Law

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1 Introduction

Set out below is a selection of franchising and/or contract-related cases and commentary from the following five markets:

- United Kingdom;
- France;
- Germany;
- Italy; and
- the Netherlands.

2 International Updates in Franchise Law – United Kingdom

There is no specific franchise legislation in the UK. However, general English contract, intellectual property, real estate and competition laws apply to franchising[1]. The franchising industry also self-regulates through the British Franchise Association's Code of Ethical Conduct, whereby the code encourages fair dealings throughout a franchise relationship. Conversely though, membership of the British Franchise Association is not compulsory.

This section will focus on two UK-based cases that will impact franchise relationships and how the courts are likely to approach disputes in such relationships. This provides a valuable perspective in the UK in the absence of specific legislation.

2.1 *The Burke Partnership v The Body Shop International Limited*[2]

Franchising agreements are often medium to long-term periods of time and include renewal options. It is common for neither party to want to delve into detailed negotiations about termination and exit strategies at the beginning of a new venture or partnership. However, it is worth considering the options a franchisor has to exit a long-term contract with a franchisee that no longer aligns with its business model.

In *The Burke Partnership v. The Body Shop Int'l Ltd.*[3], the parties, in the early 1980s, entered into two franchise agreements to operate Body Shop retail outlets in the territories of Norfolk and Cambridge (the "**Agreements**"). Both Agreements had an initial duration of five years, capable of being renewed by the Burke Partnership, also the franchisee, if certain conditions were met and the franchisee provided a three-month notice before the current term expired.

Over a period of 35 years, the franchisee renewed both Agreements multiple times, with the Body Shop accepting each renewal notice[4]. During this time, the parties did not seek to renegotiate the Agreement terms as part of any renewal process[5].

2.1(i) *The dispute*

In 2020/2021, Body Shop issued termination notices for both Agreements, citing that the franchised stores no longer aligned

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[1] Iain Bowler and Jaskeerat Sanghera, 'Franchise Laws and Regulations England & Wales 2024' (*Franchise* 2024) <https://iclg.com/practice-areas/franchise-laws-and-regulations/england-and-wales> accessed 10 April 2024.

[2] *The Burke Partnership v The Body Shop International Limited* [2023] EWHC 2897 (Ch).

[3] *The Burke Partnership* (n 2).

[4] Victoria Hobbs and Matthew Pack, 'The Body Shop's recent failure to successfully terminate a long-term franchise agreement has important practical consequences for similar contractual arrangements', (*Bird & Bird,* 12 December 2023) < https://www.twobirds.com/en/insights/2023/uk/the-body-shops-recent-failure-to-successfully-terminate-a-long-term-franchise-agreement> accessed 9 April 2024.

[5] Gordon Drakes, 'Franchise Case Law Update: The Body Shop does not come up smelling of roses', (Fieldfisher, 18 December 2023) <https://www.fieldfisher.com/en/services/franchising/franchise-commercial-law-blog/franchise-case-law-update-the-body-shop-does-not-c> accessed 10 April 2024.

with Body Shop's business practices and proposing a reasonable termination period of three years.

The franchisee contested Body Shop's right to terminate the Agreements on reasonable notice, arguing there was no express provision allowing Body Shop to terminate for convenience and that there was no basis in English law to imply a right to terminate on reasonable notice into the Agreements. Consequently, the franchisee initiated legal proceedings against Body Shop in the High Court, seeking a declaration that Body Shop's termination notices were invalid and that the Agreements remained effective.

Body Shop faced a significant challenge in convincing the court that the renewal clause in the Agreements (which could be exercised every five years if certain conditions were met) did not apply to consecutive renewals. In other words, it was a right of renewal that could be exercised only once. This argument was central to Body Shop's case, as whether the Agreements should be read as being perpetual would be relevant to whether a right to terminate for convenience on reasonable notice could be inferred[6].

2.1(ii) *The High Court's decision*

The judge ruled in favour of the franchisee, finding that Body Shop did not have the right to terminate the Agreements on reasonable notice for convenience, and the Agreements remained in force.

Body Shop argued that the Agreements were not intended to (or legally permitted to) run indefinitely. They argued that the parties could not have intended their franchise relationship to last forever when they entered into the Agreements in the 1980s. This argument is often used when contracting parties have continued to fulfil their contracts beyond a fixed term and then try to end the relationship by serving a notice to terminate on reasonable notice. The judge rejected this argument, finding that (i) this was not, in reality, a perpetual contract that could be indefinitely renewed at the franchisee's option, as the franchisee had to meet certain conditions before Body Shop was obligated to grant a renewal; and (ii) more importantly, the Agreements already contained an express provision for termination for breach, or for convenience on the part of the franchisee, and to imply additional termination rights would conflict with those explicit terms.

The judge also dismissed another argument by Body Shop that the franchisee's option to renew multiple times put Body Shop at

[6] Drakes (n 5).

a commercial disadvantage. The judge found that this argument had no relevance as to whether any terms should be implied.

2.1(iii) ***Key takeaways for franchisors***

The court dismissed many of the arguments typically used by franchisors seeking to exit long-term contracts where they lack explicit rights to terminate for convenience. This case illustrates that some franchisees are willing to engage in commercial litigation in disputes with franchisors, especially when their rights to run their business are at risk due to termination disputes.

The key takeaways from this case are as follows:

2.1(iv) ***Do not assume you can terminate for reasonable notice.***

It is commonly assumed that a long-term contract (spanning five, 10, 15+ years) should be terminable on reasonable notice, implying that either party should have an exit strategy if the relationship does not go to plan. However, this judgment affirms that such an assumption can be risky. If a franchise contract includes express rights to terminate for cause, meeting the criteria for such a termination can be quite challenging.

2.1(iv)(A) ***Be explicit about the number of times that the contract can be renewed and the conditions attached.***

Renewals that are too vague can be construed to permit multiple renewals. If the intention is to have an initial term that allows for only one renewable period (unless a further agreement is reached), it should be explicitly stated. Another challenge faced by Body Shop was that it was relatively easy for the franchisee to achieve the relevant conditions before it could request an extension which Body Shop could not refuse. The case underscores that a franchisor should not readily depend on a termination on reasonable notice being implied so as to overcome a unilateral right to renew in favour of the franchisee(s).

2.1(iv)(B) ***Be careful about perpetual roll-over of franchise agreements.***

It is a very common issue that franchise agreements are allowed to roll-over (even after the end of a fixed term) without any renegotiation. This judgment highlights the significance of actively managing franchise agreements post-signing. Acting as if a state of affairs exists, such as a unilateral right to

extend the term, can make it challenging for a franchisor to argue for termination on reasonable notice at a later stage. Franchisors can reduce these risks by actively managing their franchise agreements and planning for their renewal. A court may not always be able to restore balance in every case.

2.1(iv)(C) ***Carefully consider other options to exit and seek advice on managing that process.***

Body Shop was in a challenging situation due to its contractual position. Despite attempting to provide a long termination notice period, it was unable to successfully exit the agreement. Such hurdles can sometimes be overcome with adequate foresight and planning[7].

2.2 *Merthyr Tydfil County Borough Council v Churchill*[8]

In this landmark case, the Court of Appeal held that parties can be ordered to engage in alternative dispute resolution ("**ADR**") outside the court process, effectively overturning the principles set out in the Halsey decision[9], which is discussed below. While this is not a franchise-specific dispute, it is one that will bind English court proceedings, including those addressing franchise disputes.

2.2(i) *The dispute*

The case involved a property owned by Mr Churchill, with adjacent land owned by Merthyr Tydfil County Borough Council (the "**Council**"). Mr Churchill alleged that Japanese knotweed from the Council's land was invading his property and causing him harm. Instead of using the Council's Corporate Complaints Procedure (the "**Procedure**"), Mr Churchill chose to send a letter of claim to the Council.

The Council questioned why he hadn't used the Procedure and indicated that it would seek a stay of proceedings if he pursued litigation without doing so. Despite this, Mr Churchill went ahead with his court claim. In response, the Council applied for a stay of the proceedings, arguing that Mr Churchill had not participated in ADR via the Procedure[10].

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[7] Drakes (n 5).
[8] *Merthyr Tydfil County Borough Council v Churchill* [2023] EWCA Civ 1416.
[9] Victoria Hobbs, 'Courts do have the power to order parties to engage in ADR' (*Bird & Bird,* 19 December 2023) <https://www.twobirds.com/en/disputes-plus/shared/insights/2023/uk/courts-do-have-the-power-to-order-parties-to-engage-in-adr> accessed 9 April 2024.
[10] Hobbs (n 9).

2.2(ii) ***The initial decision***

At first instance, the judge rejected the application for a stay, believing he was obligated by the principle established in *Halsey v Milton Keynes General* (the "**Halsey Principle**"). This principle asserts that forcing genuinely reluctant parties to mediate their disputes would unjustifiably hinder their right of access to the court. Although the judge felt he was bound by the Halsey Principle, he determined that Mr Churchill had acted unreasonably in failing to comply with the Procedure. Consequently, the judge allowed the Council to appeal, considering this case to raise a significant point of principle.

Importantly, the Council's appeal did not question the reasonableness of Mr Churchill's refusal to comply with the Procedure. Instead, the appeal was based on two points: (1) the judge was initially wrong to believe that he was bound by the Halsey Principle, and (2) the Civil Procedure Rules and overriding objective states that litigation should be the last option, hence the court should have the power to stay this claim since Mr Churchill had refused to comply with the Procedure.

2.2(iii) ***The Court of Appeal decision***

The court dealt with four issues in the appeal:

Issue 1 revolved around whether the Halsey principle was integral to the court's decision in the original case. The Court of Appeal concluded that the principle was not a crucial part of the decision because the case primarily dealt with cost sanctions rather than mandating ADR participation. Additionally, the issue of judicial compulsion in ADR was not considered at the initial trial or in the appeal arguments. Therefore, the judge at first instance was not obligated to follow the Halsey Principle.

Issue 2 concerned the court's authority to stay proceedings. Mr Churchill argued that the court did not have the power to stay proceedings on the basis that he had not complied with the Procedure. He claimed that this was because the Procedure lacked several key elements, such as the involvement of a neutral third party, legal advice, and a written governing procedure, and was a disproportionate restriction on his right of access to the court. The court clarified that, ultimately, while it would consider the Procedure process, it had, and has, authority to stay proceedings to allow the parties to engage in ADR.

Issue 3 focused on how the court should decide whether to exercise its powers to stay proceedings. The court refused to lay down fixed principles by which judges should decide when to exercise these powers and confirmed the discretion lies with the

judge on a case-by-case basis to assess if ADR is suitable to achieve a fair, prompt, and cost-effective resolution.

The final issue examined whether, on the facts of this dispute, the judge at first instance should have granted the Council's application for a stay of proceedings. The court recognised that the judge at first instance might have opted for a stay of proceedings if he was aware he was not bound by the Halsey Principle. However, the court found it impractical to grant a stay at this advanced stage but allowed the appeal, indicating a preference to revisit procedural discussions later. The court recommended the parties to consider using mediation as a form of ADR to resolve this dispute[11].

2.2(iv) *Key takeaways for potential litigants*

This decision highlights a growing trend towards ADR methods. The court's flexibility in recognising various ADR mechanisms, including internal complaints processes, suggests a move away from strict guidelines. The decision underscores the importance of considering ADR in dispute resolution for its cost-effectiveness and confidentiality benefits. The court's willingness to stay proceedings to allow parties to engage in ADR indicates a likely increase in this practice. Therefore, it is crucial for potential litigants to seriously consider ADR and ensure their internal complaint procedures are robust and fair.

From a franchising perspective, ADR can be utilised for resolving franchise disputes, and dispute escalation and resolution clauses should be considered and carefully drafted.

[11] Hobbs (n 9).

3 International updates in franchise law – France

Under French law, there is no regulation that defines a franchise. Franchise operations are subject to French contract rules established in the French Civil Code, as well as by the general rules that apply to all commercial relationships in the French Commercial Code[12]. Franchise agreements are also subject to review under EU competition law. Recently, the Authorité de la concurrence, France's Competition Authority, has taken decisive action against two prominent groups, Mariage Frères and De Neuville, for practices that restricted the commercial freedom of their distributors and franchisees, respectively.

3.1 *Mariage Frères: ADLC's decision n° 23-D-12 of December 11, 2023.*

3.1(i) *Background*

The French Competition Authority (the "**Competition Authority**") fined Mariage Frères, a prominent French premium tea producer, €4 million following a report produced by the local network of the Minister of the Economy. The report highlighted that for nearly 15 years, Mariage Frères had been restricting its distributors' commercial freedom by prohibiting them from selling its branded products online and preventing the resale to other retailers.

Such restrictions were particularly impactful in the context of the growing online sales market, likely hindering the expansion of the distributors' businesses. Furthermore, by enforcing a ban on reselling to other distributors, Mariage Frères not only controlled the distribution channels but also prevented end consumers from benefitting from potentially lower prices that could arise from effective competition among all distributors.

The Competition Authority determined that these practices constituted a restriction of competition by object, contributing to a market portioning and limiting intra-brand competition, effectively forming a cartel[13].

3.1(ii) *A ban on online sales of Mariage Frères products*

Mariage Frères had established terms and conditions that prohibited its distributors from selling its products online, thus reserving the right for itself to online and distance sell its products exclusively. Distributors could promote the availability of Mariage Frères products in their physical stores but were not allowed to sell them over the Internet or use the brand's logo.

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[12] Cecile Peskine and Clémence Casanova, 'Franchise Laws and Regulations 2024' (*Franchise 2024*) < https://iclg.com/practice-areas/franchise-laws-and-regulations/france> accessed 5 April 2024.

[13] Autorité de la concurrence, 'Décision 23-D-12 du 11 décembre 2023' (Autorité de la concurrence, 11 December 2023) <Decision 23-D-12 of December 11, 2023 | Autorité de la concurrence (autoritedelaconcurrence.fr)> accessed 26 March 2024.

This policy was strictly enforced by Mariage Frères, who actively monitored its distributors' compliance and demanded the removal of its products from any distributor websites that violated this rule.

The impact of this policy was particularly significant on small businesses, who reported a substantial loss in potential revenue due to the inability to sell Mariage Frères products online – a channel that could have increased their sales significantly.

The Competition Authority investigated this practice and determined it to be anti-competitive. The clauses in the general terms and conditions not only prevented distributors from engaging in online sales but also established Mariage Frères as the sole online vendor for its products until 2019. Post-2019, the company modified its terms and conditions to require distributors to seek prior authorisation for online sales, which in practice, was not granted, effectively continuing the ban on online resales.

Moreover, during the period of this ban, between 2013 and 2021, Mariage Frères experienced a significant increase in its own online sales indicating a growing consumer trend towards online shopping. The company justified its restrictive policy as a means to maintain the luxury image of its brand, citing concerns over the potential damage to its reputation if it could not control the online presentation and marketing of its products. The Competition Authority rejected this defence, stating that since products were not sold under a selective distribution system, preserving a prestigious image did not warrant the complete neutralisation of an online sales channel[14].

3.1(iii) *The ban on reselling Mariage Frères products to other retailers*

This type of clause in the general terms and conditions of sale granted Mariage Frères exclusive rights to wholesale sales, while limiting its distributors to direct consumer sales only. Such practices can be seen as anti-competitive, as they restrict the market and limit the ability of distributors to expand their business operations.

The Competition Authority assessed this clause and considered it to be a hardcore restriction under Commission Regulations EU 330/2010 and 2022/720; Mariage Frères did not engage in a selective or exclusive distribution system and so could not justify such a restriction.

Furthermore, article 10 TFEU prohibits agreements between companies that prevent, restrict, or distort competition within the EU's internal market. Consequently, the presence of such

[14] Autorité de la concurrence (n 13).

clauses in Mariage Frères' terms and conditions, without a valid justification, were viewed as an infringement of this article[15].

3.1(iv) ***The amount of the fine resulting from the anticompetitive practices in question***

The Competition Authority levied the substantial fine of €4 million on Mariage Frères for engaging in practices deemed serious by the regulatory body. The size of the company and lack of certain management structures were not considered as factors that could lessen the severity of the penalty.

The decision underscores the Competition Authority's commitment to ensuring a franchisor's compliance with competition laws and addresses the impact of infringements on small businesses within the market[16].

3.2 ***De Neuville: ADLC's decision n° 24-D-02 of February 6, 2024.***

3.2(i) ***Background***

De Neuville is a prominent name in the French chocolate market, focusing on both wholesale and retail sales. With a network of 154 stores, it stands as the third-largest specialised chocolate distributor in France. The brand's dominance is further solidified by its franchise model, which accounts for 90% of its stores, making it the top chocolate franchise network in France.

Following a report prepared by the local network of the Minister of the Economy, the Competition Authority fined De Neuville for implementing practices aimed at (i) restricting its franchisee's ability to sell De Neuville brand chocolate online, and (ii) prospect for professional customers.

The Competition Authority discovered that between 2006 and 2019, the contractual arrangement between the franchisor and its franchisees hindered the franchisees from freely conducting online sales of their products. De Neuville exclusively reserved these rights.

Additionally, during the period from 2006 to 2022, De Neuville curtailed its franchisees' commercial autonomy in seeking business customers.

[15] Autorité de la concurrence, 'Décision n° 23-D-12 du 11 décembre 2023 relative à des pratiques mises en œuvre dans le secteur des thés de luxe*' (Autorité de la concurrence 2023).
[16] Autorité de la concurrence (n 13).

Consequently, a fine of €4,068,000 was imposed on De Neuville (jointly and severally with its parent company, Savencia Holding), together with a publication and communication injunction[17].

3.2(ii) *The distribution model for De Neuville chocolates*

The relationship between De Neuville and its franchisees is governed by a seven-year contract that does not renew automatically. The Competition Authority found that, since 2006, De Neuville has revised its franchise agreements 17 times, sometimes with overlapping versions.

Franchisees, upon signing the contract, are provided with an operating manual that outlines essential aspects of the business. This includes the use of the De Neuville brand, product descriptions, sales techniques, merchandising, and store management. Additionally, the manual, which has seen five iterations since 2006, enforces a code of conduct that addresses online sales and external commercial activities.

Adherence to the operating manual and franchise contract is mandatory for franchisees. Non-compliance can result in the premature termination of the franchise agreement, as stipulated by the French Commercial Code.

3.2(iii) *Restriction on its franchisees and online selling*

The franchise contracts in question contained a clause that explicitly prohibited franchisees from selling online, reserving the right exclusively for the franchisor. While there were exceptions for franchisees, they could only sell online within their designated territories and with the franchisor's explicit consent.

In 2014, the clause was moved to an appendix, yet the practical effect remained unchanged. It wasn't until 2019 that De Neuville revised its contractual framework to permit franchisees to engage in online sales freely.

The Competition Authority found that, before 2019, many franchisees felt the stipulations amounted to a *de facto* ban on online selling. The Competition Authority also found that since 2019, when the restrictions ended, some franchisees have established their own online sales platforms.

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[17] Autorité de la concurrence, 'Décision 24-D-02 du 06 février 2024' (Autorité de la concurrence, 15 February 2024) < https://www.autoritedelaconcurrence.fr/fr/decision/relative-des-pratiques-mises-en-oeuvre-dans-le-secteur-de-la-distribution-de-chocolats> accessed 25 March 2024.

3.2(iv) *Restrictions on its franchisees' commercial freedom in prospecting business customers*

The Authority found that, from 2006 to 2022, De Neuville's commercial strategy involved a contractual framework that dictated how sales to business customers were allocated between franchisees.

According to the De Neuville code of conduct, franchisees were required to adhere to a set commercial methodology, which included identifying potential business clients and planning canvassing campaigns.

The process mandated that franchisees initially target business customers within their own catchment area. Expansion into new territories was contingent upon the thorough canvassing of their own catchment area first.

Moreover, the handling of unsolicited business inquiries was subject to strict guidelines. Franchisees were permitted to respond to these inquires only if they aligned with the commercial methodology applicable to active solicitation. This methodology encompassed rules for the distribution and coordination of contracts between franchisees according to geographical area.

3.2(v) *The Competition Authority fines De Neuville €4,068,000*

Considering the extensive duration of these practices (13 and 16 years, respectively) and the fact that the De Neuville operates within a larger corporate group, the Competition Authority imposed the fine of €4,068,000 of De Neuville and its parent company, Savencia.

Furthermore, the Competition Authority ordered De Neuville to send a summary of the decision to all its franchisees and publish the same summary on its website and in the newspaper *Le Monde*[18].

3.3 *Cass. Com., n° 22-19.436 September of 27, 2023.*

3.3(i) *Background*

The franchisor Société Jules ("**Jules**"), running a network of men's clothing stores, decided to shift to a commission-based distribution model, providing 18 months' notice for contract termination to its franchisees. After receiving notification of this proposal to terminate, several franchisees served the franchisor with a formal notice to return their customer files.

[18] Autorité de la concurrence (n 17).

This led to a dispute over the ownership and use of customer data[19].

3.3(ii) *The Dispute*

The franchisees demanded the return of their customer files, claiming them to be incompatible and unusable. They requested the franchisor in summary proceedings return the said files and sought to prevent the franchisor from using them, on the grounds of a manifestly unlawful disturbance and imminent danger.

On 9 June 2022, the Commercial Court and then the Douai Court of Appeal granted the franchisee's request, prohibiting the franchisor from using the files and ordering it to return them to the franchisee, subject to payment of a penalty.

3.3(iii) *Legal Proceedings and Supreme Court's Observations*

The litigation reached the French Supreme Court, where the franchisor challenged the prohibition on their use of customer files after the end of the franchise agreement. The franchisor argued that the franchisee could not use the files immediately due to the non-compete clause, and therefore there was no imminent danger.

The Supreme Court observed that the Court of Appeal had acknowledged there was an absence of any contractual clause allowing the franchisor to access the customer files or its franchisees after the end of the franchise agreements. Additionally, the franchisor's counsel had indicated that they would continue to use the data from these customer files, despite the termination of contractual relations with the franchisees.

The Supreme Court upheld the decision of the lower court to prevent imminent damage resulting from the franchisor's potential exploitation of customer data of the franchised shops. Consequently, Jules was required to return the complete customer files to the franchised companies in a usable format. Furthermore, Jules was prohibited to use these files after the franchise contracts ended on 31 July 2021. The Court also ordered Jules to pay costs and a sum of €3,000 to the franchised companies. The court's decision was based on the application of Article 873 of the French Code of Civil Procedure, which allows for interim measures to prevent imminent damage[20].

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[19] Grégoire Toulouse, Fanny Levy and Dr. Benedikt Rohrßen, 'Franchising: what happens to customer files at the end of the contractual relationship' *European Franchise & Distribution Newsletter* (2024).
[20] Toulouse, Levy and Rohrßen (n 19).

3.4 *Key takeaways*

The sanctions imposed on Mariage Frères and De Neuville highlight the ongoing scrutiny of competition practices in France, particularly regarding the dynamics of online sales and market competition. In both cases, the Competition Authority underscored the principle that while suppliers and franchisors are free to organise their distribution networks, they must not implement practices that unduly restrict competition. This includes prohibiting online sales, which is seen as an unjustified restriction on the commercial freedom of distributors and franchisees and distorts the competitive landscape.

As for Jules, franchisors must clearly articulate their rights to customer databases in franchise agreements to avoid litigation and penalties. This case underlines the court's dedication to protecting franchisees' operational independence and property rights.

4 International updates in franchise law – Germany

In Germany, there is no specific law that regulates the offer and sale of franchises. However, the German Civil and Commercial Codes impose certain requirements on parties. For example, while there are no franchise-specific disclosure requirements, the Codes impose a general disclosure requirement in all contractual negotiations on both parties to disclose all material facts[21].

This section will discuss a significant ruling by the Munich Higher Regional Court regarding system adjustment clauses, in addition to providing an overview of the German Arbitration Institute (DIS) and why franchisors should be aware of it.

4.1 *Judgment by Munich Higher Regional Court dated February 8 2023 – 7 U 8606/21*

In Germany, there are only a few judgments that focus on franchise law. However, in 2023, the Munich Higher Regional Court (OLG München) made a significant franchise-related decision. The decision was made in relation to the preliminary injunction proceedings involving a well-known fast-food chain, McDonalds. The dispute centred on whether, given the franchisee had died, the franchisee's heiress was required to allow card payments in fast food restaurants. The court considered whether system adjustment clauses were valid in franchise agreements[22].

4.1(i) *Facts of the dispute*

The franchisor, McDonalds, operates a chain of fast-food restaurants and they applied for an interim injunction against the heiress of a franchisee, who was managing several McDonalds' restaurants. The parties were in dispute about who was entitled to manage the restaurants. The heiress, to ensure the revenue came directly to her, had removed the card readers from most cash registers and self-service terminals in the restaurants or prevented their use by blocking the card slot. The franchisor made an application to force the heiress to allow customers to pay by card in the restaurants[23].

4.1(ii) *Ruling of the Munich Higher Regional Court*

The Munich Higher Regional Court ruled in the franchisor's favour, citing the following[24]:

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[21] Bird & Bird LLP, 'International Franchise Laws – Germany') < https://www.twobirds.com/en/trending-topics/international-franchise-laws/page-components/international-franchise-law-tracker/germany> accessed 18 March 2024.

[22] Tom Billing, Karsten Metzlaff and Jasmin Schulzweida, 'Franchise Update: Key decisions in 2023' (*NOERR*, 4 March 2024) < https://www.noerr.com/en/insights/franchise-update-key-decisions-in-2023> accessed 18 March 2024.

[23] Billing, Metzlaff and Schulzweida (n 22).

[24] Billing, Metzlaff and Schulzweida (n 22).

4.1(ii)(A) ***Legal relationship between the parties***

The court clarified the legal relationship between the parties. Despite the franchisee's death, the franchise agreements were still in place. However, the heiress did not become a franchisee because to enter into the franchise agreement she required the consent of the franchisor, who refused to give it. The legal relationship was therefore in a state of uncertainty.

4.1(ii)(B) ***Franchisor's reputation***

The court noted that the franchise agreements required the heiress to accept non-cash payments in the restaurant without any restrictions i.e., at all cash registers and self-service terminals. The court emphasised that failure to do so would damage the franchisor's reputation. The court also highlighted that younger customers, in particular, relied on the ability to pay by card.

4.1(ii)(C) ***System adjustment clauses***

All the franchise agreements contained system adjustment clauses stating that the franchisee's heiress had to "apply the M system as amended from time to time as laid down and written in the operating manuals, documentation materials, written policies, plans, etc. which are updated from time to time and observe the corresponding principles and policies". The franchisor had to "take reasonable account of the reasonable interests of the franchisee according to the principles of good faith" in the event of changes to the system.

Therefore, the franchisor was entitled, via this system adjustment clause, to define the system standards for the fast-food restaurant chain and mandate the availability of cashless payment systems.

The court held the system adjustment clause to be valid and to not unreasonably disadvantage the franchisee's heiress (as per s307 of the German Civil Code). Ensuring the franchisee adhered to the system standard was a material element of the franchise system's functionality and the system standard included the potential for system changes. The court found the franchisor's planning of changes

to the standards aligned with the fundamental principles of franchise law.

The court stated that the franchisor's unilateral right to specify performance (as per s315 of the German Civil Code) must be exercised reasonably. The contractual clause adequately expressed this requirement by referencing the interest of the franchisee and the principles of good faith.

4.1(ii)(D) *What can we learn from this?*

The judgment by the Munich Higher Regional Court confirms the validity of system adjustment clauses in franchise agreements and shows that franchisors can set binding system standards as long as the interest of franchisees remain adequately taken into account.

4.2 *DIS Arbitration body*

The German Arbitration Institute (DIS) is a private, independent, non-profit association based in Berlin. Its aim is to promote national and international arbitration, as well as other methods of ADR including mediation, conciliation and expert determination. The DIS is funded from three different sources: (i) administrative fees – fees charged to the parties to arbitration or other ADR proceedings; (ii) membership fees – the DIS has over 1,400 members who pay annual membership fees; and (iii) events and conferences. The DIS can only be involved if the parties expressly agree to refer the dispute to the DIS.

The DIS primarily administers arbitral proceedings under the DIS Arbitration Rules. The DIS Arbitration Rules are suitable for companies of all sizes and industries, and for arbitration seated in Germany and abroad. They provide a well-structured procedural and institutional framework to ensure that arbitrations are conducted with integrity, efficiency, and fairness. Parties to DIS arbitrations benefit from the Institute's administrative know-how, extensive experience, and specialised knowledge.

The 2018 DIS Arbitration Rules prioritise early dispute resolution, efficiency, and speed. This emphasis sets them apart from other institutional rules, promoting amicable settlement only if all parties agree to it. The Rules provide a robust procedural framework that enables parties to tailor the process to their specific requirements[25].

[25] German Arbitration Institute, 'About us' (*DIS*) <https://www.disarb.org/en/about-us/about-us> accessed 18 March 2024.

4.2(i) *Relevance to international franchisors*

DIS arbitration is of particular relevance to international franchisors. With the growth of international trade in Germany, there has also been a huge upsurge in the use of arbitration as a method of effectively resolving international commercial disputes.

Choosing DIS as the arbitration body in an international context has many advantages over litigation before a German court. For example, in Germany, arbitration proceedings are private and confidential, which means that the decision of the arbitrator will not be reported in the same way as a court judgment and the parties should therefore be able to avoid any adverse publicity that often follows litigation. The parties also have the power to agree flexible procedures to ensure that the dispute is dealt with efficiently and cost-effectively e.g., the arbitration can take place virtually, cutting down on cost and travel time.

Furthermore, under DIS arbitration rules, the parties can choose an arbitrator with expertise that is relevant to the franchise industry or to the issue in dispute. They can also ensure the arbitrator is neutral and unbiased.

An arbitration award under DIS is generally final and binding. The options for challenging an award are very limited and it is generally easier to enforce an arbitral award in another jurisdiction, whereas a court judgment is usually subject to rights of appeal and tend to be harder to enforce abroad. DIS should therefore give more certainty and finality for parties. DIS is an internationally accepted institution and the costs are moderate, and the proceedings are in general handled quickly[26].

4.2(ii) *The DIS Franchise Industry Group*

In 2023, DIS and Bird & Bird LLP established the DIS Franchise Group to promote the potential of alternative dispute resolution methods in franchising and to further develop current methods and approaches in practice[27].

The DIS Franchise Group unites franchise industry experts and decision-makers to exchange experiences, critically examine current practices, and establish the use of alternative dispute resolution methods such as arbitration and mediation in franchising. The Group looks to develop concrete recommendations for practitioners in the franchising industry.

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[26] German Arbitration Institute, (n 25).

[27] Dr Jiri Jaeger, 'The DIS Franchise Industry Group: New Approaches to Alternative Dispute Resolution in Franchising' (*Bird & Bird,* 10 October 2023) < https://www.twobirds.com/en/insights/2023/germany/the-dis-franchise-industry-group-new-approaches-to-alternative-dispute-resolution-in-franchising> accessed 18 March 2024.

5 International updates in franchise law – Italy

The Franchise Act No. 192/2004 (the "**Act**") governs franchising in Italy. The Act is mainly disclosure legislation and while it does contain some mandatory rules governing the ongoing relationship between franchisor and franchisee, the relationship is primarily regulated by the general provisions of the Italian Civil Code.

Under Article 9 of Law No. 192/1998, the abuse of a client's or supplier's state of economic dependence in regard to one or more businesses is forbidden[28]. Economic dependence occurs when a business has the ability to create significant imbalance in the rights and obligations of its commercial relations with another business.

Indicators of economic dependence include: (i) the size and market position of the parties to the franchise agreement; (ii) whether prospective franchisees are obliged de facto to accept the terms of a franchise, before having detailed knowledge of the network; (iii) long-term contracts (20 years+) and the inclusion of contractual provisions that create an excessive imbalance of rights and obligations between the franchisor and franchisee; and (iv) the inability for a franchisee to exit the agreement and recover their investments, including by affiliating with other chains, with the consequent impossibility of finding satisfactory alternatives to the relationship with the franchisor.

The Italian Competition and Market Authority (the "**AGCM**") has recently opened an investigation for alleged abuse of economic dependence against a number of companies. This section of the paper will focus on the investigation into McDonald's Development Italy LLC and its alleged abuse in violation of Article 9 of Law No.192/1998[29].

5.1 *McDonald's Development Italy LLC*

On 27 July 2021, the AGCM opened an investigation against McDonald's Development Italy LLC ("**MCDI**") for allegedly abusing economic dependence. The investigation was prompted by reports from franchise operators within the McDonald's network who complained about MCDI's allegedly abusive behaviour towards franchisees, even before the conclusion of the franchise agreements. This behaviour included the imposition of a complex system of fees, royalties, financial and investment charges, sales policies and multiple obligations of conduct – all of which can be extremely burdensome for franchisees.

The ACGM grouped this behaviour into four main categories: (i) pre-contractual behaviour; (ii) clauses contained in the standard franchise agreements; (iii) conduct adopted during the contractual relationship; and (iv) post-contractual conduct[30].

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[28] Law no.192 or 18 June 1998, (Article 9 – Abuse of economic dependence) Rules on subcontracting in manufacturing activities (Italy).

[29] A546 - FRANCHISING DI MCDONALD'S. Provvedimento n. 30199.

[30] A546 - FRANCHISING DI MCDONALD'S (n 29).

5.1(i) ***Pre-contractual behaviour***

Prior to establishing the franchise relationship, the reporting parties highlighted a series of behaviours that demonstrated how future McDonald's franchisees were already in a condition of total absence of negotiating power and alternatives of choices.

In particular, the franchisees were required to undergo a period of full-time training and education at McDonald's Group restaurants, lasting between 6 months and 2 years, at their own expense and without any remuneration or reimbursement. This was an extremely onerous obligation, both economically and logistically, most notably as completion of the training did not guarantee the franchisee becoming a Group franchisee. Additionally, MCDI failed to provide, during the education period, information relating to the economic and financial management of McDonald's restaurants, their average profitability, the terms and conditions of any future negotiating proposals, as well as any information related to the location of the assigned restaurant. This resulted in an inability for franchisees to negotiate the contents of the contract or make any changes thereof.

The franchisees also noted that they only saw the contract at the time of execution at the notary's office and due to an absence of alternatives to the path already started with MCDI, they were forced to accept everything without discussion.

5.1(ii) ***Clauses contained in the standard agreement***

As for the clauses contained in the standard agreements, the AGCM noted a number of burdensome clauses in favour of the franchisor. They included the following:

5.1(ii)(A) Franchisees were subject to a highly burdensome fee system imposed by MCDI. This included an entry fee, a bank guarantee, a fixed extra fee, a base and variable rent, and a royalty for using the McDonald's system, which amounted to no less than 4% of each restaurant's annual turnover.

5.1(ii)(B) Franchisees were obligated to bear all expenses for equipment, machinery, furnishings, and any other assets used in the operation of the catering business. This included any repairs, replacements, maintenance of equipment and business premises, including new installations and improvements that became necessary as a result of evolution of changes in the McDonald's system.

5.1(ii)(C) Franchisees had to commit their manager to participating in all training activities specified by

MCDI from time to time and bear the full cost of travel, accommodation, and allowance.

5.1(ii)(D) Franchisees were obligated to invest at least 1.5% of each restaurant's monthly gross sales for local advertising.

5.1(ii)(E) Franchisees had to maintain their residence within 30 miles (50km) of the premises and devote all work activity exclusively to the operation of McDonald's premises.

5.1(ii)(F) The agreements contained a non-compete obligation which prohibited franchisees, for the duration of the contract and for one year from the date of termination, from engaging in any activities that competed with MCDI throughout the country.

5.1(ii)(G) Franchisees were prohibited from changing their corporate structure without prior approval from MCDI.

5.1(ii)(H) The agreements lacked territorial exclusivity and the franchisees were required to waive any claims resulting from the opening of McDonald's restaurants nearby.

5.1(ii)(I) Regarding exit options, the AGCM highlighted the absence of the franchisees' rights to compensation for any reason whatsoever upon termination of the contractual relationship, including the obligation to waive any right to compensation for loss of goodwill. Additionally, MCDI had the option to purchase tangible assets owned by the franchisee, and the franchisee had to waive any right to positive difference between the value of the equipment and its value upon expiration, termination or early dissolution of the agreement.

5.1(iii) ***MCDI's behaviour during the contractual relationship***

Regarding MCDI's conduct during the contractual relationship, the AGCM emphasised that the franchisees were obligated to strictly comply with MCDI's decisions on sales prices. For example, the franchisees had no discretion in adjusting product prices for consumers, even based on market conditions or restaurant location, who may have different social contexts and economic affluence. The agreement only allowed for recommended prices to be considered.

Franchisees were obligated to use MCDI's suppliers exclusively and purchase predetermined quantities at the discretion of the supply manager. In many cases, orders were centrally managed by MCDI and automatically predetermined – the latter not being a choice justified by business efficiency, given that, often, the price of imposed purchases was far higher than those charged by other suppliers.

Further restrictions on franchisees' autonomy were imposed by MCDI. These included limitations on the number, roles, and working hours of restaurant staff, regardless of actual needs of the premises. Additionally, financial parameters such as debt to equity ratio, cash flow to loan repayment ratio, and sales to current liabilities ratio were enforced, leading franchisees to allocate the majority of net revenue/earnings to capital increase.

Failure to align with MCDI's sales policies, supplier guidelines, staffing requirements, operational management, financial parameters, etc., would have resulted in the franchisee being deemed ineligible to take over management of other restaurants and, in severe or repeated cases, termination of the franchise relationship.

5.1(iv) ***Post-contractual relationship conduct***

Finally, regarding MCDI's behaviour following termination of the franchise agreement, the AGCM noted that, inter alia, at the time of expiration/termination or early termination of the agreement, the franchisees were unable to recover the investments made, both in terms of tangible assets and goodwill.

Since restaurant furnishings and equipment were structured according to MCDI's needs and choices, it would have been impossible to convert them in favour of other business affiliates. As a result, at the end of the agreement, they could only be repurchased by MCDI at low prices (that did not consider the franchisee's costs, including in terms of maintenance). Consequently, MCDI was able to resell all of the restaurant's equipment to the new franchisee who took over the management of the restaurant, effectively profiting from the investments made by the previous franchisee. The new franchisee was, in turn, forced to pay MCDI both the "entry fee" and the "extra fee", which corresponded to the goodwill generated by the previous franchisee, as well as the cost of the equipment.

Finally, the franchisees emphasised that it was impossible to fully appreciate, at the time the contract was signed, the scope and implications of the clauses providing for the absence of rights to indemnity or compensation for any cause upon termination of the contract.

5.1(v) *Concluding remarks*

In summary, the AGCM alleged that MCDI abused the franchisees' economic dependence by imposing excessive burdensome conditions. Their conduct significantly reduced the franchisees' entrepreneurial autonomy and compressed their profitability margins, thus preventing them from switching to other restaurant networks or more profitable businesses.

During the investigation, MCDI proposed new contractual standards that would reduce the gap in rights and obligations between the franchisor and its network of licensees, which addressed the competitive concerns initially raised by the AGCM. In addition, MCDI's commitment to include clarifications in its contracts, particularly with regard to recognising the autonomy of franchisees in terms of business policies and choice of suppliers, were considered appropriate to guarantee franchisee's sufficient autonomy in business choices. Had MCDI been found guilty of breaching Italian antitrust rules, they could have been fined as much as 10% of global turnover

MCDI's commitments included (i) a preliminary application process lasting four months in which the prospective franchisee receives economic and financial information relating to the management of a McDonald's restaurant; (ii) a training period which aspiring franchisees freely decide whether or not to undertake; (iii) removal of the obligation for the franchisee to reside within 50km of the restaurant; (iv) the reformulation of the non-compete obligation; (v) adding clarifying provisions on non-interference in the commercial policies of franchisees (including the franchisee's right not to apply MCDI's recommended prices and promotions); and (vi) the extension of the possibility for the franchisees to appoint suppliers of their choice. Moreover, the new contractual standards proposed by MCDI would gradually be extended to all MCDI contracts previously established and still in force in Italy. This would therefore guarantee a margin of autonomy in the entrepreneurial choices of the franchisees, consistent with the need to maintain quality standards and uniformity of image sufficient for the proper functioning of the McDonald's system[31].

This decision is part of the AGCM's broader interest in addressing abuse in franchise contracts, particularly price compliance obligations. It represents the first decision on this matter that was resolved with the acceptance of commitments.

[31] A546 - FRANCHISING DI MCDONALD'S (n 29).

5.1(vi) *Key takeaways*

The AGCM's investigation provides several key learnings for franchisors. Primarily, the investigation serves as a reminder that any conditions imposed by a franchisor on a franchisee are reasonable and do not unduly restrict their ability to run their businesses. Additionally, the investigation highlights the importance of fair and balanced franchisor-franchisee relationships, the potential consequences of restrictive practices, and the role of regulatory authorities in maintaining competitive markets. It shows that the commercial freedom of the franchisee can be limited, but remains paramount, as certain specific safeguards should remain in place.

6 International updates in franchise law – the Netherlands

The Franchise Act first came into force on 1 January 2021 and is laid down in Book 7 of the Dutch Civil Code. As a result, franchise agreements are now considered "specified agreements" and are subject to their own legal regime designed to protect franchisees. However, general contract law still applies to the interpretation of franchise agreements. Therefore, when determining whether a contract can be classified as a franchise agreement, consideration should be given to the meaning that parties could reasonably attribute to the contract in the given circumstances, and what they could reasonably expect from each other in this regard.

Within this section, I will touch upon a number of significant commercial cases that explore the franchisor/franchisee relationship and the implications they have on the interpretation of the Dutch Franchise Act.

6.1 *Standstill Period*

Article 7:914 of the Dutch Civil Code establishes the obligation of a 'standstill' period. This means that any and all information regarding the franchise agreement must be shared with the franchisee at least four weeks before the agreement is signed. No changes can be made to the franchise agreement between the time the final version is provided and the time of entering into the agreement unless the changes are to the benefit of the franchisee. Moreover, it is prohibited to induce the intended franchisee to make payments/investments related to the franchise agreement during this time. The period is designed to protect the interests of the potential franchisee by providing a structured and transparent process for entering into a franchise agreement[32].

6.1(i) *Rb Den Haag 8 November 2023, ECLI:NL:RBDHA:2023:16665 (Plaintiffs v. Burgerme)*

The first case I will discuss revolves around the interpretation and application of Article 7:914 of the Dutch Civil Code. The District Court of the Hague ruled that the statutory standstill period was violated, leading to the annulment of the franchise agreement.

The franchisee received the final version of the franchise agreement on 6 March 2021, and the agreement was concluded on 10 March 2021. The franchisee argued that this did not respect the required 4-week standstill period. Burgerme (the franchisor) countered this claim by stating that a draft version of the agreement had been provided a year earlier, on 6 March 2020, and that the final version contained only minor adjustments that were in the franchisee's favour. The franchisee, however, highlighted significant differences between the two versions, which could materially affect the terms of the agreement.

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[32] Ravinder Sukul, 'The standstill period in a franchise agreement' (*Fruytier,* 10 May 2023) <https://www.flib.nl/en/the-standstill-period-in-a-franchise-agreement> accessed 15 March 2024.

It was concluded that the conditions for annulment under Article 3:40(2) of the Dutch Civil Code were met, and the Plaintiff had validly extrajudicially annulled the Franchise Agreement on June 29, 2022, due to non-compliance with mandatory law i.e., Article 7:914(2) of the Dutch Civil Code. Legal actions that are performed during the standstill period in violation of the provisions included in Article 7:914 Dutch Civil Code are generally voidable under Article 3:40(2) of the Dutch Civil Code[33].

The court's decision to annul the franchise agreement underscores the importance of adhering to the statutory standstill period and providing the franchisee with all the relevant information in a timely manner. This ruling serves as a reminder that the standstill period consists of two elements: the obligation to provide any and all information pertinent to the franchise agreement before the standstill period, but also the prohibition to perform certain actions during the standstill period. Even if Burgerme claimed to have fulfilled its information obligations prior to the standstill period, it remains that they were not allowed to change the draft franchise agreement during the standstill period.

The case emphasises the necessity for franchisors to fully comply with the provisions of the Dutch Civil Code to ensure the validity of their franchise agreements.

6.1(ii) ***Rb Midden-Nederland 30 June 2021, ECLI: NL: RBMNE: 2021: 2840 (Plaintiffs v. Domino's)***

This case also highlights the repercussions of disregarding the obligatory standstill period.

Initially, the plaintiff engaged in the franchisor's (Domino's) selection process resulting in the franchisor providing a pre-contractual information document ("**PID**") and a draft of the revised standard franchise agreement in May 2021. The franchisor noted that the draft agreement was under review by the Franchise Advisory Council and could be subject to changes. The plaintiff was asked to acknowledge receipt of the PID to initiate the 4-week standstill period.

During the 4-week standstill period, the franchisee expressed dissatisfaction with certain provisions of the provided draft agreement and reserved the right to raise further objections. In response, Domino's informed the franchisee that they could not offer any other franchise agreement and terminated the negotiations due to a lack of trust in future collaboration.

Subsequently, the franchisee reconsidered their objections and expressed willingness to sign the original agreement. However,

[33] ECLI:NL:RBDHA:2023:16665 (The Hague).

Domino's refused to enter into any contract with the franchisee, relying on the following agreement between the parties:

"*The provision of the PID, as well as any subsequent provision of information, does not obligate the parties in any way to enter into a franchise agreement with each other*".

The judge ruled that Domino's invocation of this provision was unreasonable and unfair, given the circumstances. It was unclear whether the franchisee agreed with the provision, and although they had signed the agreement, they had been pressured by Domino's to sign quickly, with Domino's failing to mention the inclusion of this significant provision. The court found that the provision was not only hidden within the text, but also contrary to the purpose of the PID, which is intended to furnish the potential franchisee with all the essential information required to make an informed decision about whether to enter into the franchise relationship.

The court determined that the franchisor should not have retracted its offer and referenced the Dutch Civil Code, which implies that an offer must be maintained once extended[34]. This ruling underscores the legal obligation on franchisors during the standstill period and the principle that if a franchisee accepts the franchise agreement within this timeframe, the franchisor must adhere to the terms offered. The judgment would have been more favourable for Domino's if it had served the four-week standstill period and the franchisee had not accepted the offer within this time. Domino's would then retain the discretion to withdraw their franchise agreement offer, and thereby avoiding the obligations that would have been triggered by the franchisee's acceptance.

6.2 *Disclosure Requirements*

Franchisors have an obligation during the pre-contractual phrase of a franchise agreement to provide information, pursuant to Article 7:913 of the Dutch Civil Code. While franchisors are not obligated to provide profit projections to franchisees under this Article, also known as a 'prognosis', it is often common practice. However, providing inaccurate projections can result in 'misrepresentation' and voidability of the franchise agreement, as the following cases highlight.

6.2(i) *HR 25 januari 2002, ECLI:NL:HR:2002:AD7329, NJ 2003/31 (Paalman/Lampenier)*

This case involved an allegation that the franchisor, Lampenier, did not fulfil its contractual obligations as it provided misleading information to the franchisee, Paalman, that led to a significant shortfall in turnover compared to the projections. The District

34 ECLI: NL: RBMNE: 2021: 2840 (Midden-Netherland).

Court upheld Paalman's claim, agreeing that Lampenier, by providing a third-party produced report on expected turnover, had misrepresented the facts. The court held that this misrepresentation was significant enough to influence the claimant's decision to enter into the franchise agreement, which they might not have done, or at least not under the same conditions, had the turnover forecast been more accurate. The case went all the way to the Supreme Court, which ruled that franchisors are liable if they knew that a prognosis or forecast of profits, prepared by a third party at their request, contained serious flaws[35].

This case serves as a cautionary tale that while providing such a report does not bind the franchisor to its contents unless a specific obligation has been established, the accuracy of the information provided is crucial. If a franchisor knowingly disseminates a report containing serious inaccuracies without alerting the franchisee, they are on precarious legal ground. This act may be considered unlawful, potentially obligating the franchisor to compensate for any resultant damages.

6.2(ii) ***Hof's-Hertogenbosch 7 November 2023, ECLI: NL: GHSHE: 2023: 3676 (Plaintiff v. Companies)***

Similar to the previous case, this case examines whether a franchisor's failure to generate the projected revenue, as per the revenue forecast, constitutes a misrepresentation or a tortious act by the franchisor.

In 2015, discussions were held between the appellant and respondents regarding the opening on a new Kwalitaria-Délifrance branch. During negotiations, turnover forecasts were provided, suggesting a starting turnover of €425,000, with growth potential. In fact, the franchisee did not achieve the forecasted turnover and subsequently annulled the franchise agreement, claiming the projected forecast contained serious errors and were overly optimistic.

However, the mere fact that the actual turnover differs from the forecast does not provide sufficient grounds to conclude that the forecast was incorrect. The Supreme Court's jurisprudence, particularly the cases of Paalman/Lampenier (2002) and Albert Heijn Franchising B.V. (2018), has set a precedent that, under the principles of reasonableness and fairness and the nature of a franchise agreement, a franchisor is not automatically required to provide a franchisee with expected turnover or profit forecasts. This obligation may arise under special circumstances, but it is

35 ECLI:NL:HR:2002:AD7329 (Supreme Court of the Netherlands).

not a given solely because the franchisor has shared such forecasts during pre-contractual negotiations[36].

The case reminds both franchisors and franchisees to engage in transparent and diligent practices when providing revenue forecasts and throughout the negotiation of the franchise agreement.

6.2(iii) ***Rb Noord-Holland 26 July 2023, ECLI:NL:RBNHO:2023:7380 (Curator of Badman B.V. v. Mega Tegels & Sanitair Franchise B.V.)***

This case concerns revenue forecasts given by a franchisor to a prospective franchisee. The issue was whether the franchisee validly rescinded the franchise agreement out of court due to misrepresentation and whether the franchisor could be held liable for tortious conduct towards the franchisee.

The franchisee, represented by the curator of Badman B.V. ("**Badman**"), argued that the franchisor, Mega Tegels & Sanitair Franchise B.V. ("**Mega Tegels**"), presented overly optimistic sales forecasts and had misrepresented their revenue forecasts.

For a successful claim of misrepresentation, it is necessary to establish that, in the absence of the misrepresentation, the party would not have entered into the contract or would not have done so on the same terms. The alleged misrepresentation in this case was that the revenue forecasts provided in the Business Franchise Proposal were based on the longer-established Mega Tegels franchisees, rather than the lower revenue of franchisees who started their businesses between 2009 and 2011.

The court agreed with Mega Tegels that the curator had not provided sufficient evidence to support the claim that Badman would not have entered into the franchise agreement if they had been aware of the revenue generated by new franchisees. The court also found it unlikely, based on the statements made during the hearing, that Badman had a specific revenue threshold in mind that would have influenced their decision to become a franchisee or not.

The court did not follow that Mega Tegels deliberately misled Badman regarding the revenue potential as nowhere did it indicate, nor did the curator argue, that Mega Tegels stated or implied that the revenue forecasts were based on the actual revenue of franchisees who recently started their businesses between 2009 and 2011. Instead, it was undisputed that the revenue forecasts were based on longer-established Mega Tegels franchise locations and it was therefore reasonable to

[36] ECLI: NL: GHSHE: 2023: 3676 (Hertogenbosch, the Netherlands).

assume that the provided revenue forecasts did not accurately reflect Badman's revenue potential in the first three years. The court concluded that the franchisee's annulment of the agreement based on misrepresentation was not valid and that the franchisor's actions were not tortious[37].

This decision underscores the importance of due diligence on the part of the franchisee when entering into franchise agreements. Franchisees must thoroughly evaluate the financial projections and other information provided by the franchisor to ensure they are based on realistic and applicable data. The ruling also highlights the necessity for franchisor's to be transparent and provide forecasts that are representative of all franchisees' potential experience. Moreover, the decision emphasises the challenges franchisees face in proving misrepresentation in contractual agreements.

6.2(iv) ***Hof `s-Hertogenbosch 27 July 2022, ECLI: NL: GHSHE: 2022: 3268 (Rotate v. Respondent)***

In cases where a franchise agreement is affected by a claim of misrepresentation, it is important to note that during the pre-contractual phase, the franchisor has an obligation to provide information, while the franchisee has a duty to conduct due diligence. The exact extent of these obligations depends on the circumstances of the case. Moreover, according to case law from the Supreme Court, the following principles are relevant when assessing a claim of misrepresentation based on a prognosis provided before entering into a franchise agreement:

6.2(iv)(A) a franchisor is not obligated to provide a prognosis;

6.2(iv)(B) if they choose to do so, the franchisee can generally rely on the accuracy of the information provided;

6.2(iv)(C) if a prognosis is not met, it does not necessarily imply that the information provided was incorrect or contained errors (as other factors can also contribute to achieving or not achieving a prognosis).

In this case, the respondent showed interest in becoming a franchisee under Rotate's franchise program. This led to Rotate sharing the so-called 'Franchise Information' which contained, amongst other things, the financial aspects of joining the franchise network i.e., insights into the potential profits and costs associated with running one's own franchise.

[37] ECLI:NL:RBNHO:2023:7380 (Noord, the Netherlands).

The Respondent, in 2019, prematurely terminated the franchise agreement citing that the turnover achieved by the respondent fell short of the turnover forecasts included in the Franchise Information as well as the expected turnover included in the business plan. Rotate claimed €90,169.20 in respect of this early termination.

The court held that, in a situation where the franchisee considers early termination to prevent further financial decline, it would be unjust to place the burden of additional payments solely on the franchisee. As such, the court concluded that Rotate was not entitled to payment of the claimed amount due to the early termination of the franchise agreement and dismissed this part of Rotate's claim[38].

The court's opinion underscores the principle that while franchisors and franchisees enter into agreements with mutual expectations of success, the unpredictable nature of business means that outcomes cannot be guaranteed. In instances where the franchisee's financial health is at stake, the court suggests that demanding additional payments for early termination is not only unfair but also disregards the shared risk that both parties accepted at the outset of their agreement. This case serves as a reminder of the balance of interests that must be maintained in franchise relationships and the importance of equitable treatment when those relationships face challenges.

[38] ECLI:NL:GHSHE:2022:3268 (Hertogenbosch, the Netherlands).

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Judicial Update: Joint Employer & Misclassification

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1. INTRODUCTION

Like the *Browning-Ferris* wheel of years past, agency rulemaking continues to spin the franchise community in circles. Both the National Labor Relations Board (NLRB) and the Department of Labor (DOL) reversed course last year under the Biden administration and issued new rules governing joint employer[1] and independent contractor classification[2] exposing franchisors to greater employment liability risk.

As seen with the revocation of Trump-era rules,[3] reliance on agency rulemaking is subject to changing political winds. Even when more permanent fixes overcome legislative gridlock, they face presidential veto.[4] Policymakers seeking solutions for perceived injustices in the "gig economy" seem determined to expand the scope of employment despite established legal precedents and routine economic order that businesses have relied upon as organizing principles for decades.[5] These policymakers just have yet to come up with any workable standards.

Given these issues, businesses have turned to the judiciary, where recent legal challenges to the NLRB's and DOL's new rules show some promising signs that continued, strong advocacy can prevail over administrative overreach. Even when courts apply traditional, common-law standards, recent outcomes tend to be more predictable than new rules that indeterminately broaden the scope of joint employer and independent contractor classification liability.

2. JOINT EMPLOYER

Last year, the NLRB issued its new rule on joint employer liability, which as expected, once again attempted to dramatically expand the reach of the National Labor Relations Act (NLRA). In an eleventh-hour move, a federal court vacated the NLRB's new rule and restored its more bounded predecessor issued under the Trump administration. With respect to franchise-related litigation over the joint employer standards under the Fair Labor Standards Act (FLSA) and Title VII of the Civil Rights Act of 1964 (Title VII), where litigants continue to grapple with a patchwork of judicially developed tests, most cases fared well for franchisors facing joint employer liability, and those that did not provide helpful guidance for how to mitigate the risk.

2.1 NLRA Joint Employer

Given the regulatory ping-pong over the last decade, it would be difficult to understand the status of joint employment under the NLRA without some background, which explains why uncertainty continues despite the recent success by those challenging the NLRB's new rule. While their arguments have persuasive merit, they must

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[1] 29 C.F.R. § 103.40 (2023).
[2] 29 C.F.R. § 795.105, .110 (2023).
[3] 29 C.F.R. § 103.40 (2020); 86 Fed. Reg. at 1426–48.
[4] H.J. Res. 98, 118th Cong. (2023); S.J. Res. 49, 118th Cong. (2023); Statement of Administration Policy, Executive Office of the President (January 8, 2024) *available at* https://www.whitehouse.gov/wp-content/uploads/2024/01/HJRes-98-SAP.pdf ("If the President were presented with H.J. Res. 98, he would veto it.").
[5] The Protecting the Right to Organize Act, H.R. 20, 118th Cong. (2023).

not only survive appeal, but also the determination of the current NLRB to continue revisiting the joint employer standard in the future.

2.1(i) Background

Although defined nowhere in the NLRA, the idea that two or more entities can be "joint employers" has long been recognized by courts and the NLRB.[6] Historically, common law agency principles guided the meaning of an "employer" under the NLRA.[7] Courts and the NLRB followed this approach because they read the 1947 Taft-Hartley Amendments to the NLRA as implying that the definitions of "employer" and "employee" should be based on general agency principles, not labor and economic policies.[8] And so under the resulting common law agency test, a joint employer arises under the NLRA if it exercises "actual" and "significant control" over "essential terms and conditions of employment."[9] The NLRB followed this test for decades in declining joint employer status over those that merely had reserved or exercised indirect control.[10]

This changed in 2015 when the NLRB took a new approach to the joint employer standard in *Browning-Ferris Industries of California, Inc.*, reasoning it was "increasingly out of step with changing economic circumstances," despite the fact Congress had not changed the law since 1947.[11] In the NLRB's view, a joint employer can arise under the NLRA merely when it possesses a "reserved right" or by exercising "indirect" control: "[The NLRB] will no longer require that a joint employer not only possess the authority to control employees' terms and conditions of employment, but must also exercise that authority, and do so directly, immediately, and not in a 'limited and routine' manner."[12]

Just a few years later in 2018, the D.C. Circuit partially reversed *Browning-Ferris*. While the court agreed with the NLRB that "both reserved authority to control and indirect control can be relevant factors in the joint-employer analysis," it did not decide whether

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[6] *Boire v. Greyhound Corp.*, 376 U.S. 473, 481 (1964) ("Whether Greyhound, as the Board held, possessed sufficient control over the work of the employees to qualify as a joint employer . . . is essentially a factual issue"); *Franklin Simon & Co., Inc.*, 94 NLRB 576, 579 (1951) ("Under these circumstances, we are of the opinion and find that Franklin Simon and Kays-Newport constitute joint employers of the shoe department employees.").

[7] *N.L.R.B. v. United Ins. Co. of Am.*, 390 U.S. 254, 256 (1968) ("[T]here is no doubt that we should apply the common law agency test here in distinguishing an employee from an independent contractor.").

[8] *N.L.R.B. v. Town & Country Elec., Inc.*, 516 U.S. 85, 94 (1995) ("Congress intended to describe the conventional master-servant relationship as understood by common-law agency doctrine."); *Loc. 777, Democratic Union Org. Comm., v. N.L.R.B.*, 603 F.2d 862, 880 (D.C. Cir. 1978) ("Congress did not intend that an unusually expansive meaning should be given to the term 'employee' for the purpose of the Act.").

[9] *N.L.R.B. v. Browning-Ferris Indus. of Pennsylvania, Inc.*, 691 F.2d 1117, 1124 (3d Cir. 1982) ("[W]here two or more employers exert significant control over the same employees-where from the evidence it can be shown that they share or co-determine those matters governing essential terms and conditions of employment-they constitute 'joint employers' within the meaning of the NLRA."); *TLI, Inc.*, 271 NLRB 798 (1984) ("[B]y contract Crown maintained for itself the daily operational control of the drivers and, in fact, exercised such control."); *Laerco Transportation*, 269 NLRB 324 (1984) ("To establish joint employer status there must be a showing that the employer meaningfully affects matters relating to the employment relationship such as hiring, firing, discipline, supervision, and direction.").

[10] *Am Prop. Holding Corp.*, 350 NLRB 998, 1000 (2007) ("[T]he Board does not rely merely on the existence of such contractual provisions, but rather looks to the actual practice of the parties."); *In Re Airborne Freight Co.*, 338 NLRB 597 (2002) ("The essential element in this analysis is whether a putative joint employer's control over employment matters is direct and immediate.").

[11] *Browning-Ferris Indus. of Cal., Inc.*, 362 NLRB 1599, 1599 (2015).

[12] *Id.* at 1613–14.

either would be sufficient alone to establish joint employment.[13] Instead, the court held that the NLRB "fail[ed] to articulate any 'blueprint for what counts as "indirect" control'" and "never delineated what terms and conditions are 'essential' to make collective bargaining 'meaningful.'"[14] In distinguishing relevant terms and conditions, the court explained how "decisions that set the objectives, basic ground rules, and expectations for a third-party contractor cast no meaningful light on joint-employer status."[15] As a result, the court instructed the NLRB "to erect some legal scaffolding that keeps the inquiry within traditional common-law bounds and recognizes that '[s]ome such supervision is inherent in any joint undertaking, and does not make the contributing contractors employees.'"[16]

In 2020, the NLRB reconstituted under the Trump administration issued a new rule codifying its return to common law principles developed over decades before *Browning-Ferris* upset them in 2015. Under the 2020 rule, to be a joint employer one "must possess and exercise such substantial direct and immediate control over one or more essential terms or conditions of . . . employment as would warrant finding that the entity meaningfully affects matters relating to the employment relationship with those employees."[17] While evidence of indirect control is "probative," the rule clarifies it is not sufficient alone.[18] The rule also defines the "essential terms and conditions of employment" exhaustively as "wages, benefits, hours of work, hiring, discharge, discipline, supervision, and direction."[19] For each term, the rule specifies what counts as direct control and what does not.[20]

2.1(ii) NLRB's 2023 Rule

In October 2023, the NLRB, now reconstituted under the Biden administration, issued another new rule, revoking the 2020 rule, and once again expanding the scope of joint employer to include merely "[p]ossessing the authority to control . . . regardless of whether control is exercised" and "[e]xercising the power to control indirectly . . . regardless of whether the power is exercised directly."[21] The rule also adds two new broad categories to the "essential terms and conditions of employment," including "work rules and directions governing the manner, means, and methods of the performance" and "working conditions related to the safety and health of employees."[22]

In case that was not broad enough, the 2023 rule further omits a limitation from the 2020 rule that control over workers "exercised on a sporadic, isolated, or de minimis

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[13] *Browning-Ferris Indus. of Cal., Inc. v. NLRB*, 911 F.3d 1195, 1222 (D.C. Cir. 2018) ("[W]hether indirect control can be "dispositive" is not at issue in this case.").
[14] *Id.* at 1220.
[15] *Id.* at 1219–20.
[16] *Id.* at 1220.
[17] 29 C.F.R. § 103.40(a) (2020).
[18] *Id.*
[19] *Id.* § 103.40(b).
[20] *Id.* § 103.40(c).
[21] 29 C.F.R. § 103.40(e) (2023).
[22] *Id.* § 103.40(c) The other "essential terms and conditions of employment" under the rule are: "Wages, benefits, and other compensation;" "Hours of work and scheduling;" "The assignment of duties to be performed;" "The supervision of the performance of duties;" and "The tenure of employment, including hiring and discharge." *Id.*

basis" is insufficient to establish status as a joint employer.[23] The 2023 rule further discards another limiting principle guiding even the *Browning-Ferris* decision in 2015: that a joint employer possess "sufficient control over employees' essential terms and conditions of employment *to permit meaningful collective bargaining*," which embodies one of the NLRA's fundamental purposes.[24]

Initially set to go into effect on December 26, 2023, the NLRB postponed the 2023 rule's effective date to February 26, 2024 after a coalition of business groups including the U.S. Chamber of Commerce and the International Franchise Association filed a lawsuit in the U.S. District Court for the Eastern District of Texas challenging the rule.[25] The court further postponed the rule's effective date to March 11, 2024, and shortly before issued its final judgment in the case.[26]

2.3(iii)Chamber of Commerce of the U.S., v. NLRB

In, *Chamber of Commerce of the U.S., v. NLRB*, the Chamber's challenge rested on the grounds that the 2023 rule is inconsistent with the common law and its failure to articulate a comprehensible standard rendered it arbitrary and capricious.[27] Both the Chamber and the NLRB filed motions for summary judgment, while the NLRB sought to transfer the case on jurisdictional grounds to its presumptively more favorable D.C. Circuit.[28] Ultimately, the court granted the Chamber's motion for summary judgment, and denied both of the NLRB's motions, which resulted in the 2023 rule's revocation and the 2020 rule's restoration.[29]

According to the NLRB, the "regulatory framework involves two steps." [30] First, the entity must be a "common-law employer," and then second, "it must also have control over one or more essential terms and conditions of employment."[31] The court thus observed, "The interpretive dispute first turns on whether the new rule has a meaningful 'step two' analysis filter for qualifying as a joint employer," beyond its "initial requirement that a joint employer be a common-law 'employer.'"[32] Given the new rule's breadth, the Chamber objected that "the second test is always met if the first test is met."[33] In that case, the 2023 rule is either the same as the common law agency test, or more likely much broader.[34]

This was easy enough to show. When asked during oral argument for an example of an entity satisfying step one but not step two, the NLRB replied, "there might be a

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[23] 29 C.F.R. § 103.40(d) (2020).
[24] *Browning-Ferris*, 362 NLRB at 1600.
[25] *Chamber of Com. of the U.S.*, v. NLRB, 2024 WL 1203056 at *8 (E.D. Tex. Mar. 8, 2024).
[26] *Id.*
[27] *Id.* at *8.
[28] *Id.*
[29] *Id.* at *17.
[30] *Id.* at *12.
[31] *Id.* at *12.
[32] *Id.* at *11.
[33] *Id.*
[34] *Browning-Ferris*, 911 F.3d at 1219. ("It is the Board's failure when applying that factor in this case to hew to the relevant common-law boundaries that prevent the Board from trenching on the common and routine decisions that employers make when hiring third-party contractors and defining the terms of those contracts."

hypothetical example," but "was unable to back up that suggestion with any actual example," and "candidly admitted that it 'struggled with that.'"[35] Ultimately, the "scaffolding" the D.C. Circuit had instructed the NLRB to erect in 2018 was not doing any work.[36]

The court then proceeded to tear down the framework of the new rule's other provisions. By "stating that exercising indirect control . . . or possessing reserved authority . . . is itself sufficient to establish status as a joint employer," the new rule "make[s] no allowance for further test under the common law of agency."[37] And given how the new rule defines "essential terms and conditions of employment" so broadly, "virtually every entity that contracts for labor" would be a joint employer, since "virtually every contract for third-party labor has terms that impact, at least indirectly, at least one of the specified 'essential terms and conditions of employment.'"[38]

From an administrative law perspective, the court noted that the NLRB's rationale for its new rule "appears arbitrary and capricious":

> [T]he Board . . . failed to reasonably address the disruptive impact of the new rule on various industries . . . , resolve ambiguities in a way making the rule more predictable than common-law adjudication, or explain how the rule does anything other than mandate piecemeal bargaining that will likely promote labor strife rather than peace by forcing an underdefined category of entities to take a seat at a bargaining table and negotiate over a multitude of influences that may otherwise be presented (and resolved) only through the invisible hand of the marketplace.[39]

Ultimately, the court did not make a "definitive resolution" about whether the rule was arbitrary and capricious because it "rest[ed] its conclusion on the unlawfulness of the rule's sweep beyond common-law limits."[40]

The court did, however, decide that the NLRB's revocation of the 2020 rule was arbitrary and capricious. It rejected the NLRB's rationale that the 2020 rule was unlawfully narrow, explaining that "[t]he common law sets of the outer limits of a permissible standard" and the NLRB "has long been permitted . . . to erect prudential requirements within those bounds."[41] Turning to the NLRB's "policy considerations," the court found "it did not articulate a good reason (or any reason at all) why it believed a joint-employer standard set in adjudications to be preferrable to a standard set in rulemaking."[42] The

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[35] *Chamber*, 2024 WL 1203056 at *13.
[36] *Browning-Ferris*, 911 F.3d at 1220.
[37] *Chamber*, 2024 WL 1203056 at *13.
[38] *Id.* at *14.
[39] *Id.* at *15.
[40] *Id.*
[41] *Id.*
[42] *Id.* at *16.

court left open the possibility that "[s]uch a reason may exist, but the Board must at least articulate it for it to support its alternative rationale for the recission."[43]

As a result, the court issued a "final judgment vacating the 2023 Rule, both insofar as it rescinds the current version of 29 C.F.R. § 103.40 and insofar as it promulgates a new version of that regulation."[44] The NLRB will presumably appeal the decision to the Fifth Circuit, where it will await further review.

In the meantime, the NLRB has other, non-mutually exclusive options. The NLRB could engage in "agency nonacquiesence," which generally "refers to the practice of an agency refusing to follow the case law of one court of appeals in actions it takes that will be reviewed by a different court of appeals."[45] In other words, the NLRB could take the position that its recent loss does not apply in other jurisdictions. There is some historical precedent for the NLRB engaging in such controversial practices.[46] The circumstances here, however, would present uncharted legal territory and risk the court's contempt.[47]

Alternatively, the NLRB could go back to the drawing board, trying again to draft a "blueprint for what counts as 'indirect' control" along the D.C. Circuit's advice in 2018.[48] Its last attempt suggests it is an impossible task. But while it toils away on that, it could also propose new rulemaking solely to revoke the 2020 rule. This would send us back to the still uncertain landscape following the D.C. Circuit's partial reversal of *Browning Ferris*. The court in *Chamber* acknowledged a rationale for this "may exist," assuming the NLRB can explain why it would be preferrable to the 2020 rule.[49]

For now, the 2020 rule remains operative, which counts as a significant victory for the franchise business model. But barring a more permanent legislative fix, or the exhaustion of appellate review, joint employment under the NLRA seems likely to remain a topic for years to come.

2.2 FLSA Joint Employer

Since the DOL's recission of the Trump administration's joint employer rule under the FLSA, it has yet to issue any further proposed rulemaking on a replacement. As a result, joint employer claims under the FLSA continue to be guided by judicially developed standards. However, in one significant victory last year, a franchisor overcame allegations

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[43] *Id.*
[44] *Id.* at *17.
[45] Benjamin M. Barczewski, Cong. Research Serv., R47882, Agency Nonacquiescence: An Overview of Constitutional and Practical Considerations 3 (2023).
[46] *Id.* at 17 ("The NLRB has a long history of engaging in venue choice nonacquiescence. The judicial review provision of the National Labor Relations Act (NLRA) permits a challenge to an order issued by the NLRB in multiple circuits, making it difficult for the NLRB to predict which circuit (if any) will hear a challenge to one of its orders.").
[47] *Id.* at 19 ("Intracircuit nonacquiescence has generated considerable debate primarily because it raises serious separation of powers concerns . . . ."); *Heartland Plymouth Ct. MI, LLC v. Nat'l Lab. Rels. Bd.*, 838 F.3d 16, 18 (D.C. Cir. 2016) ("[T]he Board's longstanding 'nonacquiescence' towards the law of any circuit diverging from the Board's preferred national labor policy takes obduracy to a new level. . . . [W]hat the Board proffers as a sophisticated tool towards national uniformity can just as easily be an instrument of oppression, allowing the government to tell its citizens: 'We don't care what the law says, if you want to beat us, you will have to fight us.'").
[48] *Browning-Ferris*, 911 F.3d at 1220.
[49] *Chamber*, 2024 WL 1203056 at *16.

of joint employer liability even when the court rejected its argument that reserved control alone was insufficient. First, some background provides context for the status of joint employment under the FLSA.

Under the Trump administration, the DOL issued a rule effective March 16, 2020 narrowing the standard for joint employment under the FLSA by requiring "actual exercise of control."[50] Soon after, however, much of the rule was vacated by a federal court in New York on September 8, 2020.[51] In July 2021, the Biden administration's DOL announced another rule to fully rescind the Trump-era rule, although it declined to replace it with anything.[52] While the DOL stated it was continuing to consider whether additional guidance is warranted, it has yet to propose any new rulemaking, leaving courts to continue interpreting the scope of joint employer liability under the FLSA.[53]

While the Supreme Court has yet to articulate a joint employer standard for liability under the FLSA, it has noted that its uniquely expansive definition of "employ," meaning "suffer or permit to work," confers a "striking breadth."[54] For the purpose of the FLSA, this has led courts to "expand the scope of employment relationships beyond the common-law understanding" and adopt various iterations of an "economic realities" test.[55]

Most are based on the one articulated by the Ninth Circuit in *Bonnette v. Cal. Health & Welfare Agency*.[56] It considers four factors in imposing joint employer liability:

> [W]hether the alleged employer (1) had the power to hire and fire the employees, (2) supervised and controlled employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records.[57]

Though a few circuits have not articulated a joint employer standard for the FLSA, all others adhere to some variation of this test, with most having created a variety of additional, sometimes non-exhaustive, factors for consideration.

For example, the Ninth Circuit, initially responsible for the more clear-cut *Bonnette* factors, has since ironically developed a more convoluted list of things to consider:

(1) whether the work was a specialty job on the production line;

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[50] 20 C.F.R. § 791.2(a)(3)(i) (2020).
[51] *New York v. Scalia*, 490 F. Supp. 3d 748, 796 (S.D.N.Y. 2020) ("The Department's novel interpretation for vertical joint employer liability conflicts with the FLSA and is arbitrary and capricious.").
[52] 86 Fed. Reg. at 40954 (2021) ("[T]he Department [is] not proposing regulatory guidance to replace the guidance located in part 791.").
[53] *Id.* ("[T]he Department will continue to consider legal and policy issues relating to FLSA joint employment before determining whether alternative regulatory or subregulatory guidance is appropriate.").
[54] *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 326 (1992).
[55] *U.S. Equal Emp. Opportunity Comm'n v. Glob. Horizons, Inc.*, 915 F.3d 631, 639 (9th Cir. 2019).
[56] 704 F.2d 1465, 1470 (9th Cir. 1983).
[57] *Id.* at 1470.

(2) whether responsibility under the contracts between a labor contractor and an employer pass from one labor contractor to another without material changes;

(3) whether the premises and equipment of the employer are used for the work;

(4) whether the employees had a business organization that could or did shift as a unit from one worksite to another;

(5) whether the work was piecework and not work that required initiative, judgment or foresight;

(6) whether the employee had an opportunity for profit or loss depending upon the alleged employee's managerial skill;

(7) whether there was permanence in the working relationship; and

(8) whether the service rendered is an integral part of the alleged employer's business.[58]

As one can see, courts have begun conflating factors from the previously separate standard used for evaluating independent contractor classifications.[59] Courts now grapple not only with the form and extent of control necessary to establish joint employer liability but also the weight to assign various factors as well.[60]

Last year in *Knerr v. Boulder BJ, LLC*, the U.S. District Court for the District of Colorado did just that in holding that a franchisor, its owners, and an affiliated entity were not joint employers under the FLSA.[61] In *Knerr*, former pizza delivery drivers sued the franchisor, multiple franchisees, and various affiliated individuals and entities for violations of the FLSA.[62] The parties filed cross-motions for summary judgment, with the franchisor and other defendants arguing they were not joint employers.[63]

The court articulated the test for determining joint employer status under the FLSA as whether they "co-determine[d] the essential terms and conditions of employment," and "exercise[d] significant control" over the plaintiffs, most importantly control over their termination.[64] Other factors identified by the court included, "the ability to promulgate work rules and assignments," "set conditions of employment," "day-to-day supervision of

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[58] *Moreau v. Air France*, 356 F.3d 942, 947-948 (9th Cir. 2004).

[59] This is a problematic development as the differences between joint employer and independent contractor classification warrant different tests considering different factors. The test for independent contractor classification can consider a broad array of factors bearing on economic realities and workers' dependance because in every misclassification case, the putative employer has at least hired the worker in some capacity, as either an employee or independent contractor, and hiring is one of the most fundamental terms of employment. On the other hand, putative joint employers typically have not hired the employees at issue, and so the relevant factors must bear on their control to establish common law agency. Otherwise, there is no principled distinction between contracting and employing for services, as economic dependence often arises in distribution chains and otherwise normal business affairs.

[60] *Merrill v. Pathway Leasing LLC*, 2018 WL 2214471 at *6 (D. Colo. May 14, 2018).

[61] 2023 WL 6612123 at *7 (D. Colo. July 14, 2023).

[62] *Id.* at *1.

[63] *Id.* at *2.

[64] *Id.* at *6.

employees," and "control of employee records."[65] The court, however, disagreed with the franchisor that the standard required actual control: "Unexercised authority should be considered along with exercised authority in evaluating the level of control a purported employer has over the employment relationship."[66]

Although this sounds like trouble, the court ultimately held that the nature of the franchisor's reserved control did not sufficiently relate to the plaintiffs' essential terms and conditions of employment. The court reasoned that although the franchise agreements obliged franchisees to ensure the drivers had certain qualifications, such as licenses and insurance, and those with unacceptable driving records "be assigned to strictly non-driving duties," these provisions did not give the franchisor control over their employment and termination.[67] The fact the franchisor "promulgated limited 'work rules'" for the drivers was also insufficient to show it "co-determined the essential terms and conditions of their employment."[68] The court further reasoned that a list of the drivers' duties and qualifications in the franchisor's operations manual was merely a "suggested list," and concerned brand protection, not labor practices.[69] Similarly, the court characterized the limits the franchisor set on acceptable labor costs as only "guidelines" that did not determine the drivers' wages.[70]

Ultimately, the key to the franchisor's success in *Knerr* was that "[t]he relevant provisions of the Franchise Agreements and the Operations Manual are focused on protection of the [franchisor's] brand." As the court held, "Requiring conformity with operational standards and details in order to further that aim is not the same as exercising control over the terms and conditions of franchisees' employment relationships."[71] The takeaway is that, in both drafting and litigation, the focus must remain on how franchisees' obligations are intended to uphold franchisors' brand standards and not provide control over essential terms and conditions of employment.

2.3 Title VII Joint Employer

Unlike the FLSA, most courts treat joint employment under Title VII more consistently with the common law of agency.[72] This is because Title VII does not have the same broad definition of "employ" as the FLSA, which courts have found warrants a more expansive version of the economic realities test.[73] Since Title VII contains "completely circular" definitions of "employee" and "employer," courts have generally

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[65] *Id.*
[66] *Id.*
[67] *Id.* at *8.
[68] *Id.*
[69] *Id.*
[70] *Id.* at *9.
[71] *Id.* at *7.
[72] *Felder v. United States Tennis Ass'n*, 27 F.4th 834, 843 (2d Cir. 2022) (common law test); *U.S. Equal Emp. Opportunity Comm'n v. Glob. Horizons, Inc.*, 915 F.3d 631, 638–39 (9th Cir. 2019); *Faush v. Tuesday Morning, Inc.*, 808 F.3d 208, 214 (3d Cir. 2015) (common law test); *Knitter v. Corvias Military Living, LLC*, 758 F.3d 1214, 1225-27 (10th Cir. 2014) (joint employer test instead of hybrid test).
[73] *Glob. Horizons, Inc.*, 915 F.3d at 638–39 ("The economic-reality test is based on the broad statutory definitions found in the FLSA and the AWPA and the regulatory guidance described above. . . . Because those features are not present in the Title VII scheme, we see no basis for supplanting the common-law test with the economic-reality test.").

heeded the Supreme Court advice to rely "on the common law of agency," for which control, not economic dependance, is the principal consideration.[74]

Nevertheless, courts still vary in how they interpret and apply the common law agency test under Title VII. For example, the Fourth Circuit has developed a "hybrid test," which purports to combine common law agency principles with the economic realities test, although "the common-law element of control remains the 'principal guidepost' in the analysis."[75] This has led some courts to question whether there is any "functional difference" between these various formulations of the test.[76]

Despite this unsettled landscape, there were several cases over the last year in which franchisors prevailed in avoiding joint employer liability under Title VII. These cases reflect a positive trend towards courts weighing a putative employer's control under the common law of agency as more significant than a putative employee's economic dependance under the economic realities test. In one case where a franchisor failed to successfully resolve its joint employer status on a motion to dismiss, the alleged facts provide helpful guidance for what to avoid.

In *Moody v. Empire Hotel Development, Inc.*, a group of plaintiffs alleged claims for employment discrimination against a hotel franchisee, their formal employer, as well as its franchisor as a joint employer.[77] In addition to other joint employer allegations about the franchise relationship, the plaintiffs focused on the fact the franchisor sent corporate trainers during the hotel's opening, who during their weeklong training, subjected them to discrimination.[78]

On summary judgment, the U.S. District Court for the Southern District of New York held the franchisor was not a joint employer.[79] The court applied recent Second Circuit precedent holding "that to establish a joint employment relationship with an entity other than a plaintiff's direct employer, the plaintiff must show that the purported joint employer exercised 'significant control' over the terms and conditions of the employee's employment."[80] In other words, "not just operational control or supervision over the plaintiff's formal employer."[81]

The court applied this standard to hold that many common aspects of a franchise relationship did not support a finding of joint employment liability. The court cited the franchise agreement's allocation of employment responsibilities to the franchisee, the

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[74] *Clackamas Gastroenterology Assocs., P.C. v. Wells*, 538 U.S. 440, 444–45 (2003) (ADA); *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323, (1992) (ERISA); *Cmty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 740 (1989) (Copyright Act).

[75] *Butler v. Drive Auto. Indus. of Am., Inc.*, 793 F.3d 404, 414 (4th Cir. 2015); *see also Love v. JP Cullen & Sons, Inc.*, 779 F.3d 697, 702 (7th Cir. 2015) ("the Knight test is merely a more structured analysis of whether the putative employer exercised sufficient control, and whether the "economic realities" are such that the putative employer can be held liable under Title VII.").

[76] *Murray v. Principal Fin. Grp., Inc.*, 613 F.3d 943, 945 (9th Cir. 2010).

[77] 2023 WL 5480729 at *1 (S.D.N.Y. Aug. 24, 2023).

[78] *Id.* at *2.

[79] *Id.* at *1.

[80] *Id.* at *5.

[81] *Id.*

franchisee's use of its own employment documents, policies, and practices, as well as the franchisee's general control over its employees' hiring, scheduling, pay, job duties, records, discipline, direction, and supervision.[82]

The court rejected the plaintiffs' argument that the franchisor's "one-week Brand Standards Training and franchise relationship" constituted "sufficient control over the terms and conditions of the employee's employment" to warrant a finding of joint employment.[83] The court cited with approval other cases holding that "[c]ourts 'have generally concluded that franchisors are not employers.'"[84]

In *Teague v. 7-Eleven, Inc.*, a pro se plaintiff alleged an employment discrimination claim against a franchisor, without also suing its franchisee, who was her formal employer.[85] The plaintiff alleged that "'to the best of [her] knowledge . . . [she has] only worked for [the franchisor],' noting that almost everything 'that was presented to [her] was from [the franchisor]," mostly because it bore the franchisor's logos.[86]

On summary judgment, the U.S. District Court for the Central District of Illinois held the franchisor was not a joint employer.[87] The court applied the Seventh Circuit's version of an "economic realities" test to analyze joint employment under Title VII, under which the common law of agency is reflected by the fact "the employer's right to control is the most important [factor], and a court must give it the most weight."[88]

In ruling for the franchisor, the court found "minimal evidence to support that [the franchisor] exercised control and supervision over Plaintiff's work."[89] According to the franchise agreement, the franchisee "exercised 'complete control'" over its employees.[90] Further, the franchisor "took no part in [the franchisee's] employment policies and decisions," and "was not involved in hiring, supervising, disciplining, or firing employees."[91]

Although the plaintiff presented evidence that the franchisor's "name and logo appeared on her uniform and various company papers," the court held that "does not show [the franchisor] exercised control over her but rather suggests that Plaintiff worked at a . . . franchise conforming to the requisite . . . franchise image."[92] The court observed how the franchise agreement "emphasizes the importance of 'uniform presentation' . . . and establishes certain guidelines to maintain the '[the franchisor's] Image,' such as

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[82] *Id.*
[83] *Id.* at *6.
[84] *Id.* at *5 (citing *Rivers v. Int'l House of Pancakes*, 2021 WL 860590 at *3 (S.D.N.Y. Mar. 8, 2021) (quoting *Cordova v. SCCF, Inc.*, 2014 WL 3512838 at *4 (S.D.N.Y. July 16, 2014) (collecting cases)).
[85] 2023 WL 4426017 at *1 (C.D. Ill. July 10, 2023).
[86] *Id.* at *3.
[87] *Id.* at *6.
[88] *Id.* at *2.
[89] *Id.* at *4.
[90] *Id.*
[91] *Id.*
[92] *Id.*

ensuring 'excellent customer service' and conforming to 'changes in operating standards, products, programs, services, methods, forms, policies and procedures.'"[93]

In *Goodwill v. Anywhere Real Est. Inc.*, a plaintiff alleged joint employer liability for employment discrimination against both a franchisee and franchisor of real estate agencies.[94] The plaintiff's narrative told how, since the franchisor "has the power to terminate the franchise agreements," it also has the "power to force franchisees . . . to comply strictly with [its] policies, procedures, and guidelines," which "acts as a kind of straight jacket that gives [it] de facto control over a franchisee's day-to-day operations."[95] Specifically, the plaintiff argued the franchisor's involvement with training, professional ethics and regulatory issues, and tracking of information about individual agents "demonstrates that [the franchisor] has direct involvement with the personnel management of individual [employees]."[96]

The U.S. District Court for the District of Maine granted the franchisor's motion to dismiss holding the plaintiff's allegations failed to state a claim for joint employer liability.[97] The court applied the First Circuit's joint employer test,[98] which articulates a "host of factors," and requires the joint employers to "exert significant control over the same employees and share or co-determine those matters governing essential terms and conditions of employment."[99]

The court described the plaintiff's allegations, "essentially [the franchisor's] provision of hand-crafted policies and training-technology systems, information collection and sharing, and professional ethics oversight," as merely "establish[ing] a typical franchise scenario, albeit one catered to professional services."[100] As a result, the court held that "the provision of these documents, tools, and systems and the collection of data do not support the inference that [franchisor] is a participant, let alone an authoritative force, when it comes to employee relations between [its franchisee] and its realtors such as in regard to matters associated with compensation, assignments, discipline, retention, or the like."[101]

In *Doe v. Golden Krust Caribbean Bakery & Grill Inc.*, a plaintiff alleged claims for hostile work environment and retaliation against a franchisee, her formal employer, as well as its franchisor as a joint employer.[102] In addition to other characteristics omnipresent in every franchise relationship, the plaintiff alleged the franchisor "set[] and enforce[d] requirements on all of its franchises . . . in areas such as monitoring employee

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[93] *Id.* at *3.
[94] 2023 WL 4034372 at *1 (D. Me. June 15, 2023).
[95] *Id.* at *1.
[96] *Id.* at **1–2.
[97] *Id.* at *4.
[98] *Id.*
[99] *Rivera-Vega v. ConAgra, Inc.*, 70 F.3d 153, 163 (1st Cir. 1995).
[100] 2023 WL 4034372 at *4.
[101] *Id.*
[102] 2023 WL 2652264 at *1 (E.D.N.Y. Mar. 27, 2023).

performance and specifying procedures that employees must follow (thus controlling employees' work, including the work of Plaintiff)."[103]

The U.S. District Court for the Eastern District of New York granted the franchisor's motion to dismiss holding the plaintiff's allegations failed to state a claim for joint employer liability.[104] As discussed above, the court applied the same recent Second Circuit precedent to "analyze a list of non-exhaustive factors drawn from the common law of agency," and requiring joint employers to "share significant control of the same employee," specifically referring to "daily employment activities."[105]

The court distinguished the plaintiff's allegations about "various aspects of day-to-day control or influence that [the franchisor] had over the [franchisee]," holding they were immaterial, and explained that the relevant inquiry focused instead on "how that allowed the [franchisor] to control Plaintiff's 'daily employment activities.'"[106] The court held the plaintiff's allegations about the franchisor "monitoring employee performance and specifying procedures that employees must follow" did not mean it was "directly involved in her 'hiring, firing, training, promotion, discipline, supervision, . . . handling of records, insurance, [or] payroll.'"[107]

The court contrasted the situation where a joint employer "visited plaintiff's workplace," "evaluated plaintiff," and "that as a direct result of that evaluation plaintiff was terminated."[108] Thus, absent allegations of the franchisor's "direct contact with the Plaintiff or personally supervis[ing] her work," the court found her allegations insufficient to state a claim for joint employer liability.[109]

In *Acuff v. Dy N Fly, LLC*, a plaintiff alleged hostile work environment against a franchisee, her formal employer, as well as its franchisor as a joint employer.[110] According to the plaintiff, the franchisee's owner-manager sexually harassed her and other employees, and after reporting that to the franchisor's owner, the franchisee did not re-hire her on return from sick leave.[111]

The U.S. District Court for the Southern District of Michigan denied the franchisor's motion to dismiss holding the plaintiff's allegations stated a claim for joint employer liability. The court applied the Sixth Circuit's joint employer test, which "look[s] to an entity's ability to hire, fire or discipline employees, affect their compensation and benefits, and direct and supervise their performance."[112]

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[103] *Id.* at *4.
[104] *Id.* at *5.
[105] *Id.* at *3.
[106] *Id.*
[107] *Id.* at *4.
[108] *Id.*
[109] *Id.*
[110] 2023 WL 3293278 at *1 (E.D. Mich. May 5, 2023).
[111] *Id.* at **1–3.
[112] *Id.* at *4; *see also E.E.O.C. v. Skanska USA Bldg., Inc.*, 550 F. App'x 253, 256 (6th Cir. 2013).

The court identified several allegations relating to the franchisor's direct involvement with the situation that plausibly established its status as a joint employer:

- The franchisor's owner "personally introduced" one of the harassed employees to the franchisee "for the purpose of her working as a manager";
- The franchisor's owner "dictated . . . word-for-word a text message" for one of the harassed employees to send to the franchisee in attempt to address his conduct;
- After one of the harassed employees reported the franchisee's conduct to the franchisor's owner, he said he would meet with the franchisee to "address [his] conduct"; and
- The franchisor's owner offered one of harassed employees a severance payment in exchange for a release.[113]

While maybe well-intentioned, these are obviously things a franchisor should not do to mitigate joint employer risk.

The court also observed that the franchisor's operations manual "imposes detailed policies governing terms and conditions of employment, including workplace sexual harassment."[114] While the court noted that the franchise agreement "disclaim[ed] . . . responsibility over personnel decisions," and identified it as a "factor that weighs against Plaintiffs' joint employer theory," it held it was "*not* a decisive one, especially at the pleadings stage."[115]

Acuff presents a fact pattern that can be avoided. The court declined to dismiss the plaintiff's joint employer claims against the franchisor because it directly involved itself in the franchisee's employment practices. If a franchisee's employee reports employment-related misconduct to a franchisor, it may be necessary to consider whether and how it could impact brand standards and the franchisee's obligations under the franchise agreement, but the response to the employee should be to consult the franchisee's employment policies, and if necessary, consult a lawyer.

In *Moody*, *Teague*, *Goodwill*, and *Golden Krust*, the courts held that fundamental characteristics typical of most franchise relationships are generally insufficient to turn franchisors into joint employers. The most important factor tends to be control, and in the areas where a franchisor reserves or exercises its control, so long as they are sufficiently related to brand standards, as opposed to essential terms and conditions of employment, franchisors can reduce their joint employer risk under Title VII.

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[113] 2023 WL 3293278 at *5.
[114] *Id.* at *6.
[115] *Id.*

3. MISCLASSIFICATION

Earlier this year, the DOL issued a new rule casting greater uncertainty over worker classifications. The new rule eliminates the DOL's previous guidance about which of its non-exhaustive factors are of primary importance. As a result, franchisors must again consider how unique aspects of their franchise systems might implicate any number of conceivable factors that could be used to determine whether their franchisees could be classified as employees.

Fortunately, the DOL has not gone so far as to adopt the ABC test, which starts from the assumption that all workers are employees. In Massachusetts, one of the states that has adopted the ABC test, a closely watched decision over its applicability to the franchise model is once again up for appellate review.[116]

3.1 FLSA Independent Contractor Classification Test

A worker is an employee under the FLSA if "as a matter of economic reality the worker [is] dependent upon the business to which [he or she] render[s] service."[117] This standard is not derived from the text of the FLSA itself, which as discussed above, has an exceeding broad and unhelpful definition of "employ."[118]

Instead, the "economic realities" test is derived from the Supreme Court's decision in *Bartels v. Birmingham*.[119] Lower courts have articulated variations of the factors relevant to the inquiry, but the most common six are: (1) the employer's ability to control the manner of the worker's performance, (2) the worker's opportunity for profit or loss as a result of his or her own managerial skills, (3) the worker's investment in materials to be used in the work, (4) whether the work requires a special skill, (5) the extent to which the worker's relationship with the alleged employer is permanent, and (6) the degree to which the work performed is integral to the alleged employer's business.[120]

The economic realities test considers the "totality of the circumstances," meaning that no one factor is dispositive.[121] Since the factors are non-exhaustive, courts have expanded upon and recharacterized those listed above.[122] "The ultimate concern is whether, as a matter of economic reality, the workers depend upon someone else's business for the opportunity to render service or are in business for themselves."[123]

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[116] 81 F.4th 73, 74 (1st Cir. 2023).
[117] *Bartels v. Birmingham*, 332 U.S. 126, 130 (1947).
[118] 29 U.S.C. § 203(e)(1).
[119] *Bartels*, 332 U.S. at 130.
[120] *Karlson v. Action Process Serv. & Private Investigations, LLC*, 860 F.3d 1089, 1092 (8th Cir. 2017); *Brock v. Superior* *912 *Care*, 840 F.2d 1054, 1058 (2d Cir.1988); *Donovan v. Dial-America Marketing, Inc.*, 757 F.2d 1376, 1382 (3rd Cir. 1985); *Donovan v. Brandel*, 736 F.2d 1114, 1119-20 (6th Cir.1984).
[121] *Brock*, 840 F.2d at 1058.
[122] *Id.*, at 1059 ("The factors that have been identified by various courts in applying the economic reality test are not exclusive."); *Coal. for Workforce Innovation v. Walsh*, 2022 WL 1073346, at *15 (E.D. Tex. Mar. 14, 2022) ("Over time, the economic reality factors, themselves, have evolved.").
[123] *Brock*, 840 F.2d at 1058.

During the Trump administration, the DOL adopted a rule that provided greater clarity for independent contractor classification under the FLSA.[124] It articulated only five factors, but permitted consideration of others if they "in some way indicate whether the individual is in business for him- or herself, as opposed to being economically dependent on the potential employer for work."[125] It further provided that the "core factors" were control and opportunity for profit or loss.[126]

This year, however, the Biden administration's DOL issued a new rule, effective March 11, 2024, replacing the Trump-era rule.[127] The most important change is that it "returns to a totality-of-the-circumstances analysis of the economic reality test in which the factors do not have a predetermined weight."[128] It also adds, as an explicit factor, the "[e]xtent to which the work performed is an integral part of the potential employer's business."[129] And it explicitly "allows for consideration of reserved rights while removing the provision in the [previous rule] that minimized the relevance of retained rights."[130]

Thankfully, the new rule does not go nearly as far in expanding "employee" status as the infamous "ABC test" adopted in a growing number of states. But since no factors receive greater consideration under the new rule's totality of the circumstances analysis, its indeterminacy makes it more difficult for businesses to predict whether their workers will be treated as independent contractors or employees.

The new rule is facing at least three legal challenges, although none have prevented it from going into effect.[131] Of primary interest, *Coalition for Workforce Innovation v. Su*, revives an existing, stayed action from 2021 challenging a similar rule previously issued by the Biden administration's DOL.[132]

In that case, the U.S. District Court for the Eastern District of Texas vacated the Biden administration's attempt to revoke and replace the Trump administration's rule, but the decision was rendered moot when the DOL withdrew its rule and began working on its current replacement.[133] Now that the DOL has issued its new, retooled rule, the challenge has resumed with summary judgment briefing that will be completed this summer before a court that already struck down a similar rule before.[134]

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[124] 86 Fed. Reg. at 1246–47.
[125] *Id.*
[126] *Id.*
[127] 29 C.F.R. § 795.110 (2024).
[128] 89 Fed. Reg. at 1638.
[129] 29 C.F.R. § 795.110(b)(5) (2024).
[130] 89 Fed. Reg. at 1638.
[131] *Fridard's Transp., LLC v. United States Dep't of Labor*, USDC No. 24-cv-00347 (E.D. La. Feb. 8, 2024); *Warren v. United States Dep't of Labor*, USDC No. 24-cv-00007 (N.D. Ga. Jan 16, 2024); *Coalition for Workforce Innovation v. Su*, USDC No. 21-cv-00130 (E.D. Tex. 2021).
[132] USDC No. 21-cv-00130.
[133] *Coal. for Workforce Innovation v. Walsh*, 2022 WL 1073346 at *20 (E.D. Tex. Mar. 14, 2022) ("Despite the DOL's purported desire to provide clarity, the Department did not address the inconsistencies and lack of coherence in the manner in which the economic realities test was applied across the country prior to the Independent Contractor Rule [issued under the Trump administration].").
[134] USDC No. 21-cv-00130 (ECF No. 49).

3.2 ABC Test

A growing number of states have adopted some version of the ABC test,[135] either through legislation,[136] or judicial activism.[137] Unlike other independent contractor classification tests, the ABC test begins with the presumption that any individual providing services is an employee unless all three prongs of the test are met.[138]

Under the ABC test, the following three requirements must be met for a worker to escape classification as an employee:

> (A) The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
>
> (B) The person performs work that is outside the usual course of the hiring entity's business.
>
> (C) The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.[139]

Prong (B) is the most problematic for franchising, as well as distribution systems and supply chains, and frankly any contracting parties in the same line of work, because their contractors' course of "business" may or may not be similar depending on how broadly or narrowly one describes it.[140] Since the ABC test does not balance factors in determining whether a worker is an employee, its rigid approach makes it far more difficult for businesses to predictably contract for labor or services without exposing themselves to employment liability.

A closely followed case applying Massachusetts' ABC test recently made its way once again to the First Circuit, which has certified yet another pivotal question for the Massachusetts Supreme Judicial Court (SJC).[141] In *Patel v. 7-Eleven, Inc.*, a putative class of franchisees sued their franchisor alleging they were misclassified as independent contractors in violation of state wage law.[142] While the U.S. District Court for the District of Massachusetts initially held the FTC Franchise Rule preempted Massachusetts' ABC

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[135] Jon O. Shimabukuro, Cong. Research Serv., R46765, Worker Classification: Employee Status Under the National Labor Relations Act, the Fair Labor Standards Act, and the ABC Test 3 (2021). ("[The ABC test] has been adopted in at least 20 states and the District of Columbia to determine employee status for purposes of various state labor and employment laws.").

[136] Conn. Gen. Stat. § 31-222(a)(1)(B)(ii); Mass. Gen. Laws Ann. ch. 151A, § 2; N.H. Rev. Stat. Ann. § 282-A:9(III).

[137] *Dynamex Operations W. v. Super. Ct.*, 416 P.3d 1, 40 (Cal. 2018); *Hargrove v. Sleepy's, LLC*, 106 A.3d 449, 453 (N.J. 2015).

[138] Cal. Lab. Code § 2775(b)(1).

[139] *Id.*

[140] Rochelle Spandorf, *The Desperate Consequences of Flunking the "Abcs"*, 41 FRANCHISE L.J. 439, 445 (2022) ("Prong B is the most vexing element of the ABCs as it conditions independent contractor status on a worker performing work outside the usual course of the hiring entity's business.").

[141] *Patel v. 7-Eleven, Inc.*, 81 F.4th 73, 74 (1st Cir. 2023).

[142] *Patel v. 7-Eleven, Inc.*, 485 F. Supp. 3d 299, 302 (D. Mass. 2020), *vacated and remanded*, 2022 WL 4545497 (1st Cir. Apr. 25, 2022).

test's application to franchising, that ruling was vacated after appeal and certified question to the Massachusetts SJC.[143]

After the First Circuit remanded the case back to the district court for further proceedings, it turned to the question of whether the franchisees were employees under Massachusetts' ABC Test, which as a threshold matter only applies to "an individual performing any service."[144] The district court again ruled in the franchisor's favor, holding its franchisees did not meet this threshold.

The district court reasoned the franchisees' contractual obligations were not services performed for the franchisor because it "does not pay the franchisees for the performance of any alleged obligations," but rather it "actually provides the franchisees with services in exchange for franchise fees."[145] While there is case law in other jurisdictions supporting this interpretation,[146] the Massachusetts statute is unique in that other states' statutes limit the ABC test's supplication to services for "remuneration" or "wages."[147]

Now the case is back on the same track, with the franchisees appealing to the First Circuit, who certified another question to the Massachusetts SJC about what "performing any service" means in the context of franchising.[148] The outcome will likely turn on how the court interprets the franchisor's royalty arrangement, in which it "establishes and maintains a bank account, where the store's gross profits are held and from which the [royalty] is paid," and "[a]fter the [the royalty] is paid, [the franchisor] 'agree[s] to . . . pay' each franchisee the remaining gross profits as weekly draw."[149]

These draws, however, are funded entirely from the franchisees own' customer revenue.[150] And while the franchisor also benefits from the revenue through its royalty, the Massachusetts SJC previously held the ABC test's "threshold is not satisfied merely because a relationship between the parties benefits their mutual economic interests."[151] Oral argument took place on April 1, 2024 and a decision by the court is pending.

4. CONCLUSION

Last year's agency rulemaking shows that the franchise community must continue to remain vigilant about policymakers' efforts to expand joint employer and independent

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[143] *Patel v. 7-Eleven, Inc.*, 2022 WL 4545497 at *1 (1st Cir. Apr. 25, 2022); *Patel v. 7-Eleven, Inc.*, 183 N.E.3d 398, 407–11 (Mass. 2022).
[144] *Patel v. 7-Eleven, Inc.*, 618 F.Supp.3d 42, 46 (D. Mass. 2022).
[145] *Id.* at 48.
[146] *AC&C Dogs, LLC v. New Jersey Dep't of Lab.*, 753 A.2d 737, 740 (N.J. App. Div. 2000) (""The implication of this section is that the remuneration flow from the putative employer to the alleged employee."); *Kirby v. Indiana Emp. Sec. Bd.*, 304 N.E.2d 225, 22 (Ind. Ct. App. 1973) (finding that "no services were rendered" where putative workers paid putative employer "a straight percentage of their gross receipts").
[147] Ind. Code § 22-4-8-1; N.J. Stat. § 43:21-19; Wash. Rev. Code § 50.04.140(1); Del. Code tit. 19, § 3302(10)(K); Haw. Rev. Stat. § 383-6; La. Stat. Ann. § 23:1472(12)(E); Neb. Rev. Stat. § 48-604(5); N.H. Rev. Stat. § 282- A:9(III); Nev. Rev. Stat. § 612.085; Vt. Stat. tit. 21, § 1301(6)(B); N.M. Stat. § 51-1-42(F)(5).
[148] *Patel*, 81 F.4th at 76.
[149] *Id.* at 74.
[150] *Id.*
[151] *Patel v. 7-Eleven, Inc.*, 183 N.E.3d 398, 411 (Mass. 2022).

contractor misclassification liability. Strong advocacy helps courts understand franchising and the business model prevail against administrative overreach.

There is no one-size-fits-all to avoiding joint employer and independent contractor misclassification liability. Franchisors must compare the unique aspects of their system with the various factors articulated by agencies and courts, identify weaknesses, and either address them or emphasize others as strengths. In operations, franchisors must train their field representatives about support boundaries. From a risk management perspective, franchisors should consider requiring franchisees to carry employment practices liability insurance with endorsements adding them as additional insureds.

Ultimately, some degree of control is inherent in franchising. The key is to characterize and practice that control by focusing on how it advances brand standards, which is fundamental to franchising, as opposed to day-to-day employment practices, which are the responsibility of franchisees.