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BASICS TRACK: FRANCHISE LITIGATION

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I. INTRODUCTION

All franchise relationships are created by contract: the franchise agreement. Thus, every detail governing dispute resolution, whether its venue, forum, or scope, typically is governed by what the parties reduced to a writing in the contract. Anything not reduced to a writing (and oftentimes even when it is) has to be decided by a third party, typically an arbitrator or a judge, when a dispute arises and the parties do not agree.

This paper provides an overview of common issues that arise in the franchise relationship involving the franchise agreement, including pre-suit resolution, where and when to file a lawsuit, and a general overview of franchise litigation and arbitration. This paper examines these issues from both the franchisee's and franchisor's perspective, and covers commonly asserted claims and defenses by both parties.

II. PROCEDURAL BATTLES

Parties to franchise agreements should be mindful of important details that govern where, what, when, how, and by whom franchise disputes are handled. Details such as jurisdiction, venue, choice of law, and forum (arbitration vs. litigation) are customarily part of most contracts, and frequently incorporated into most franchise agreements. Despite entering into binding contracts, disputes over these provisions arise in the context of franchise disputes. One reason for these disputes is that franchisors and franchisees are frequently located in different states. The party filing the dispute will race to file in the most convenient forum to gain what it perceives as the "home court advantage." Whether arguing over the enforceability of the arbitration clause, jurisdiction, or venue, there is generally a consistent body of law that is applied, so that parties can know the strengths and weaknesses of prevailing on procedural battles.

III. FEDERAL AND STATE FRANCHISE LAWS

Many disputes that arise in the franchise context arise under federal and state franchise laws, which originate from the sale of the franchise or govern the franchise relationship. Compliance with disclosure and other requirements is crucial to avoid liability. Federal and state regulations were enacted to address historical abuse in franchising, setting clear standards especially involving the sale of franchises. Depending upon which state you are in, there are additional hurdles and barriers to entry into the franchise sales market for franchisors and franchisees.

In the United States, the sale of every franchise must meet federal requirements, in addition to state franchise requirements and state relationship requirements, which can vary from state to state.[1] Federal Franchise Rule 16 C.F.R. § 436 (the "FTC Rule") contains the majority of the federal obligations and related regulations promulgated by the Federal Trade Commission (the "FTC").

The number one directive from the FTC is that a franchisor must provide

[1] *State Franchise Laws*, https://franchise.law/state-franchise-laws/ (last visited April 15, 2022).

prospective franchisees an appropriate franchise disclosure document, or an "FDD," at least 14 days before entering into a franchise agreement for the sale of a franchise or accepting any payment connected with the franchise sale. The purpose of the FDD is to provide prospective franchisees with information about the franchisor, the franchise system, and the agreements they will need to sign so that they can make an informed decision before deciding to make the investment in the franchise.[2]

The FDD must include twenty-three (23) items ranging from contact information, the trademark that the franchisees will use, a description of the business, and language that includes the estimated cost of the franchise investment.[3] It is important to note that while the FTC rule establishes the requirements for the FDD, FTC staff do not review or approve the FDD in advance of publication. Therefore, a prudent franchisee should consult with an experienced franchise lawyer to make sure they perform the proper due diligence before signing up. Despite the federal regulation, the FTC Rule does not confer a private right of action on an aggrieved franchisee. However, this does not change the burden for the franchisor. All franchisors must be diligent and truthful, and must adhere to the Rule requirements, as FTC staff can investigate and bring actions in federal court for violations.[4]

Beyond the FTC Rule, twenty-five States impose additional requirements on franchisors to either register or file in order to remain in compliance with state law by way of state statutes. Registration states require franchisors to register the FDD and other franchise information on an annual basis.[5] Other states have what are called "business opportunity" laws, which regulate the sale of business opportunities in those states. Although franchises and business opportunities are different, these states require that franchises be filed before they can be sold under some circumstances.[6] Depending on the state, the filing may be annual, one time, or none at all if a franchisor utilized a registered trademark with their brand. The remaining twenty-five states do not have franchise statutes.[7]

Additionally, a number of states have special laws aimed at protecting local

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[2] 16 CFR §436.2

[3] 16 CFR §436.5. The complete list of 23 items can be found in the following article: *What Information Does a Franchise Disclosure Document (FDD) Contain?*, https://www.franchise.org/faqs/what-information-does-a-franchise-disclosure-document-fdd-contain (last visited April 14, 2022).

[4] *F.T.C. v. Minuteman Press*, 53 F. Supp. 2d 248, 258 (S.D.N.Y. 1998).

[5] There are 14 registration states that require franchisors to register the FDD and other information on an annual basis: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. *See State Franchise Laws*, https://franchise.law/state-franchise-laws/ (last visited April 15, 2022).

[6] There are 11 states with business opportunity laws or laws that require that franchises be filed before they can sell franchises: Connecticut, Florida, Georgia, Kentucky, Louisiana, Maine, Nebraska, North Carolina, South Carolina, Texas, and Utah. While not a franchise statute, Oregon has the Oregon Trade and Regulation and Practices Act (Or. St. §650.005). *See State Franchise Laws*, https://franchise.law/state-franchise-laws/ (last visited April 15, 2022).

[7] The 25 states are: Alabama, Alaska, Arizona, Arkansas, Colorado, Delaware, District of Columbia, Idaho, Iowa, Kansas, Massachusetts, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Oklahoma, Pennsylvania, Tennessee, Vermont, West Virginia, and Wyoming. *See State Franchise Laws*, https://franchise.law/state-franchise-laws/ (last visited April 15, 2022).

franchisees. For example, some state franchise relationship laws may require particular timing of notice of non-renewal, and some states also require "good cause" for the franchisor not to renew the relationship.[8] Most of these statutes define "good cause" to be conduct imputable solely to the franchisee, such as failure to comply with a material provision of the franchise agreement. When a franchisor terminates a franchise agreement, the terminated franchisee may seek to invoke the protection of the franchise law in the state in which the franchisee is located, notwithstanding the fact that the agreement provides that the law of the franchisor's state applies.[9]

A. State vs. Federal Court

The franchise agreement will likely specify the choice of law, jurisdiction, and forum for any litigation occurring in court. If a suit is not being handled through arbitration, a franchisor or franchisee may decide to sue in state or federal court. The determination of whether the matter should be filed and heard in state or federal court depends on the nature of the substantive claims, where the parties reside, and whether or not the franchise agreement has a venue clause. The court must have authority to decide the claim (i.e. subject matter jurisdiction) and authority over the parties (i.e. personal jurisdiction). If either are lacking, the case will likely be subject to a venue transfer or dismissal.[10] Furthermore, if the franchise agreement contains a valid forum selection clause, the Supreme Court has held that forum selection clauses will control in all but the most exceptional circumstances.[11]

1. Personal Jurisdiction

The issue of personal jurisdiction commonly arises when a franchisor and franchisee are in different states and disagree over where their dispute should be resolved. Naturally, each party wants to litigate in their own backyard. Personal jurisdiction is a constitutional requirement: the United States Constitution, as well as state law, requires that the parties have "certain minimum contacts with the forum" in which the court sits that "does not offend traditional notions of fair play and substantial justice.[12] Since most states' long-arm statutes extend the boundaries of personal jurisdiction as far

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[8] States that require "good cause" for non-renewal are Arkansas, California, Connecticut, Delaware, Hawaii, Indiana, Iowa, Minnesota, Nebraska, New Jersey, Puerto Rico, Rhode Island, U.S. Virgin Islands, and Wisconsin.

9 For an in-depth review of case law, *see* Thomas M. Pitegoff, *Choice of Law in Franchise Agreements*, Franchise Law Journal L.J. 1 (1989-1990).

[10] Venue is governed by the statutory framework at 28 U.S.C. § 1391, Venue generally; § 1404, Change of Venue; § 1406, Cure of Waiver of Venue Defects, and Fed. R. Civ. P. 12(b), Defenses and Objections, the procedural basis to dismiss or transfer venue.

[11] *See Atlantic Marine Constr. Co. v. U.S. Dist. Court for the W. Dist. of Tex.*, 134 S. Ct. 568 (2013) which is an in-depth procedural ruling that discusses forum selection clauses (i.e. when parties have agreed to a forum selection clause, a district court should ordinarily transfer the case to the forum specified in that clause). Moreover, a forum selection clause may be enforced by a transfer motion under Section 1404(a) rather than a motion to dismiss under Section 1406(a) or FRCP 12(b)(3). For a comprehensive discussion of *Atlantic Marine* and its progeny, *see* Earsa Jackson and Jim Meaney, *Forum Selection Clauses After Atlantic Marine*, American Bar Association 37th Annual Forum on Franchising, October 15-17, 2014.

[12] *International Shoe v. Washington*, 326 U.S. 310 (1945).

as the constitutional requirements, most courts combine the analysis into a single inquiry in determining if the requirements of due process are satisfied.[13]

Many courts have found that the franchise agreement and payments required thereunder to the state where the franchisor is headquartered to be sufficient minimum contacts to pass the threshold constitutional question. Absent express language consenting to jurisdiction in the franchise agreement, the Courts will examine whether it is foreseeable that the parties would have to litigate in the state in question.

But what does foreseeability mean? *Burger King v. Rudzewicz* is the seminal case involving a termination of a franchise agreement that examined the issue of personal jurisdiction.[14] There, the franchisor plaintiff, Burger King, based in Florida, sued franchisee defendants based in Michigan in United States District Court for the Southern District of Florida using Florida's long arm statute for breach of contract and trademark infringement under the Lanham Act. Burger King claimed the court's diversity jurisdiction pursuant to U.S.C. §1332, and its original jurisdiction over federal trademark disputes under U.S.C. §1338(a). Burger King alleged that the franchisees breached their franchise agreement "within the jurisdiction of the court by failing to make payments to its place of business in Miami, FL." Ultimately, the court held that there was or should have been a reasonable expectation that the defendant franchisees would be summoned to a Florida court for claims arising out of the franchise agreement because communications and payments to Burger King in Florida were sufficient to constitute a "substantial and continuing relationship" with Florida so that due process would not be violated. Hence, it was foreseeable.

Since *Burger King*, newer cases involving franchising have taken a deeper dive into the jurisdictional analysis. However, what happens when the franchise agreement is silent? The Court may look to factors such as visits by the franchisee to the headquarters of the franchisor, in addition to payments made and received from headquarters to show that the franchisee should have foreseen that they would have to litigate in that state.[15]

2. Subject Matter Jurisdiction

Subject matter jurisdiction involves the type of claim at issue. Both federal and state courts must have the ability to hear the specific kinds of claims at issue to establish subject matter jurisdiction. While state courts generally maintain jurisdiction over a person and can hear any type of claim arising under federal or state law, the Federal District Courts of the United States are granted subject matter jurisdiction over specific types of actions. Unless the statutes specify that the federal courts have exclusive jurisdiction, it

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[13] *Inamed Corp. v. Kuzmak*, 249 F.3d 1356, 1359-60 (Fed. Cir. 2001) (determining whether personal jurisdiction exists over out-of-state defendant involves two inquires: whether a forum states' long arm statute permits service of process, and whether the assertion of personal jurisdiction would violate due process).
[14] *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985)
[15] *Baskin Robbins Franchising, LLC v. Alepenrose Dairly, Inc*., 825 F.3d 28 (1st Cir. 2016). *See also Red Robin Int'l, Inc. v. Lehigh Valley Rest. Group, Inc.*, No. 15-CV-02602-REB-KLM, 2016 WL 397559, at *1 (D. Co. Feb. 2, 2016).

is to be exercised concurrently with that of state courts. The Lanham Act, which governs trademark infringement actions, is an example of a federal statute that provides for concurrent jurisdiction in state and federal court.

Unlike state courts, litigants seeking to be heard in federal court must meet certain thresholds in order for the federal court to obtain subject matter jurisdiction. A party wishing to litigate in federal court must either show that the suit arises under a federal question or that there is diversity of citizenship.

a. Federal Question Jurisdiction

Claims that arise under the United States Constitution, a federal law, or a treaty of the United States belong in the category of federal question jurisdiction. The Lanham Act, and claims that arise under federal anti-trust or RICO laws, are examples of claims that invoke federal question jurisdiction.

b. Diversity of Citizenship

Diversity of citizenship is established if the franchisor and franchisee reside in different states (or if either party resides in a foreign country) and the amount at issue exceeds $75,000, exclusive of costs.[16] As with all federal cases, there are heightened pleading requirements. "It is long settled law that a cause of action arises under federal law only when the plaintiff's well-pleaded complaint raises issues of federal law."[17] A plaintiff seeking to invoke federal diversity jurisdiction must plead facts in the complaint to "show that there is 'complete diversity' among all parties, such that no party has the same citizenship as any party on the other side."[18]

Maintenance of an action in federal court based on diversity of citizenship may be problematic when the defendant, as in most franchising cases, is a corporation. A corporation is deemed a citizen of "any state by which it is incorporated and the state where it has its principal place of business."[19] Problems may arise if the corporation has offices in one state in which it holds its board meetings and transacts its financial affairs, but carries on a large part of its actual business operations in other states. Generally, courts look to the activity of the corporation rather than the location of its boardroom or executive offices.[20] Limited liability companies are citizens of every state in which any individual member is a citizen.[21]

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[16] 28 U.S.C. §1331(a).
[17] *Metropolitan Life Ins. Co. v. Taylor*, 481 U.S. 58, 63 (1987).
[18] *Reid v. The Wailers*, 606 F. Supp. 2d 627, 629 (E.D. Va. 2009) (citing 28 U.S.C. §1332(a)).
[19] 28 U.S.C. §1332(c)(1).
[20] *See Kelly v. U.S. Steel Corp.*, 284 F.2d 850 (3d Cir. 1960) (holding that the principal place of business of United States Steel Corporation was in Pennsylvania where the greater part of the staff was located, and not in New York where its board met, it did its banking business, and from which dividends were mailed).
[21] *See Americold Realty Trust v. ConAgra Foods, Inc.*, 136 S. Ct. 1012, 1016-17 (2016); *Lindley Contours, LLC v. AABB Fitness Holdings, Inc.*, 414 F. App'x 62, 64 (9th Cir. 2011); *Johnson v. Columbia Properties Anchorage, LP*, 437 F.3d 894, 899 (9th Cir. 2006).

The majority of franchise disputes are litigated in federal court rather than state court because they typically involve monetary claims or legal rights valued at more than $75,000 and they arise between franchisors and franchisees or vendors who are often located in different states. In cases where the only relief sought is an injunction or a declaration of rights (and not the recovery of damages), the $75,000 jurisdictional requirement is measured by the value of the rights to be vindicated.

3. Forum Selection Clauses

Generally, franchisors and franchisees typically prefer to litigate or arbitrate in their home venues. A forum selection clause can help identify where a dispute should be heard. Franchise agreements usually contain a forum selection clause that provides that all or certain types of disputes between the franchisor and franchisee are required to be filed in a state or federal court where the franchisor is located. Some franchise agreements contain mandatory forum selection clauses for most claims that can arise but reserve the right to sue in the franchisees' home state courts for particular claims, such as enforcing post-term trademark rights or non-compete covenants.

In the franchise context, battles over forum selection clauses arise when the franchise agreement is not carefully drafted to contain a mandatory clause. However, even with a carefully drafted franchise agreement, disputes arise over the scope of the clause and whether it covers the claims in issue. More often, disputes over the enforceability of the forum selection clause may ensue. Federal law governs the enforceability of forum selection clauses in diversity cases, and recognizes only three exceptions to their enforceability: (1) that the inclusion of the forum selection clause in the agreement was the product of overreaching; (2) that the party challenging the enforcement will, for all practical purposes, be deprived of its day in court because of the inconvenience or unfairness of the selected forum; and (3) that the enforcement of the forum selection clause would contravene a strong public policy of the forum state.[22]

Typically, it is the franchisee who will challenge the forum selection clause. It is rare that a franchisee can successfully challenge a forum selection clause on the basis of fraud because of the unambiguous form of the clause itself, which is almost always sufficient to defeat a claim that the franchisor mislead the franchisee into thinking it was something different than what it says on its face or that the franchisor would not enforce it. Claims of inconvenience or unfairness are equally difficult to overcome because the party claiming such must show that it cannot afford to litigate its claims in the contractually chosen forum, but that it can afford to litigate if the case proceeds in the forum where the case was filed. Franchisees more often successfully challenged forum selection clauses on the basis that they contravene a strong public policy of the forum state. In fact, the franchise and business opportunity statutes in several states contain anti-waiver

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[22] *See M/S Breman v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972) which held that forum selection clauses were "prima facie valid and should be enforced unless enforcement is shown by the resisting party to be unreasonable under the circumstances". In essence, forum selection clauses were enforceable provided they were freely negotiated and not the result of "fraud, undue influence, or overweening bargaining power." *Id.* at 407 U.S. at 12-13.

language, which seek to override any contractual language that amounts to a waiver of protection of the state statute. Most of the anti-waiver provisions prohibit franchisors from forcing franchisees to waive coverage under state law. While most do not void a contractual provision establishing a forum outside the franchisee's home state, some state statutes have venue statutes applicable to the franchise relationship which franchisees will rely heavily upon to construct some relief from the broad holding of *Atlantic Marine*, *infra.* [23]

B. Pre-suit Considerations of Dispute Resolution

There are unique advantages and disadvantages to both arbitration and litigation that this paper will explore. The pathway to resolving franchise disputes is usually set out in the contractual terms of the franchise agreement, or other operative agreements governing the parties' relationship. The dispute resolution clause of a contract is an important part of the agreement that should not be glazed over. Whether or not your contract has a valid arbitration clause can influence the overall outcome of the dispute. Generally, if the governing contract has a valid arbitration clause, the dispute will be resolved in arbitration. In instances where the contract is silent, the dispute will be resolved in court.

As part of franchise agreements that contain arbitration clauses, franchisors will require disputes be resolved through binding arbitration with a carve out for access to courts in certain cases such as trademark infringement or matters where emergency relief may be needed. Even in franchise agreements that hold each party responsible for their own attorney's fees in arbitration, some franchise agreements specify that if a party attempts to bypass the agreed upon arbitration clause by filing a suit in court, it will result in the losing party paying all attorneys' fees to defend the litigation.

C. Arbitration vs. Litigation: Pros and Cons

Proponents of arbitration commonly point to several advantages it offers over litigation, court hearings, and trials. The benefits of arbitration versus litigation are often debated, and the perspective of those benefits usually depends on which side you are sitting on—franchisee or franchisor—and whether you are bringing the claim or defending it. The three most commonly promoted benefits of arbitration are the following: (1) time, (2) costs, and (3) flexibility. Arbitration is favored because of its procedural simplicity, confidentiality, and faster final judgments. Litigation, on the other hand, is typically preferred over arbitration due to its lower upfront costs, including arbitration filing fees, administrative fees, and arbitrator's compensation fees, as well as access to a jury trial.

By the time a franchise dispute gets to a place where a judge or arbitrator is asked to intervene, the franchisor and the franchisee have likely gone through some type of pre-dispute resolution process or efforts that have failed, and they have exhausted all other

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[23] *See* Earsa Jackson and Jim Meaney, *Forum Selection Clauses After Atlantic Marine*, American Bar Association 37th Annual Forum on Franchising, October 15-17, 2014 for a detailed chart of venue statutes applicable in the franchise context at pp. 17-23.

means. The parties are typically eager to get the matter resolved at that point, however, any dispute resolution involving third parties costs money. Arbitration is designed to allow parties to participate fully, with an opportunity to structure the resolution. In fact, most arbitration agreements give the parties a chance to come to a mutual agreement on the selection of the arbitrator. The intent of arbitration is to allow the parties to work together peacefully to resolve their dispute, rather than punish each other through litigation tactics, such as motion practice and aggressive discovery, both of which also drive up costs.

In any forum, whether it is litigation or arbitration, the longer the dispute takes to decide, the more costly it becomes. Time is money. This is so, not only because of initial filing fees, but also the costs of legal counsel and arbitrators, as they are typically compensated by the hour or by tiered flat rates depending on how much time a matter takes. Other factors, including operation of the franchised business and the ultimate disposition being left in limbo while the dispute is resolved is disruptive and chaotic for the franchisee and their employees. Generally, the franchisor also favors a fast resolution.

While arbitration is usually less costly than litigation because it is faster, the entry fees are higher than traditional litigation. Arbitrations typically require filing and advanced administrative fees up front. Hence, for matters that resolve early, arbitration can prove to be far more costly than traditional litigation if looking at filing fees alone. One study by a consumer watchdog group compared the cost of arbitration versus litigation and found that the cost of initiating an arbitration is significantly higher than the cost of filing a lawsuit: $6,650 to $11,625 to initiate a claim to arbitrate a consumer claim worth $80,000 versus $221 to file that action in a particular county court.[24] However, these figures are not truly comparing “apples to apples,” as they include the arbitrator’s compensation costs but not the cost of private attorney’s fees to litigate. It remains to be seen whether litigation in court or arbitration is the most cost effective in early termination situations.

1. Time: How fast is arbitration vs. litigation when completed?

Arbitration is designed to be a prompt and efficient administration of disputes, offering parties faster, final decisions while having access, even without an attorney, due to its simple procedures. On average, it takes 222 days—or 75% of the process to reach a hearing stage with the American Arbitration Association (“AAA”).[25] According to the AAA, only one-third of the cases filed with AAA-ICDR will reach the hearing stage.[26] Nearly two-thirds of disputes filed settle before the first hearing, many of which without accruing any arbitrator compensation.[27] Conversely, a case filed in the United States District Court takes more than twelve months or longer to get to trial, far longer than cases adjudicated by an arbitration hearing.[28]

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[24] *The Pros and Cons of Using Arbitration Instead of Litigation,* https://www.nolo.com/legal-encyclopedia/arbitration-pros-cons-29807.html (last visited April 15, 2022).
[25] American Arbitration Association, *Filing Considerations*, https://go.adr.org/covid-19-filing-considerations.html (last visited April 15, 2022).
[26] *Id*.
[27] *Id*.
[28] American Arbitration Association, *Measuring the Costs of Delays in Dispute Resolution*,

How quickly an arbitration proceeding is completed depends on several factors, including the agency and its arbitration rules, the complexity of the matter, the conduct of the other side, and the arbitrator. Depending on the arbitration agency and its rules, some arbitrations can be completed in six months or less. However, if the matter becomes contentious, arbitrations can extend well over a year or more, making the timing similar to that of a traditional litigation case, and undermines the reasoning to favor arbitration.

2. Informal, Flexible Procedures

Arbitration is a less formal process than a traditional court proceeding. Due to its simplified rules of evidence and procedures, it is more accessible to unrepresented (pro se) parties. The setting of an arbitration is more relaxed. Even scheduling arbitration hearings is more flexible than trials—they can be scheduled around the availability of the parties, and even occur on nights and weekends as the arbitrator is a private party and does not have to adhere to a public court schedule. An arbitration is typically held in a conference room versus a courtroom, and the procedural rules are relaxed. Unlike a judge, an arbitrator does not have to follow precedent of outcomes in prior cases or exclude evidence, since arbitration decisions are not published.

Arbitrators have significant discretion as to what evidence will be allowed to be submitted. Therefore, arbitrators can consider key information that would not be admissible in court. They are also able to exercise discretion in making decisions without the same restraints as a court.

Considering COVID-19, most US courts have suspended non-emergency court proceedings and trials. Arbitral tribunals, however, are using video conferencing and other tools to keep cases moving. Arbitral tribunals are now routinely issuing procedural orders to address circumstances that are unique to a virtual arbitration hearing (i.e., remote participants, specification regarding videoconferencing, and platforms).[29]

3. Limited Discovery

Discovery can be one of the most intrusive and costly parts of litigation. Franchisors typically want to avoid discovery of their confidential information and the tactical advantages that can be employed in litigation if certain information was to be made public. Arbitration dispenses with discovery procedure in full or in part (i.e., interrogatories, depositions, request for production of documents) by which each party obtains information and documents from the other party related to the dispute. Notably,

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https://go.adr.org/impactsofdelay.html#:~:text=Cost%20to%20Business%20with%20a%20Delay%20in%20Resolution&text=Direct%20losses%20associated%20with%20additional,than%20%24180%20million%20per%20month (last visited April 20, 2022).

[29] Practical Law Litigation and Practical Law Arbitration, *Arbitration vs. Litigation in the US*, Practical Law Practice Note w-006-5897.

however, attorney-client privilege applies in arbitration just like court.[30]

In litigation, franchisees may seek to use discovery as to the treatment of other franchisees who allegedly are similarly situated to inflict maximum litigation expense on the franchisor and thereby increase settlement leverage, which would typically not be available in arbitration. Such discovery may or may not be allowed. Given the broad standards applicable to the discovery process and courts' general reluctance to make relevance determinations at the discovery stage, potentially invasive discovery may be permitted even if the responsive material ultimately is deemed inadmissible at trial or on summary judgment.[31]

4. Confidentiality

Unlike court proceedings, which are open to the public, arbitration proceedings are usually held in private. Franchisors are especially concerned about disclosure of their trade secrets and intellectual property, in addition to their policies or other franchisees information, which in a franchise system, can be dangerous if used against them. AAA Commercial Rule R-25, for example stated in pertinent part, "[a]ny person having a direct interest in the arbitration is entitled to attend hearings." The public is not a "person having a direct interest in the arbitration." Since the hearings are not typically open to the public and because arbitration is conducted pursuant the agreement of the parties, the parties can, and often do, agree to keep the entire arbitration and all related information and documents confidential.

Moreover, arbitration decisions, unlike court decisions, are not published. This means that access to an arbitrator's decisions and the details, including the confidential information and documents that were included in the arbitration, do not make their way into the public domain.[32]

Court proceedings generally cannot be kept confidential from the public. In fact, with today's modern court systems, most dockets are publicly searchable online. Parties who desire to keep information private must take steps to do so by way of seeking protective orders or moving to seal certain documents. However, there is no guaranty that such motions will be granted as they are up to the Judge's discretion.

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[30] AAA Commercial Arbitration Rules, R-34(c). "Evidence: The arbitrator shall take into account applicable principles of legal privilege, such as those involving the confidentiality of communications between a lawyer and client."

[31] *Cohn v. Taco Bell Corp*., 147 F.R.D. 154 (N.D. Ill. 1993) (allowing requested discovery concerning other franchisees as potentially indicative of bad faith); *Burger King Corp. v. C.R. Weaver*, 169 F.3d 1310 (11th Cir. 1999) (affirming denial of discovery with respect to other franchisees).

[32] Note that the arbitration award becomes part of a court's file, as it must be confirmed in a court in order to be enforced. Additionally, a party can move to set aside the award in court. In either case, the details of the arbitration award could become public knowledge unless steps are taken to keep it confidential, as the arbitration award is typically submitted for the court's consideration.

5. Finality

The main difference between arbitration and litigation is the finality of the award. An arbitration award is generally a final, non-appealable award, while a court judgment is subject to appeal.[33] The opportunity to appeal in court can keep litigation going for years.[34]

U.S. courts are reluctant to interfere with an arbitrator's interpretation and application of law. Accordingly, arbitral awards are given deference by U.S. courts. In fact, the US Supreme Court held that it is the arbitrator's construction of the contract that was bargained for, and the "arbitrator's construction holds, however good, bad, or ugly."[35]

This can be viewed favorably, or unfavorably, depending on whether you agree with the arbitrator's decision. An arbitrator's award is hard to shake. Although an arbitration award can be challenged in court, an award will be vacated only in extremely rare and limited circumstances, such as where the award was procured by fraud or where the arbitrator has exceeded his or her powers.[36]

One of the biggest risk factors for any party litigating in court verses arbitration is the effect of a binding judgment and precedent, as it relates to new claims. If a case is litigated to final judgment and the decision is unfavorable, the court's decision could be binding in subsequent litigation.

6. No Opportunity for a Jury Trial

One last thing to consider is that parties who agree to arbitrate likewise waive their right to a jury trial. In arbitration, the arbitrator not only hears and decides issues and arguments raised by the parties before the final hearing, but also acts as the ultimate decision-maker at the final hearing. In litigation, except in certain circumstances, the parties typically can have their case heard and decided by a jury if they desire.[37] Depending on the story of the case, a jury trial can be a substantial benefit over arbitration, especially where a party's case appeals to emotion or notions of fundamental unfairness. If the issues in a case are complicated or technical, a jury trial may not be the right option. Either way, jury trials can be very expensive and last for days or weeks, depending on

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[33] The major US-based arbitral institutions (American Arbitration Association, or "AAA", International Institute for Conflict Prevention and Resolution (CPR) and JAMS now provide for appellate arbitration procedures. Parties can agree to appellate arbitration procedures as part of the arbitration agreement. Arbitration Compared to Litigation. Practical Law Litigation and Practical Law Arbitration, *Arbitration vs. Litigation in the US*, Practical Law Practice Note w-006-5897.

[34] *Arbitration vs. Litigation: The Choice Matters*, https://www.wnj.com/Publications/Arbitration-vs-Litigation-The-Choice-Matters (Feb. 8, 2019).

[35] *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064, 2071 (2013); *see also Benihana, Inc. v. Benihana of Tokyo, LLC*, at *14 (S.D.N.Y. July 15, 2016) (noting that appellate courts review factual determinations made in a bench trial for clear error but in the context of a challenge to an arbitral ruling, federal courts may not review findings of fact even for manifest disregard)).

[36] This is the general rule under the Federal Arbitration Act. *See* 9 U.S.C. § 10. Individual states may have different standards.

[37] Oftentimes, parties to a franchise agreement contractually agree to waive trial by jury.

the issues, as compared with arbitration, which is shorter and less expensive.

D. Other Concerns Involving Franchise Disputes

1. Ongoing Relationship of Parties

Whether in litigation or arbitration, while either is pending, the franchisee still needs to operate its business and protect its investment, and the franchisor must manage and develop the brand and protect brand standards. Thus, when a dispute arises, the resolution of the same does not always mean the end of the franchisor-franchisee relationship.

2. Potential Systemwide Impact of Franchise Disputes

Due to the unique structure of the franchise system in that it is set up for uniformity, an unfavorable decision in litigation could have far-reaching consequences across a franchise system, especially due to the accessibility of online case decisions across the United States. While defaults are reviewed on a case-by-case individual basis, a franchisee may argue that the franchisor waived its rights in another circumstance by not defaulting a similarly situated franchisee.

In addition, a franchisee may claim discrimination if they are not treated the same as other franchisees, regardless of whether the matter is litigated or arbitrated. The reality is that franchisees speak to one another, and while the individual agreements may be confidential between the parties, franchisees may try to seek discovery of the treatment of other franchisees to prove their case.

IV. PRE-SUIT RESOLUTON

A. Mediation

Mediation is a negotiation assisted by a neutral third party, whose role is to help those involved in a particular dispute clarify their business interests, overcome obstacles to communication, and fashion an efficient and realistic resolution of the matter.[38] Mediation is either mandatory (i.e. required under the franchise agreement) or optional (parties voluntarily seek intervention), and is typically the last step before litigation, but the first step in dispute resolution involving a neutral third party. Depending on the type and size of the dispute, mediation can be a cost-effective approach to dispute resolution.

Compared to a full arbitration or litigation of the matter on the merits, mediation entails a limited expenditure of time by counsel to bring the mediator up to speed on the issues, facts, and legal arguments involved, as well as attendance by counsel and an executive with settlement authority at a mediation session that typically lasts one or two

[38] Peter Klarfeld, Michael Lewis, and Peter Silverman, *Mediating Franchise Disputes*, American Bar Association 32nd Annual Forum on Franchising (Oct. 14-16, 2009).

days.[39]

Mediation is most beneficial when parties come to the table open minded, and are seeking to avoid the time, expense, and exposure of litigation. The advantages of mediation benefit both franchisees and franchisors alike, as the process aims at reaching a voluntary settlement before litigation. In addition, mediation can provide a "reality check" to the parties by providing a disinterested evaluation of the strengths and weaknesses of the case before committing to an expensive arbitration or litigation. The downside of mediation is that since it is non-binding, if the parties do not reach an agreement, or do not follow through on an agreement reached, the time and money spent on mediation is lost and the parties are left to commence arbitration or litigation to resolve the dispute, increasing the overall cost of the dispute.

B. Work-out Agreements, Forbearance, and Probation Agreements

Before resorting to litigation or arbitration, often times, franchisors will offer franchisees alternative solutions to resolve their defaults by coming to a mutual agreement and giving the franchisees time to fix the problem. In situations where the franchisees are good operators but have fallen behind on their financial obligations, some franchisors might offer payment plans or promissory notes, as opposed to termination, so that the franchisee can stay open and operating. A payment plan or promissory note gives the franchisee time to pay back overdue royalties while getting back on their feet, but still maintain their "good standing" in the franchise system. In situations where operational compliance is an issue, a franchisor may offer the franchisee a probation agreement. A probation agreement requests a formal commitment for measured improvement within a specified time period when the franchisee is struggling with operational defaults, in exchange for an un-contested termination. Both options help to avoid the time and expense of arbitration or litigation.

In situations involving multiple defaults, franchisors may offer ad-hoc work out agreements to fit the needs of a particular fact pattern, especially when a franchisee has varying degrees and types of defaults and arbitration or litigation could become complex and costly for both parties. This becomes even more pragmatic if the franchisee's situation is fraught and delicate. For example, when a franchisee with many franchises holds substantial debt to the franchisor and to other creditors, the franchisor should proceed cautiously with an open mind toward creative commercial resolutions because arbitration or litigation could create adverse outcomes for all parties, including large numbers of closures, uncollectible debts, and unnecessary legal fees throwing good money after bad, and of course, bankruptcy.

Rather than push the franchisee out of the system, the franchisor may be better served by collaborating with the franchisee to find a resolution that moves the franchisee to more solid ground while gradually rectifying defaults and debts. A franchisor may structure a work out agreement in multiple parts or stages, combining various requirements such as payment plans, commitments to make operational improvements,

[39] *Id.*

and even agreed-upon timeframes for a struggling franchisee to sell specific locations. This allows a franchisee the opportunity to simplify their portfolio, redirect their efforts, and, if needed, to use purchase proceeds from the sale of locations to address any amounts owed to the franchisor.

Whether it be a straightforward payment plan or an intricate workout agreement, prudent franchisors should view alternative resolutions to arbitration or litigation as an opportunity to avoid the costs and time of arbitration or litigation, to work with the franchisee toward rehabilitation, and to identify and secure outcomes that benefit the franchisor but may not always be available or guaranteed in arbitration or litigation (such as a timeframe to sell off locations). However, often times such agreements are not possible or do not come to fruition, and the parties end up arbitrating or litigating their dispute.

V. ARBITRATION

An arbitration agreement is a contract, within a contract. Generally, a court will decide challenges to enforceability and scope issues of the arbitration agreement, while an arbitrator will address challenges to the underlying franchise agreement containing the clause. However, as more fully discussed in this paper, there are nuances to this general rule.

A. Arbitration Enforcement Issues

Despite having a written arbitration agreement, arbitration clauses and the enforcement thereof are among the first issues raised in opposition to arbitration. Typically, franchisees seek to avoid arbitration, and thus, seeks to avoid resolving the dispute through arbitration. This forces the opposing party to file a motion to compel arbitration in cases where the matter was first filed in court, or seek to stay the court proceeding while the arbitrator makes a decision on the issue of scope. The Federal Arbitration Act[40] ("FAA") is the law that governs arbitration agreements in franchise relationships between franchisors and franchisees located in different states, and is the lens through which courts will typically render decisions, even if state franchise statutes exist.

The question of "arbitrability" refers to the threshold issue of whether an arbitrator has the authority to rule on a dispute. The issue arises when one party disputes the enforceability of the arbitration agreement, which is usually the franchisee. The scope can be examined in two veins: first, whether the clause covers the dispute in issue; and second, whether the court or the arbitrator should decide the issue of arbitrability, also known as delegation. Either way, both of these issues are generally resolved by a court.

The Supreme Court provided clarity on the resolution of both issues. In the case,

[40]The FAA is a statute enacted in 1925 that provides the basic legal principles applicable to arbitration in the United States, codified at 9 U.S.C. §1-16.

Moses H. Cone Memorial Hospital v. Mercury Construction Corp.,[41] the Supreme Court, interpreting the FAA, held that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." As a result, arbitration clauses are to be construed broadly, and arbitration should not be denied "unless it may be said with positive assurance that that arbitration clause is not susceptible of an interpretation that covers the asserted dispute."[42]

In addition to which substantive claims of the franchisor and franchisee are required to be arbitrated, courts presume that the parties intend arbitrators, not courts, to decide disputes about the meaning and application of particular procedural preconditions to arbitration," such as "waiver, delay, or a like defense to arbitrability," and "the satisfaction of 'prerequisites such as time limits, notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate.'"[43]

The other issue concerning scope that frequently arises in the franchise context is whether the court or the arbitrator should decide the issue of arbitrability of a particular dispute or the enforceability of the agreement itself. When faced with a well-drafted arbitration clause that delegates the authority of deciding to the arbitrator (also known as "a delegation clause"), a franchisee typically cannot overcome this well-settled principle. If the parties "clearly and unmistakably" indicate in their arbitration agreement that the issue of arbitrability or enforceability of the arbitration agreement itself is for the arbitrator to decide, courts will honor that agreement.

The U.S. Supreme Court once again set the precedent for this principle to stand in the landmark case, *Rent-A-Center, West, Inc. v. Jackson*.[44] There, the Supreme Court upheld the enforceability of an arbitration clause that delegated to the arbitrator "any dispute relating to the…enforceability of this Agreement, including but not limited to any claim that all or any part of this Agreement is void or voidable."[45]

B. Enforceability

Arbitration agreements are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for revocation of any contract."[46] Thus, when courts exercise jurisdiction under chapter two of the FAA, they apply federal law to the question of whether an agreement to arbitrate is enforceable.[47] The presumption in favor of arbitration under the FAA creates a preemptive effect on state statutes that preclude arbitration and general choice of law provisions, unless the contract expressly evidences the parties' clear intent that state arbitration law applies. Thus, franchisors should draft

[41] 460 U.S. 1 (1983).
[42] *David L. Threlkeild & Co., v. Metallgesellschaft Ltd*, 923 F.2d 225, 250 (2d Cir. 1991), *cert. dismissed*, 501 U.S. 1267 (1991).
[43] *BG Grp., PLC v. Republic of Argentina*, 134 S. Ct. 1198, 1207, 188 L. Ed. 2d 220 (2014).
[44] 130 S.Ct. 2772 (2010).
[45] *Id*.
[46] 9 U.S.C. § 2.
[47] *See Smith/Enron Cogeneration Ltd. P'ship, Inc. v. Smith Cogeneration Int'l, Inc*, 198 F.3d 88, 96 (2d Cir. 1999).

their arbitration agreements to provide a clear statement that the FAA governs the agreement.

The federal preemption also means that a state may not pass a law that specifically seeks to undermine arbitration agreements. Notwithstanding, a franchisee may still raise common law defenses to the enforceability of an arbitration clause, such as fraud, unconscionability, adhesion, or lack of mutuality of understanding, or some other inequity. However, a well-drafted delegation clause will usually dispose of these arguments.

Franchisees should be mindful and remember to raise any objection to the arbitrator's exercise of jurisdiction over the dispute, as a party waives its right to contest the same if it does not timely object during the arbitration proceedings.[48]

C. Non-Signatory Challenges

Clearly, the franchisor and the franchisee who signed the franchise agreement can expect to be able to enforce a franchise agreement and the arbitration clause contained therein against each other. However, in many franchise relationships, there are entities and other individuals who may not be parties to the franchise agreement but are fully involved in the franchisee's business operations. These "third parties" could be family members, operating entities, employees, independent contractors, or even business associates. In many franchise relationships, there are tangential agreements such as leases, guarantees, or licenses that could involve related parties that come into play. Non-signatory issues frequently arise where a contracting party is a member of a group of companies, and its parent or the other subsidiaries have been involved in the commercial transaction but are not signatories to the contract.

Often times, non-signatories to arbitration agreements are compelled to arbitrate or may choose to arbitrate if they have a relationship to the party and can establish certain legal thresholds. To this end, courts generally have identified five circumstances where signatories to arbitration agreements can compel non-signatories to arbitration: (1) incorporation by reference; (2) assumption; (3) agency; (4) veil-piercing/alter ego; and (5) estoppel.[49]

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[48] *Stone v. Theatrical Inv. Corp.*, 64 F. Supp. 3d 527, 533 (S.D.N.Y. 2014), *reconsideration denied*, 80 F. Supp. 3d 505 (S.D.N.Y. 2015) (president and shareholder was held jointly and severally liable for arbitration award even though he was not a party to the agreement because he participated in arbitration and did not object to arbitrator's exercise of jurisdiction over him).

[49] *See Arthur Andersen LLP v. Carlisle*, 556 U.S. 624, 631 (2009) (non-party to arbitration agreement may seek a stay under U.S.C.A.§3, 16(a)(1)(A) if the relevant state contract law allows him to enforce the agreement); *Crawford Prof'l Drugs, Inc. v. CVS Caremark Corp*., 748 F.3d 249, 257 (5th Cir. 2014) (non-signatory plaintiffs were equitably estopped from refusing to arbitrate); *CD Partners, LLC v. Grizzle*, 424 F.3d 795, 799 (8th Cir. 2005) (nonsignatory can enforce arbitration clause against signatory when "the relationship between the signatory and nonsignatory defendants is sufficiently close that only by permitting the nonsignatory to invoke arbitration may evisceration of the underlying arbitration agreement between the signatories be avoided or when claims presume the existence of the written agreement); *Zurich Am. Ins. Co. v. Watts Indus., Inc*., 417 F.3d 682, 687 (7th Cir. 2005) (no grounds to compel arbitration against nonsignatory on estoppel theory since nonsignatory did not receive direct benefit); *Trippe Mfg. Co. v. Niles*

The issue of non-signatories frequently arises in the context of third party beneficiaries. To prevail under a third-party beneficiary theory, the party seeking to compel arbitration must produce evidence of a clear intent to benefit the third party.[50]

While the prevailing view across the United States has been to uphold arbitration clauses involving third party beneficiaries, the Eleventh Circuit recently rejected a non-signatory franchisee's motion to compel arbitration because it was outside the coverage of the FAA.[51] In *Calderon v. Sixt Rent A Car, LLC*, the Eleventh Circuit narrowly interpreted an arbitration clause in a rental car contract the plaintiff entered into on Orbitz.com, a third-party reservations site. There, the court held that the clause did not apply to a dispute between the plaintiff and the rental car company because the arbitration agreement was outside the coverage of the FAA, and the suit concerned Sixt's practices, not Orbitz's and because Sixt was not a third-party beneficiary of Orbitz's Terms of Use and did not meet conditions for equitable estoppel.

Delving into the history of the FAA, Judge Newsom, in his concurring opinion, explained how arbitration contracts used to be "functionally unenforceable" because courts allowed parties to revoke arbitration agreements. As a result, Congress passed the FAA in 1925 to guarantee that written arbitration agreements would be enforceable. The FAA is limited to "controversies that arise out of the contract containing the arbitration agreement or the transaction evidenced thereby."

The court's opinion is significant in that it represents one of the first Eleventh Circuit opinions considering whether the FAA, including its strong presumption in favor of arbitration, applies to disputes with only a tangential relationship to the contract containing the arbitration clause. Additionally, Judge Newsom's concurring opinion may give litigants a roadmap for challenging the *Moses H. Cone* canon, perhaps with the goal of seeking certiorari on this issue from the Supreme Court.

D. TROs and Preliminary Injunctions

In the context of a franchise dispute, franchisor and franchisees may need to seek emergency relief or redress from a court or arbitral tribunal in the form of a temporary restraining order ("TRO") and/or a preliminary injunction. A preliminary injunction is an "extraordinary remedy that may only be awarded upon a clear showing that the plaintiff is

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Audio Corp., 401 F.3d 529, 532 (3d Cir. 2005) (nonsignatory purchaser of assets could not be equitably estopped from challenging arbitration clause since no evidence of direct benefit) was not bound to arbitrate under NY Law); *Employers Ins. of Wausau v. Bright Metal Specialties*, 251 F.3d 1316, 1322 (11th Cir. 2001) (Plaintiff was bound to arbitrate when it assumed the contract); *Int'l Paper Co. v. Schwabedissen Maschinen & Anlagen GMBH*, 206 F.3d 411, 416-17 (4th Cir. 2000) (Plaintiff estopped from refusing to arbitrate because rights it seeks to assert hinge on contract); *Thomson-CSF, S.A. v. Am. Arbitration Ass'n*, 64 F.3d 773, 776 (2d Cir. 1995) (court's hybrid approach that did not fit squarely into approved theories to bind non-signatory was rejected).

[50] *Ex parte Stamey*, 776 So.2d 85, 92 (Ala. 2000) (holding under a third-party-beneficiary theory a nonsignatory could enforce an arbitration agreement against a signatory because the agreement specifically stated that the signatory had agreed to arbitrate disputes against the nonsignatory).

[51] *Calderon v. Sixt Rent a Car, LLC*, 5 F.4th 1204, 1207 (11th Cir. 2021).

entitled to such relief."[52] Issues involving the need for emergency relief arise for franchisors in the enforcement context. Specifically, franchisors frequently seek to enforce post-termination contractual provisions such as discontinuance of use of trademark and trade dress, compliance with non-compete or non-solicitation covenants, or other post-termination use of their trademarks under the Lanham Act. The risk to a franchisor's consumer relationships, reputation, and trade secrets can lead a court to enjoin such behavior. However, without the proper evidence of irreparable harm, a court may deny the relief sought.[53] Under most franchise agreements, franchisors may seek emergency relief to enforce compliance with system standards, particularly in cases where a public health or safety of the franchisor's goodwill are affected.

On the other hand, a franchisee may learn that its franchise rights and sole source of income are about to be terminated and seek emergency relief to prevent termination of the franchise agreement from becoming effective and triggering the post-termination obligations. The requests, however, are not always well received, because courts often consider franchise agreements to be personal service contracts and therefore, not entitled to the equitable remedy of specific performance.[54]

Even where a franchise agreement contains an arbitration clause, there is usually a judicial path for emergency relief. Commercial contracts, including franchise agreements, will specify that while all disputes must be submitted to arbitrations, parties may still seek injunctive relief in court to obtain certain relief quickly.

While historically not always the case, TROs and preliminary injunctions are now available from either a court or an arbitrator. In 2013, the AAA amended its commercial rules to obtain "emergency measures of protection."[55]

AAA's Rule 38 provides that a party has the opportunity to obtain emergency relief within days. According to AAA Rule 38 (a) and (b), when a party in need of emergency relief notifies the AAA of the nature of and reason for the requested relief, "the AAA shall appoint …within one day of receipt…a single emergency arbitrator designated for rule on emergency applications." No later than two business days after appointment, the AAA

[52] *Winter v. Natural Res. Def. Council*, 555 U.S. 7, 22 (2008).

[53] For a list of cases, *see* Paula J. Morency and Alison R. Grow, *Winning Round One: A Preliminary Injunction Motion in a Franchise Case*, American Bar Association 41st Annual Forum on Franchising (by, Oct. 11-12, 2018).

[54] *See e.g., Burger King v. Agad*, 911 F. Supp. 1499, 1506-07 (S.D. Fla. 1995) (reasoning that franchise agreements are considered personal service contracts and as such are immune from a mandatory injunction requiring specific performance of the agreement); *N. Am. Fin. Group, Ltd. v. S.M.R. Enterprises, Inc.*, 583 F. Supp. 691, 699 (N.D. Ill. 1984) ("A franchise agreement of the type contemplated here is at least partially a contract for personal services."); *but see Bray v. QFA Royalties LLC,* 486 F. Supp. 2d 1237, 1247 (D. Colo. 2007) (citation omitted) ("Courts have recognized that the threatened loss of a franchise business before the lawfulness of a termination can be determined constitutes irreparable harm sufficient to warrant injunctive relief."); *LaGuardia Assocs. v. Holiday Hospitality Franchising, Inc.*, 92 F. Supp. 2d 119, 131 (E.D.N.Y. 2000) (citation omitted) ("The franchise relationship is the lifeline of the franchisee's business; the franchisee's investment of capital, time, and effort in promoting the franchisor's goods or services—to the general exclusion of competing goods and services—would be irreparably lost upon termination. Money damages cannot make the franchisee in such situations whole.")

[55] American Arbitration Association Rules, R-38.

emergency arbitrator must establish a schedule for consideration of the emergency relief. The schedule must provide a reasonable opportunity for all parties to be heard, but it need not be in person. AAA Rule 38(d) permits telephone or video conference, or written submissions.

If the emergency arbitrator is satisfied that the irreparable harm threshold has been met and that the moving party is entitled to relief, they may enter an interim order or award granting the relief, but the arbitrator must state the reasons for the order or award.[56]

In actual practice, however, these emergency relief procedures in arbitration may not afford the relief sought. Just like any other arbitration award, the TRO or preliminary injunction is not self-enforcing (as a court order would be). Therefore, unless and until it is confirmed by a court, the award may not have any teeth.

E. POST-ARBITRATION AWARD ENFORCEMENT ISSUES

Unfortunately, obtaining an arbitration award is not the last step for franchisees or franchisors to realize the relief requested in an arbitration proceeding. Even though it is a binding decision, an arbitration award cannot be enforced until it has been confirmed by the appropriate federal or state court. Given the strong recognition of arbitration awards by U.S. courts, the process for confirming an arbitration award is relatively simple, but not free of additional hurdles.

Arbitration awards can be confirmed in federal or state courts. Mainly the FAA governs recognition and enforcement of arbitral awards, although other provisions of law and state laws can apply as well. For example, if an arbitration award terminates a franchisee's license to operate, the franchisor must still have such award confirmed by a court of law for it to be effective and recognized by that jurisdiction.

Pursuant to Section 12 of the FAA, parties have three months in which to file a motion to vacate, modify, or correct an arbitration award after the same is filed or delivered.[57]

Where the FAA applies, an arbitration award may only be vacated in limited circumstances:

(1) The award was obtained by corruption, fraud or undue means;
(2) Any of the arbitrators were partial or corrupt;
(3) The arbitrators were guilty of misconduct in refusing to postpone the hearing on sufficient cause shown;
(4) The arbitrators exceeded their powers or so imperfectly executed them that they did not make a mutual, final and definite award on the subject matter submitted.[58]

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[56] See AAA Rule 38(e). JAMS provides a similar emergency relief in its Rule 2(c).
[57] 9 U.S.C. § 12.
[58] 9 U.S.C. §10

The U.S. Supreme Court opined that "[i]t is only when [an] arbitrator strays from interpretation and application of the agreement and effectively 'dispense[s] his own brand of industrial justice' that his decision may be unenforceable."[59] The Sixth Circuit questioned whether arbitrators are bound to follow the law at all: "The very idea that an arbitral decision is not appealable for legal error leads to the conclusion that the arbitrator is not necessarily bound by legal holdings of this court."[60]

Similarly, a court may not modify or otherwise correct an arbitration award where (a) there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award; (b) the arbitrator(s) have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted; or (c) the award is imperfect in matter of form not affecting the merits of the controversy, so as to effect the intent thereof and promote justice between the parties.[61]

Parties who seek to enforce arbitration awards must be mindful of time limits imposed by federal and state statutes, which will vary. Depending on where the party is seeking to enforce the arbitration award, it may need to wait anywhere between 30 to 90 days before filing. This allows the time that the award could be challenged to expire.[62] In practice, the party seeking to enforce the arbitration award will wait out the requisite period for modification and/or vacatur to ensure that the other party "waived" the ability to contest the award. Nonetheless, parties must be prudent and not wait too long to confirm an award, as they only have one year after the award is made to confirm.[63] The application to confirm the arbitration award is rather simple.

If filing under federal law, specifically 9 U.S.C. §13, the party moving for the order confirming the award should include:

(a) The arbitration agreement; the selection or appointment, if any, of an additional arbitrator or umpire; and each written extension of the time, if any, within which to make the award.
(b) The award; and
(c) Each notice, affidavit, or other paper used upon an application to confirm, modify, or correct the award, and a copy of each order of the court upon such an application.

Most state statutes are similar to the FAA with respect to submission

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[59] *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, 559 U.S. 662, 687 (2010).
[60] *Schafer v. Multiband Corp.*, 551 Fed. Appx. 814, 820 (6th Cir. 2014), *cert. denied*, 573 U.S. 932 (2014).
[61] 9 U.S.C. § 11.
[62] For example, Connecticut G.S. §52-90 provides that "No motion to vacate, modify or correct an award may be made after thirty days from the notice of the award to the party to the arbitration who makes the motion" while the FAA provides for three months.
[63] 9 U.S.C. § 9.

requirements.[64] Once confirmed, the arbitration award will carry the same force and effect as a judgment, and give the prevailing party access to any post-judgment remedies in the jurisdiction where confirmed.

VI. SUBSTANTIVE CLAIMS AND DEFENSES

A. Common Franchisee Claims

Franchisee claims against a franchisor typically fall within one of three categories of claims: (i) claims arising before the parties enter into an executed franchise agreement or a recognized franchise relationship exists; (ii) claims arising during the term of the franchise relationship;[65] and (iii) claims arising from the end of the franchise relationship. The remedies a franchisee seeks differ depending on the nature and timing of their claims.

1. Pre-Relationship Claims

Before a franchise relationship begins by contract or otherwise, a franchisee should complete a thorough review of the franchise opportunity to determine if the franchisor's brand, product, and business model fit the franchisee. In addition to the franchisee's due diligence, a franchisor should ensure the franchisee meets the franchisor's qualifications and standards required to operate within the franchise system.

During these initial stages, franchisees may engage in discussions and review a significant amount of material through franchise expositions, brokers, advertising, word of mouth, general research, and other sources, some provided by the franchisor or brokers and some not. The content and representations in these discussions and materials, including a franchisor's FDD are the sources of pre-relationship claims—particularly if a franchisor or its representatives fail to strictly comply with registration and disclosure laws.

a. The FTC Franchise Rule and State Franchise Disclosure/Investment Laws

The most common source of franchisee claims is the FDD required by the FTC's Rule. From the franchisee's perspective, the FTC's Franchise Rule is designed to protect franchisees by mandating franchisors provide franchisees with information regarding the purchase and operation of a franchise before franchisees pay the franchisor money or sign an agreement. The FTC Rule does not afford franchisees a statutory private right to action, however. As a result, such "disclosure violations" are most frequently asserted

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[64] A prudent attorney should pay close attention to service of process requirements and recognition of arbitration awards by defaults in preparing the application to confirm in federal and state courts, as well as venue clauses. Also, note that the award is now public. Steps should be taken to keep the award confidential, to the extent possible, if there is confidential information contained in the award.

[65] Traditionally, a formally executed franchise agreement signifies the beginning of a franchise relationship. However, in more unusual circumstances, a franchise relationship may exist without a valid franchise agreement. For purposes of this article, references to the existence of franchise relationship assume the relationship is established through a valid franchise agreement.

through either common law fraud-based claims or "Little FTC" claims commonly asserted under state Unfair and Deceptive Trade Practices Acts. Franchisees also frequently assert and include claims under state registration and relationship laws in those states enacting such protections as identified and discussed above.

b. Common Law Fraud Based Claims

The most common claims against a franchisor based upon pre-relationship conduct are common law fraud-based claims, including fraud, fraudulent inducement, and negligent misrepresentation.

Although the elements of these claims vary by state, generally common law fraud or deceit claims require the following: (i) a false representation or concealment of a material fact; (ii) reasonably calculated to deceive; (iii) with the intent to deceive; (iv) which in fact does deceive; and (v) injury to the franchisee upon that franchisee's reasonable reliance on the false material fact.[66] The elements to a claim for fraud in the inducement are essentially duplicative of claims for fraud in most jurisdictions with the caveat that the intent of providing or omitting false information was to induce the franchisee into executing the franchise agreement.[67]

The difference between a claim for fraud and negligent misrepresentation is the element of intent (i.e., whether the false or misleading information was intentionally communicated to the franchisee). To succeed on a claim for negligent misrepresentation, the franchisee must show: (i) that the franchisor provided false information to the franchisee; (ii) the franchisee justifiably relied on the specific information provided to their detriment; and (iii) the franchisor was negligent or did not exercise reasonable care in providing the information.[68] Depending on the jurisdiction, a franchisee may not be required to prove that the statement, representation, or fact be false but, instead, is simply materially misleading.[69]

The most common source of fraud-based claims is the actual or perceived differences between what a franchisee was either told during the pre-sale process or is contained in the franchisor's FDD and the franchisee's post-sale experience. While

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[66] *Cluck-U Chicken, Inc. v. Cluck-U Corp.,* No. 8:15-CV-2274-T-MAP, 2017 WL 10275957, at *8 (M.D. Fla. June 6, 2017). The Middle District of Florida denied summary judgment to a franchisor based on disputes of material facts as to whether the franchisor fraudulently induced and materially misrepresented start-up costs. Applying Maryland law, the court noted that inaccurate projections may become fraudulent or be a misrepresentation if the franchisor knew that they were inaccurate at the time they were made.

[67] *Eclipse Medical, Inc. v. American Hydro-Surgical Instrs., Inc.*, 262 F. Supp. 1334 (S.D. Fla. 1999) (noting elements for fraud in the inducement are (1) defendant misrepresented a material fact; (2) defendant knew or should have known the statement was false; (3) defendant intended for statement to induce plaintiff to enter into contract or business relation; and (4) plaintiff was injured by acting in justifiable reliance upon the statement).

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

[69] *See Coraud LLC v. Kidville Franchise Co., LLC*, 121 F. Supp. 3d 387, 393 (S.D.N.Y. 2015) (applying New York law); *Long John Silver's Inc. v. Nickleson*, 923 F. Supp. 2d 1004, 1014 (W.D. Ky. 2013) (applying Minnesota law).

required to conform all statements and discussions with the information set forth in the franchisor's FDD, franchisor representatives may sometimes exaggerate or inflate the disclosures and experiences with the brand. It is important to note, here, however, that mere puffery or opinion is typically not actionable.[70] Whether a statement is considered puffery, opinion, or misrepresentation is typically a fact specific inquiry.[71]

Traditional disclosure areas resulting in fraud-based claims include financial performance representations, initial investment costs, misleading promises or guarantees in operation, training, and support. This is not an exhaustive list because fraud-based claims may arise from any number of discussions or disclosures in almost any area of the franchise relationship. The only barometer is whether a franchisee would reasonably rely upon such a statement or omission and if such statement or omission would materially affect the franchisee's decision to enter the franchise relationship. Importantly, silence or omission also gives rise to fraud-based claims when the omitted information materially affected the franchisee's reliance upon the information actually provided or communicated.[72]

Of the listed disclosure areas commonly resulting in fraud-based claims, two of the most common include financial performance representations and initial investment costs.

i. Financial Performance Representations

Financial Performance Representations or FPRs are one of the most litigated franchise disputes under fraud-based claims and the subject of numerous cases. The FTC requires franchisors to disclose financial performance representations in Item 19 of the FDD under the FTC Rule.[73] Any communications, representations, or statements from the franchisor or its representatives should strictly echo the FPRs in the FDD.

Franchisors and their representatives do not, however, always comply with such obligations and franchise sales lore is replete with examples of FPRs occurring on the back of cocktail napkins and more sophisticated methodologies where the disclosure made in a discussion does not comport with the Item 19 disclosures. In addition, franchisees may base claims upon instances where a franchisor's statements or

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[70] *See Steak n Shake Enterprises, Inc. v. Globex Co., LLC*, 110 F. Supp. 3d 1057, 1083 (D. Colo. 2015), *aff'd*, 659 F. App'x 506 (10th Cir. 2016) (statements such as the franchise would be "highly profitable" and projections regarding future profitability are "mere puffery" and cannot be the basis of a misrepresentation claim because they are predictions about the future and not the misrepresentation of an actual fact).

[71] *Id.*

[72] *See Hanley v. Doctors Exp. Franchising, LLC*, No. CIV.A. ELH-12-795, 2013 WL 690521, at *22 (D. Md. Feb. 25, 2013). This matter involved an Item 7 disclosure by Doctors Express based upon amounts from a current franchisee who opened the franchise operation six (6) years prior to the disclosure. In that time frame, the Medicare and insurance laws changed drastically and the franchisor knew or should have known that this change materially altered the initial startup costs as disclosed in Item 7 and as misrepresented to the franchisees. Essentially, the Court held that the franchisee properly stated claims for fraud based on the franchisors misrepresentations and omissions, the discrepancy and projected and actual costs, and the undisclosed facts known by the franchisor.

[73] For further discussion, *see* Section III.

representations of expected financial performance are not based on or reflective of current or past facts, data, or circumstances.[74] Likewise, a franchisee may base claims on inaccurate information regarding the success rate, performance, and profits of past or current franchisees.[75]

Before filing a claim based on statements or representations regarding future performance or expected earnings, it is important to research the specific jurisdiction in which the claims arise because these claims are not actionable in all jurisdictions.[76] In addition, some jurisdictions allow franchisors to avoid liability where such claims are disclaimed, merged, or waived with a franchise questionnaire.[77]

ii. Initial Investment Costs

Fraud claims arising from a franchisor's estimate of the initial investment costs to open a franchise are also common. Like financial performance representations, the FTC Rule requires franchisors to disclose estimated costs to the franchisee for their initial investment into the franchise through Item 7 of the FDD.[78] Such initial investment costs might include initial franchise fees, rent, construction or leasehold improvement costs, initial marketing fees and packages, equipment costs and packages, computer systems and software, signage, insurance, supplies, permitting, and more.

Franchisees reasonably rely on these estimates to determine the amount of capital necessary to enter the franchise relationship and whether they may meet those needs. Thus, if a franchisor provides estimates that fail to accurately reflect current circumstances, then such disclosures may be actionable under fraud-based claims. These claims are difficult, however, absent evidence that the inaccuracies were known or should have been known to the franchisor.[79]

As a practical matter, however, determining whether a franchisor's initial investment disclosures are accurate is difficult without actually taking the leap into the franchise development stage. Once a franchisee is aware their initial investment costs

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[74] *See Hanley v. Drs. Exp. Franchising, LLC*, No. CIV.A. ELH-12-795, 2013 WL 690521, at *21 (D. Md. Feb. 25, 2013).

[75] *See Bans Pasta, LLC v. Mirko Franchising, LLC,* No. 7:13-CV-00360-JCT, 2014 WL 637762, at *2 (W.D. Va. Feb. 12, 2014); *see also Avon Hardware Co. v. Ace Hardware Corp.*, 998 N.E.2d 1281, 1288 (Ill. App. Ct. 2013) (noting false representations of historical financial data such as the past performance of franchisees is actionable under fraud or negligent misrepresentation subject to cautionary language accompanying such representations).

[76] *See Steak n Shake Enterprises, Inc*, 110 F. Supp. 3d at 1083 (D. Colo. 2015) (noting that future profitability projections cannot by the basis of any misrepresentation claim and that representations for the future are not actionable under Colorado and Indiana law); *Long John Silver's Inc.*, 923 F. Supp. 2d at 1019 (noting future projections are generally not actionable unless the future projections were derived from false or misrepresented past or existing facts).

[77] *See* Section IV.B. below.

[78] 16 C.F.R. § 436.5(g).

[79] *See MTR Capital, LLC v. LaVida Massage Franchise Dev., Inc.*, 17-CV-13552-TGB, 2020 WL 6536954, at *6, 9 (E.D. Mich. Nov. 6, 2020) (noting an element of both fraud in the inducement and negligent misrepresentation is that the franchisor must know or should have known that representation was false).

are materially different than the estimates provided, a franchisee should take swift action instead of continuing development, opening, and operating the franchised business before claiming fraud against the franchisor because courts often find that the truthfulness or applicability of initial investment costs should be ascertainable at any point prior to opening the franchise.[80]

c. The FTC Act and Unfair and Deceptive Trade Practices Acts

The FTC Act is a federal act aimed at protecting consumers and businesses from "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce."[81] While unfair competition and unfair or deceptive acts or practices are declared unlawful under the FTC Act, only the FTC is empowered to prevent unlawful conduct under the FTC Act.

Since the FTC Act does not provide a private right of action to franchisees or other consumers, state legislatures enacted their own consumer protection statutes that protect franchisees and other consumers from unfair or deceptive trade practices, including those of franchisors. These statutes are known as "Little FTC Acts" or Unfair and Deceptive Trade Practices Acts.

Many of these statutory frameworks provide franchisees with a private right to action for violation of the FTC Rule, while others only provide protection to consumers/purchasers of household goods and services.[82] Examples of states enacting "Little FTC Acts" that provide franchisees with a private right to action against a franchisor include, but are not limited to, Connecticut, Florida, Georgia, Illinois, New Jersey, Ohio, and Texas.[83]

These "Little FTC Acts" serve as an additional avenue to combat franchisor misconduct and violations of the FTC's Franchise Rule. Many of these acts apply a lesser standard or burden of proof than is typically required under common law fraud-based claims. Some Little FTC Acts essentially provide franchisees with an indirect private right to action for a franchisor's violation of the FTC Franchise Rule or even provide that a violation of any of the FTC Rules is considered a per se violation of that state's Little FTC

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[80] *See MTR Capital, LLC v. LaVida Massage Franchise Dev., Inc.*, 17-CV-13552-TGB, 2020 WL 6536954, at *6, 9 (E.D. Mich. Nov. 6, 2020) (finding a franchisor violated the Florida Deceptive and Unfair Trade Practices Act but awarding the return of the franchise fee and noting that any losses suffered by the franchisee "once they began preparing and operating the franchise" "severed the causal chain" due to the franchisee's own mismanagement); *see also Ultimate Franchises, Inc. v. Parsons*, SACV172153JVSJDEX, 2018 WL 6016153, at *4 (C.D. Cal. June 13, 2018) (finding that alleged misrepresentations were barred under the statute of limitation as the franchisee failed to provide why they did not discover the falsity sooner).

[81] 15 U.S.C. § 45(a).

[82] For example, "Little FTC Acts" in Michigan (MCL 445.903), Pennsylvania (68 Pa. Code §201-9.2), and Virginia (Va. Code. Ann. § 38.2-6013), among others, do not provide protection for business entities or commercials transactions.

[83] *See* Conn. Gen. Stat. Ch. 735a *et seq.*, Fla. Stat. §501.201 *et seq.*, Ga. Code Ann. §10-1-372 *et seq.*, 815 ILCS 510 *et seq.*, N.J.S.A. 8C:56-8-2 *et seq.*, Oh. Rev. Code §1345.01 *et seq.*, and Tex. Bus. & Com. §17.01 *et seq*.

Act.[84]

It is also important to consider which legal claims provide franchisees the most comprehensive damages. Under the "Little FTC Acts," damages may include injunctive relief, attorneys' fees and costs, treble damages, and rescission though there are nuances in different jurisdictions. As a result, franchisees should consider which theories provide the most comprehensive damages claim under the applicable law before determining whether to assert claims under fraud-based theories or under one of the available statutory schemes. Even then, courts may limit the scope of a franchisee's recovery. For example, the Eastern District of Michigan recently limited a franchisee's recovery to the return of the initial franchise fee paid where it is possible the franchisee's business judgment led to its full amount of damages even though the court determined the franchisor violated the Florida Deceptive and Unfair Trade Practices Act.[85]

2. Claims Arising During the Term of the Franchise Relationship

Claims arising during the term of the parties' franchise relationship are incredibly broad in scope and may cover almost any aspect of the relationship and any type of interaction between the franchisor and franchisee. The most frequent claims arising during the term of the franchise relationship sound in contract based on a breach of the franchise agreement. However, in more limited circumstances, claims against a franchisor for breach of the implied covenant of good faith and fair dealing may also exist.

a. Breach of Contract

The basis for the most common breach of contract claims asserted by franchisees are (i) a lack of support, guidance, or training; (ii) failure to properly apply or spend advertising funds; and (iii) a violation of the franchisee's protected territory or encroachment. Although other contract-based claims exist, such as wrongful termination and failure to allow a transfer or approve a renewal of the franchise agreement, we address those claims in the section below discussing claims arising from the end of the franchise relationship.

i. Lack of Support, Guidance, and/or Training

The most common franchisee claim arising during the term of a franchise relationship is founded upon the franchisor's failure to provide the contractually required support, guidance, or training. It is critical for franchisees to understand the level of support, guidance, or training a franchisor is obligated to provide. In many instances, franchise agreements only obligate franchisors to provide support, guidance, or training

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[84] *See, e.g.*, Fla. Stat. § 501.203(3)(a) (providing that a violation of any rules of the FTC Act is a violation of Florida's Deceptive and Unfair Trade Practices Act); Wash. Rev. Code § 19.100.190(1) (providing that a violation of Washington's Franchise Investment Protection Act constitutes an unfair or deceptive act or practice under Washington's Consumer Protection Act).

[85] *MTR Cap., LLC v. LaVida Massage Franchise Dev., Inc.*, No. 17-CV-13552-TGB, 2020 WL 6536954, at *1 (E.D. Mich. Nov. 6, 2020) (finding that a franchisor violated Florida's Deceptive and Unfair Trade Practices Act and limiting damages to the return of the initial franchise fee).

on a discretionary basis which makes prevailing on such claims difficult even though franchisees believe franchisors are required to provide substantial support and guidance "as needed" to their day-to-day business operations.

Successfully maintaining these actions requires franchisees to provide historical and detailed evidence of the franchisor's failure to provide adequate support, guidance, and training in accordance with the franchise agreement's obligations and the damages resulting from those failures.[86] In some circumstances, franchisees may be able to show that the franchisor failed to provide proper or adequate training or failed to consistently answer a franchisee's call for help, or otherwise failing to interact or respond to the franchisee over the course of the franchise agreement.

ii. Advertising

In established franchise systems, the franchisor usually operates a national advertising fund into which the franchisees pay a specified amount pursuant to the franchise agreement. Although the advertising fund is intended to advertise and promote the entire franchise system, franchisees frequently complain about a franchisor's effective use of the funds or that franchisors abuse, misuse, or divert funds inappropriately.

Franchisees must carefully analyze their franchise agreements to determine how much discretion is granted to the franchisor and if there are any specific requirements or limits on that discretion or the use of advertising funds. Most franchise agreements grant franchisors broad discretion in determining how the funds are used and managed, however. As a result, a franchisor's marketing plan or advertising must result in clearly deficient efforts.[87]

Franchise agreements also allow franchisors to utilize marketing funds in a variety of ways and for certain overhead and administrative expenses relating to the administration of the advertising fund. Absent clarity on permitted uses of funds, franchisees will argue the franchisor breached its contractual obligation to properly manage and utilize such funds, which may succeed if the franchisor did not properly disclose such expenses.[88] As with claims for a lack of support, the franchise agreement

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[86] *See Fox v. Dynamark Sec. Centers, Inc.*, 885 F.2d 864 (4th Cir. 1989) (finding that "it was appropriate for the jury, as trier of fact, to address and to resolve the questions of whether the training provided by [franchisor] . . . was so inadequate as to constitute a breach because of bad faith performance and unfair dealing"); *Oakleaf of Illinois v. Oakleaf & Assocs., Inc.*, 173 Ill. App. 3d 637, 647, 527 N.E.2d 926, 933 (Ill. App. Ct. 1988) (finding in favor of franchisee where evidence suggested that franchisor's failure to promptly provide spares parts and its poor quality of technical help caused franchisee damages).

[87] *JM Vidal, Inc. v. Texdis USA, Inc.*, 764 F. Supp. 2d 599, 615 (S.D.N.Y. 2011) (denying summary judgment to franchisor on advertising-related contract claims asserted by the franchisee and noting, among other things, that a "reasonable jury could conclude" the franchisor's promotion of a franchisee's opening were "half-hearted at best" and its advertising for the franchisee was "knowingly insufficient to afford it a chance at success").

[88] *Rodgers v. Ohio Valley CFM, Inc.*, 774 F.2d 1163 (6th Cir. 1985) (finding no error in jury's award of damages to franchisee for breach of contract where franchisor "never disclosed to franchisees that it was charging to the advertising fund overhead, operating, or any other expenses besides direct advertising costs" and failed to comply with its requirement to expend 1% of gross sales on advertising).

permits franchisors such wide discretion that succeeding on these claims is difficult.[89]

iii. Territorial Encroachment

As a part of the bargained for exchange in the franchise system, franchisees typically expect to operate their franchise free from competition from both the franchisor and other franchisees in the same franchise system, as well as other streams of commerce. Franchise agreements usually memorialize that expectation by providing the franchisee with specific territorial protections and limitations, including limiting the franchisee's operation within the territorial boundaries. While the physical place of a competing franchise or corporate location within the protected territory may be an obvious basis for asserting an encroachment claim,[90] other types of encroachment, such as sale of products in a supermarket under the terms of the encroachment provision of a franchise agreement, may not seems so apparent.[91]

As franchisor's options to bring their products and services to market increase through grocery stores, discount clubs, internet sales, non-traditional locations, such as airports and ghost kitchens, issues regarding territorial encroachment will also increase. As a result, franchise agreements increasingly contain provisions allowing franchisors to offer their products through other streams of commerce even though such locations are within the franchisee's protected territory.[92] Therefore, vigilance by franchisees to determine if franchisor products are sold in their territory in an unauthorized manner or in a manner that destroys the benefit of their bargain, as well as tying such sales to decline in revenue is imperative for a franchisee to succeed on such claims.[93]

b. Covenant of Good Faith and Fair Dealing

Very rarely is there an express covenant of good faith and fair dealing in the franchise agreement. Under the majority of current case law, the covenant of good faith and fair dealing is a covenant implied in the franchise agreement. As such, the standard application varies greatly on a state-by-state basis. While it is widely recognized that

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[89] *Moghaddam v. Dunkin Donuts, Inc.*, 322 F. Supp. 2d 44 (D. Mass. 2004) (granting franchisor summary judgment despite allegations of diversion of money from advertising fund).

[90] *Bryman v. El Pollo Loco, Inc.*, No. MC026045, 2018 WL 8459745, at *35 (Cal. Super. Aug. 01, 2018) (approving a jury award in an encroachment dispute against the franchisor for breach of the covenant good faith and fair dealing for opening a corporate location within 2.25 miles of the franchisee's location and invalidating as unconscionable provisions allowing the franchisor to establish new locations wherever it wants).

[91] *Carvel Corp. v. Noonan*, 3 N.Y.3d 182, 188, 818 N.E.2d 1100 (2004) (noting that the jury awarded franchisee for franchisor's breach of the franchise agreement and the implied covenant of good faith and fair dealing when the franchisor sold its products to supermarkets for sale).

[92] *Interim Health Care of N. Illinois, Inc. v. Interim Health Care, Inc.*, 225 F.3d 876 (7th Cir. 2000) (no breach of protected territory where servicing patients in the franchisee's territory was permissible per the terms of the contract).

[93] *See Bryman v*, 2018 WL 8459745, at *35 (finding franchisor's placement of company location in close proximity to franchisee's location was unconscionable and breached covenant of good faith and fair dealing).

every contract contains the implied covenant of good faith and fair dealing,[94] in some jurisdictions, the implied covenant of good faith and fair dealing is not actionable as a standalone claim.[95] In these jurisdictions, accompanying allegations of breach of contract are also required because the implied covenant cannot override the express terms of a contract and will not serve to add obligations where none exist.[96]

Often, franchisees are better suited to pursue such claims where the franchisor unreasonably exercises its discretion or power in such a way that it unfairly disadvantages its franchisees and frustrates the purpose of the franchise agreement.[97] A franchisor may breach the implied covenant of good faith and fair dealing in instances where it is granted the discretion to make changes or unilateral decisions under the franchise agreement and the scope of that discretion is unclear.[98] Proving claims for breach of the implied covenant of good faith and fair dealing is more difficult than a breach of contract claim.

3. Claims Arising from the End of the Franchise Relationship

Many franchisee claims also arise from the end of a franchise relationship. Most commonly, such claims arise at the time of transfer of the franchise and upon either termination or renewal of the franchise agreement. Franchisee rights in these instances are not only subject to the terms of the rights granted by the franchise agreement at issue, but also, in certain states, franchise relationship statutes in the jurisdictions where they exist. A franchisee's best chance of succeeding on these claims arise in those jurisdictions in which franchise relationship laws exist because franchise relationship statutes are designed to level the playing field tilted in favor of the franchisor by the franchise agreements. In those instances where franchise relationship statutes provide a

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[94] *Moran v. Crystal Beach Capital, LLC*, No. 8:10-CV-1037-T-30AEP, 2011 WL 17637, at *3 (M.D. Fla. Jan. 4, 2011) (noting that Florida "recognizes the implied covenant of good faith and fair dealing in every contract"); *Bonfield v. AAMCO Transmissions, Inc.*, 708 F. Supp. 867 (E.D. Ill. 1989) (allowing a franchisee's claim for breach of the covenant of good faith and fair dealing to survive the motion to dismiss stage and noting that the franchisee will ultimately need to prove that the franchisor acted unreasonably and did not provide proper notice for requiring changes in its operations manual).

[95] *See Burger King Corp. v. Weaver*, 169 F.3d 1310, 1317–18 (11th Cir. 1999) (noting that to have an actionable claim for breach of the implied covenant of good faith and fair dealing, then there must also be a breach of an express term of the contract and the claims shall not be duplicate of each other); *Enola Contracting Servs., Inc. v. URS Grp., Inc.*, No. 5:08CV2-RS-EMT, 2008 WL 1844612, at *3–4 (N.D. Fla. Apr. 23, 2008) ("A cause of action based on the covenant cannot be maintained: (1) in the absence of breach of an express term of the contract; (2) to override or vary the terms of the contract; or (3) where the allegations underlying the claim for breach of the implied covenant are duplicative of those which support the claim for breach of contract.").

[96] *Id.*

[97] *Bryman*, 2018 WL 8459745, at *35 (approving a jury award in an encroachment dispute against the franchisor for breach of the covenant good faith and fair dealing for opening a corporate location within 2.25 miles of the franchisee's location and invalidating as unconscionable provisions allowing the franchisor to establish new locations wherever it wants).

[98] *See Enola Contracting Servs., Inc. v*, 2008 WL 1844612, at *3–4 (a potential claim for breach of the implied covenant and fair dealing arises when: (1) the contract is ambiguous about the permissibility of conduct, or (2) when the conduct is undertaken pursuant to a grant of discretion and the scope of that discretion has not been designated.").

franchisee more rights in these matters, it is also imperative to determine whether the franchise relationship statute also contains a provision invalidating the choice of law provision in the franchise agreement to avoid the more favorable provisions of the franchise agreement.

a. Transfer Approval

A natural tension and difficulty between franchisors and franchisees exist when franchisees wish to sell or transfer their franchises to a third party. Franchisors include many conditions and provisions in franchise agreements arguably designed to protect the franchise system and avoid the franchisor accepting as a franchisee a third party with whom it is unfamiliar. As a result, franchise agreements include a franchisor's right of approval of the transaction and the proposed transferee, among others, such as a right of first refusal. In turn, franchisees resent these restrictions and believe these conditions and rights serve to depress the value of the business franchisees tirelessly worked to build.

Franchisee claims arising from a franchisee's attempt to sell or transfer the franchise are founded upon one of three claims: breach of contract if the franchisor fails to comply with the franchise agreement's stated terms and conditions; breach of the implied covenant of good faith and fair dealing if the franchisor fails to reasonably exercise its discretion in approving the sale or transfer; or breach of the relevant state's franchise relationship law if the franchisor fails to comply with its statutory obligations. Prevailing on the contract-based claims is difficult because franchise agreements are carefully designed to protect the franchisor's right to disapprove a proposed transfer in its sole and absolute discretion. As a result, success is often more possible in those states where franchise relationship laws exist that contain franchisee protections in transfer situations because those statutes typically only permit a franchisor to deny a transfer request if the proposed transferee fails to meet the franchisor's "reasonable current qualifications" or a "bona fide business reason" exists.[99]

b. Wrongful Termination

The most common franchisee claim arising from the end of the parties' relationship is a claim for wrongful termination by the franchisor. Such claims are likewise typically founded upon a breach of the franchise agreement, a breach of the implied covenant of good faith and fair dealing, or a statutory relationship law. Traditionally, statutory relationship laws provide franchisees the best avenue for success because they frequently impose notice and opportunity to cure requirements and "good cause" standards upon franchisors.[100] Although the details vary by state, states with such

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[99] *See, e.g.*, Iowa Code §523H.5.1 *et seq*. (only allowing refusal of transfer if proposed transferee does not meet then-current reasonable qualifications); New Jersey Franchise Practices Act, N.J., Stat. Ann. §56.101 *et seq*. (requiring a bona fide business reason for refusal of transfer).

[100] As identified above, states with laws governing franchise relationships include Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Tennessee, Virginia, Washington, and Wisconsin.

standards typically require franchisors to provide a reasonable period for a franchisee to cure the default and only allow termination if the franchisee fails to timely cure the default and such default is considered material. For example, a failure to pay undisputed fees or maintain system standards, selling unapproved products, abandoning the franchise, repeated defaults, and unauthorized use of the franchisor's trademark all support a termination for cause under applicable statutes.[101]

Absent protections from a franchise relationship statute, franchisees must rely on the terms and conditions of their franchise agreement to protect them from a wrongful termination. A claim for wrongful termination will exist in instances where a franchisor fails to strictly follow termination procedures set forth in the parties' franchise agreement. Traditionally, franchise agreements contain rights for the franchisor to terminate the franchise agreement's term before expiration with and without providing a franchisee the written notice of default and an opportunity to cure it. Defaults typically requiring written notice and an opportunity to cure the default include a failure to pay fees, report sales, comply with the terms and conditions of the system's operations manual, or purchase goods from approved sources. Franchise agreements also permit the immediate termination of a franchise agreement without notice and opportunity to cure for violations that jeopardize the integrity of the relationship or brand image, such as health and safety violations and criminal conduct, as well as bankruptcy.

The inquiry into whether the termination at issue is wrongful should not end simply upon a review of the enumerated causes for termination in a statute or the franchise agreement.[102] Instead, franchisees must examine the details of the circumstances to determine whether the franchisee may contest the stated basis for termination or argue the franchisor's discretion in declaring the default and terminating the franchise violates the franchise agreement or the implied covenant of good faith and fair dealing or may be excused by a force majeure event.

c. Renewal or Successor Franchise Agreements

Whether codified by franchise relationship statutes or the franchise agreement, franchise agreements typically provide franchisees with the right to renew their franchise agreement or enter into a successor franchise agreement after the initial term of the franchise agreement concludes.[103] Not surprisingly, franchisees rights with regard to a renewal or successor franchise agreement are much stronger under state franchise relationship laws that address renewal or successor rights than in the franchise agreement where the franchisee typically must comply with stated conditions to renew.

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[101] *See*, *e.g.*, Cal. Corp. Code §20021 (setting forth reasonable grounds for termination of a franchise).

[102] *See G.M. Garrett Realty, Inc. v. Century 21 Real Estate Corp.*, 17 Fed. Appx. 169, 2001 WL 980558 (4th Cir. 2001) (affirming jury finding of wrongful termination where franchisor terminated for failure to pay disputed fees because not all cause is "good cause").

[103] States with franchise relationship laws specifically addressing renewal include Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Washington, and Wisconsin.

[104] Although not universal, many statutes require franchisors to provide franchisees with a minimum amount of notice of franchisor's election not to renew a franchise agreement or for "good cause" for non-renewal to exist where most franchise agreements do not.

Franchisors often strictly control the circumstances, terms, and conditions upon which a franchisee may either renew the then-expiring franchise agreement on the same terms and conditions or enter a successor franchise agreement on then-current terms and conditions through the franchise agreement. Common conditions placed upon a franchisee attempting to renew or obtain a successor agreement include investing in capital expenditures to update the franchise's image, including signage, furniture, fixture, and equipment, materially complying with the franchise agreement throughout the term of the franchise and at the time of the expiration of the initial term of franchise, and providing the franchisor with a full general release of all claims.

As with transfer rights, a natural tension between franchisor and franchisee exists because franchisees often want to enjoy a second term of the franchise agreement on the same terms and conditions—and, importantly, fees—paid under the original term of franchise agreement while franchisors often want to "update" the franchise agreement's terms and conditions to the then-current fees and system standards which typically change and increase over time. Therefore, franchisees should address these issues, if possible, before executing the franchise agreement. Either way, franchisees should fully understand their rights before expiration of the franchise agreement's initial term.

B. Common Franchisor Defenses To Franchisee Claims

Franchisors respond to claims by franchisees in several ways. If the filing of a claim by a franchisee does not lead to a negotiated resolution through a mediation or discussion between counsel, franchisors may attack procedural aspects of the claim, defend the allegations and claims, and/or file a counterclaim.

1. Common Procedural Defenses of Franchisors

As discussed above, there are both strategic and substantive reasons supporting a franchisor's decision to attack a franchisee's claim for procedural reasons.

Often, franchisees file claims in their local jurisdiction, whether in state court or arbitration, despite the franchise agreement's requirement for a specific court, alternate dispute resolution process, or venue. In such instance, a franchisor with its principal place of business in a different state may either remove the claim from state court to federal court along with a transfer to the franchise agreement's chosen forum, or seek dismissal altogether. In such instances, courts generally enforce the franchise agreement's terms

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[104] *See Rogers Family Foods, LLC v. DFO, LLC*, No. 19-1476 (DWF/ECW), 2020 WL 5816589 (D. Minn. Sept. 30, 2020) (highlighting disparate rights between statutory protections and contract where court granted franchisor's motion for summary judgment on contract and implied covenant of good faith and fair dealing claims arising from a failure to renew the franchise agreement but denied the franchisor summary judgment on franchisee's statutory based claims).

where the parties selected a forum and venue.[105] This strategy is not always successful, however.[106] Franchisors seeking dismissal or stays of franchisee filed claims based on the existence of an arbitration provision are usually successful.[107]

Franchisees often seek the application of the laws in their local jurisdiction perceiving them as more favorable or, in some states, to take advantage of franchise relationship laws discussed above. By contrast, franchisors prefer and seek the consistent application of the laws of their principal place of business to obtain continuity and predictability in the enforcement of their franchise agreements. As a result, franchisors frequently seek to enforce the franchise agreement's choice of law provision, which typically succeed provided the chosen law bears a substantial relationship to the parties or dispute,[108] and a state's franchise relationship law does not prohibit application of the law chosen.[109]

Another potential procedural attack on a franchisee's claims is the assertion of the statute of limitations to those claims if those claims were not timely brought. In determining whether a statute of limitations applies, litigants must confirm the relevant period both in the applicable state's statute relating to limitations because state laws differ.[110] Similarly, claims arising from the same dispute under the same state's laws may differ. For example, a claim for the breach of a franchise agreement in Illinois is ten years while a claim under Illinois' Franchise Disclosure Act is between 90 days and 3 years depending.[111]

2. Common Substantive Defenses of Franchisors

Franchisors also assert a number of similar legal defenses to franchisee claims in addition to asserting factual defenses to franchisee claims. Two very common legal defenses available to franchisors are the reliance upon the franchise agreement's merger and integration clause, as well as the economic loss rule.

Franchise agreements typically contain provisions that state that the written franchise agreement is the entire agreement between the parties and all prior representations, understandings, and agreements are superseded by the written

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[105] *See Columbia Aircraft Sales, Inc. v. Piper Aircraft, Inc.,* 3:20-CV-00701 (JAM), 2020 WL 5904939 (D. Conn. Oct. 6, 2020), *certificate of appealability denied*, 3:20-CV-00701 (JAM), 2020 WL 7353912 (D. Conn. Dec. 14, 2020) (finding a Connecticut franchisee protected under the Connecticut Franchise Act but still subject to the choice of law and forum selection clauses).

[106] *See Crest Furniture, Inc. v. Ashley Homestores, Ltd.*, 120CV01383NLHAMD, 2020 WL 6375808, at *1 (D.N.J. Oct. 30, 2020) (noting that forum clauses are presumed invalid under the New Jersey Franchise Practice Act).

[107] *See* Section V, above.

[108] *See Cardoni v. Prosperity Bank*, 805 F.3d 573, 581 (5th Cir. 2015) (noting requirement that of a substantial relationship to the chose state's law).

[109] *See e.g.,* Ind. Code § 23-2-2.7-1(5).

[110] For example, the statute of limitations for a breach of a written contract is three years in North Carolina and five in Florida. *See* N.C. Gen. Stat. Ann. §1-52 and Fla. Stat. §95.11(2)(b).

[111] 735 ILCS 5/13-206 (providing statute of limitations of 10 years) and 815 ILCS 705/27 (setting statute of limitations for statutory violations at 90 days after delivery of notice of violation by the franchisor, 1 year after the franchisee becomes aware of facts or circumstances reasonably indicating a claim exists, or 3 years after the act or transaction constituting the violation, whichever is shorter.)

contract. Such merger and integration clauses are often the focal point of a franchisor's defense to franchisee claims relying upon pre-contract claims because they often limit a franchisee's claims or the evidence permitted at trial.[112]

Franchisors also rely upon the economic loss rule to combat claims based in tort that arise from a franchisor's performance under the franchise agreement. Although each state's laws differ, the economic loss rule generally requires a contracting party to seek remedy in contract and not tort for purely economic losses. For example, claims that a franchisor negligently performed its duties under the franchise agreement.[113]

C. Common Franchisor Claims

There are a variety of claims that are often asserted by franchisors against franchisees and either occur during the parties' normal course of operations or at the time of termination. The following sections discuss some of the more common claims asserted by franchisors against franchisees.

1. Non-Compliance with System Standards

A claim that is commonly asserted by franchisors is based on a franchisee's failure or refusal to comply with system standards. System standards are an important component of any franchise system, as they are generally established to promote efficiency in the operation of the franchised system, as well as to ensure the quality and uniformity of the goods and services provided by franchisors. If a franchisee is uncooperative or unwilling to follow the system standards, the franchisor risks the possibility of weakened brand identity, which can have potentially lasting effects on the system. Additionally, one franchisee's noncompliance with system standards without enforcement can cause non-compliance by other franchisees. Therefore, franchisee compliance with system standards is an important and necessary part of any franchise system and one a franchisor typically takes seriously.

Litigation involving system standards often involves a franchisor's pursuit of a preliminary injunction to require the franchisee to adhere to the system standards. Several courts have recognized a franchisee's violation of a franchisor's health, sanitation, or safety standards constitutes irreparable injury to a franchisor's trademarks and good will that can warrant the issuance of a preliminary injunction.[114]

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[112] *See Sugarlips Bakery, LLC v. A&G Franchising, LLC*, 3:20-CV-00830, 2022 WL 210135, at *11 (M.D. Tenn. Jan. 24, 2022) (finding a merger and integration clause may limit the evidence a franchisee uses to support its fraud claims, it does not bar the claims where the franchisees rely on statements in the documents themselves, including the FDD).

[113] *See e.g., Huddle House, Inc. v. Two Views, Inc.*, 2013 WL 1390611, at *5 (N.D. Ga. Apr. 4, 2013) (dismissing franchisee's negligence claim based upon the franchisor's alleged breach of the franchise agreement and alleged misuse of franchisee's trademarked property).

[114] *See e.g.*, *Baskin-Robbins, Inc. v. A. Ender, Ltd.*, No. CV-B-99-206-ECR (PHA), 1999 WL 1318498 (D. Nev. Oct. 28, 1999) (franchisor obtained an injunction requiring franchisee to comply with health and sanitation standards); *see also Dunkin' Donuts Franchised Restaurants LLC, et al v. D&D Donuts, Inc.*, 566 F. Supp. 2d 1350 (M.D. Fla. 2008); *GNC Franchising LLC, et al. v. Sala*, No. 06-00191, 2006 U.S. Dist. LEXIS 11320 (W.D. Pa. Mar. 20, 2006).

A franchisee's failure to adhere to system standards is also commonly included in franchise agreements as a basis for termination (though termination must be accompanied by proper notice and a cure period).[115] In order to prove noncompliance with system standards, franchisors will need to establish a clear record of the violations. This might include documentary evidence of the non-compliance, including for example quality assurance reports, photographs, third party evaluations, customer complaints, among others.

2. Monetary Claims

Franchisor claims for monetary default, also known as non-payment, are typically based on the franchisee's failure to pay certain monetary obligations set forth in the franchise agreement. These monetary obligations might include failure to pay royalties,[116] advertising fees, or payments of products or services. These nonpayment claims are generally straightforward breach of contract actions, as most franchise agreements contain specific provisions stating that failure to pay fees when due is a material breach of the franchise agreement. Moreover, the relevant accounting for whether such payments were paid (or not paid) is easily ascertainable by the franchisor and verifiable by the court. This is especially true with electronic systems tracking sales.

A franchisee will often defend itself against nonpayment claims by arguing that withholding payments of fees is justified, because of some action of the franchisor. These alleged prior breaches might include not providing requisite support to the franchisee or materially breaching the franchise agreement in some other way. Notably, however, the law is well settled that franchisees have two options when faced with an alleged prior breach of the franchise agreement by the franchisor.[117] *Jiffy Lube* and its progeny make clear that a party to a contract cannot claim the benefits of that contract (i.e. continuing

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[115] *S&R Corp. v. Jiffy Lube Intern., Inc.*, 968 F.2d 371 (3d Cir. 1992).

[116] The majority of franchise agreements include an obligation that the franchisee pay royalties, on a weekly or monthly basis, over the term of the franchise agreement. These fees are usually calculated as a percentage of gross sales of the franchise (oftentimes between 4% and 6%), or can be a fixed amount to be paid periodically regardless of sales.

[117] *See, e.g.*, *S&R Corp. v. Jiffy Lube Intern., Inc.*, 968 F.2d 371 (3d Cir. 1992) ("[W]hen one party to a contract feels that the other contracting party has breached its agreement, the non-breaching party may either stop performance and assume the contract is avoided, or continue its performance and sue for damages. Under no circumstances may the non-breaching party stop performance *and* continue to take advantage of the contract's benefits."); *HDOS Franchise Brands, LLC v. El Paso Hot Dog, LLC*, No. : 3-21-cv-00201-AJB-BLM, 2021 WL 5629923, at *6 (S.D. Cal. June 29, 2021); *Tim Hortons USA, Inc. v. Tims Milner LLC*, No. 18-cv-24152, 2019 WL 7376768, at *3) (S.D. Fla. July 23, 2019); *Ramada Worldwide, Inc. v. Hotel of Grayling, Inc.*, No. 08-3845 (KSH), 2010 WL 2674460, at *9 (D.N.J. June 30, 2010) ("under no circumstances may the non-breaching party stop performance and continue to take advantage of the contract's benefits"); *Burger King Corp. v. Majeed*, 805 F. Supp. 994, 1003-04 (S.D. Fla. 1992) ("There is no legal support for defendants'' position that, because they have asserted damage claims against [franchisor], they may therefore operate royalty and rent-free for however long their damage action remains pending. 'A franchisor's right to terminate a franchisee exists independently of any claims the franchisee might have against the franchisor. The franchisor has the power to terminate the relationship where the terms of the franchise agreement are violated."); *Burger King v. Austin,* Bus. Fran. Guide (CCH) ¶ 9788 at 22,069 (S.D. Fla. Dec. 26, 1990).

use of the franchisor's marks and system), while simultaneously refusing to perform its own obligations. (i.e., monetary payment obligations). As a result, a franchisee who believes it is not getting the requisite support from the franchisor or that the franchisor breached the franchise agreement in another way can either (1) continue to pay its monetary obligations under the franchise agreement and sue the franchisor for breach of the franchise agreement, or (2) stop paying the required monetary obligations, consider the franchise agreement terminated, and cease all performance under the franchise agreement.[118]

While nonpayment cases are fairly straightforward, a franchisor must still make sure that it complies with the notice and cure requirements set forth in the franchise agreement. A franchisor's default or termination of the franchise agreement must adhere to the requirements set forth in the franchise agreement itself, as well as any applicable state laws. The notice should clearly state the facts constituting the default and the requirements of a successful cure, as well as the cure deadline and the consequences of a failure to cure. The default notice should be transmitted in strict compliance with the notice provisions of the franchise agreement—for example, to the specified notice address by the specified means of delivery. If litigation ensues, the value of an accurate, complete, and legally-compliant notice cannot be exaggerated.

3. Abandonment

Another claim franchisors often bring against franchisees is for abandonment or closure of the franchise. This occurs when a franchisee "walks away" from the franchise prior to the expiration of the franchise agreement, or fails to operate it for a specified period of consecutive days. Many franchise agreements do not entitle franchisees to a cure period when they abandon the franchise. And, several state franchise laws provide that the franchisor may terminate the franchise immediately or upon shortened notice if the franchisee voluntarily abandons the franchise.[119] In other words, abandonment can be an incurable default under the franchise agreement.[120]

However, not all abandonments have constituted incurable defaults under the franchise agreement, and some courts have held that such determination turns on what it means to "abandon" a franchise. For example, an email from a franchisee stating that he would close the store, taken in the context that he meant that it was closing for temporary reasons, was not evidence of abandonment.[121] Such a case is important in the

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[118] *Id*.

[119] Ark Code Ann § 4-72-202(7)(C); Cal Bus & Prof Code § 20021(b); Ill St Ch 815 § 705/19(b); Iowa Code §§ 523H.7(3)(c), 537A.10; MN ST § 80C.14, subd. 3(a)(1); Miss Code Ann § 75-24-53; MO ST § 407.405; NE ST § 87-404; NJ ST § 56:10-5; WA ST § 19.100.180(2)(j).

[120] *In re Deppe*, 110 B.R. 989 (Bankr. D. Minn. 1990) (bankruptcy court held that a gas station's failure to operate its franchised gas station for nineteen days was an incurable default); *see also Zeidler v. A&W Restaurants, Inc.* No. 99 C 2591. 2001 WL 62571 (N.D. Ill. Jan. 25, 2001) (holding that because franchisee abandoned franchise location, franchisor justified in terminating franchise agreement and franchisee could not demonstrate that termination was wrongful).

[121] *See Creative American Educ., LLC v. Learning Experience Systems, LLC*, No. 9:14-CV-80900, 2015 WL 2155645, at *5-6 (S.D. Fla. May 7, 2015) (Where a franchise agreement stated that the franchisor would

context of COVID-19, as it might allow franchisees to attempt to argue that temporary closure for a limited period of time for the health and safety of its employees and customers, does not constitute an abandonment under the franchise agreement that should result in termination. While the language of the franchise agreements will still control in situations of abandonment or closure, and this type of argument seems to fit more squarely under a force majeure clause, *Creative American Educ., LLC v. Learning Experience Systems, LLC* provides franchisees with some hope that if the franchise is forced to temporarily close, it is possible to avoid termination of the franchise agreement. However, it should be noted that temporary closure could potentially be evidence of other breaches as well.

4. Non-Compete Claims

Nearly all franchise agreements contain covenants restricting the franchisee's ability to compete with the franchisor during or after the term of the franchise agreement. Competing businesses are usually defined as those businesses that operate in the same business sector as the franchisor, offering the same or similar goods or services. Typically, franchise agreements contain two types of covenants not to compete: (1) an in-term covenant not to compete, which provides that the franchisee will not compete with the franchisor during the term of the franchise agreement; and (2) a post-term covenant not to compete, which provides that the franchisee will not compete with the franchisor for a period of time following termination or expiration of the franchise agreement.

The goal of covenants not to compete in franchise agreements is to protect the franchisor's system during the term of the franchise agreement, during some period following, or both. Specifically, covenants not to compete in franchise agreements protect the franchisor's trade secrets and other confidential business information, as well as its goodwill, market share, and name recognition.

Notably, the interpretation and enforcement of in-term and post-term non-competition clauses is controlled by state law, so it is important for franchisors and franchisees alike to review the governing state statutes or applicable common law to determine the enforceability of a covenant not to compete.[122] Some states generally refuse to enforce covenants not to compete.[123] Other states have statutes that presume reasonable covenants not to compete when they comply with certain requirements.[124]

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have grounds to terminate if the franchisee ceased to operate, it was not necessarily a breach of the agreement for the franchisee to say that he proposed closing the franchise the next day. When, in context, there were operational problems that needed to be addressed in the short term, a temporary closure did not reflect abandonment by the franchisee); *but see Burger King Corp. v. Barnes*, No. 95-CV-1408, 1996 WL 529281 (S.D. Fla. Aug. 28, 1996) (holding that abonnement occurred where franchisee sent letter to franchisor stating that franchisee would be closing franchise and suspending performance of his obligations under the franchise agreement).

[122] For a comprehensive and state-by-state analysis of the enforceability of non-compete agreements in the franchise context, *see* Michael R. Gray and Natalma M. McKnew, COVENANTS AGAINST COMPETITION IN FRANCHISE AGREEMENTS (3d ed. 2012).

[123] *See e.g.,* CAL. BUS. & PROF. CODE § 16600; N.D. CENT. CODE § 9-08-06; OKLA. STAT. § 15-219A.

[124] *See e.g.,* Fla Stat. § 542.335 ("[E]nforcement of contracts that restrict or prohibit competition during or

However, most states will enforce "reasonable" restrictive covenants, and undertake the following four-part test in assessing such reasonableness. Generally, the covenant must: (1) be ancillary to an otherwise lawful contract; (2) be no greater than required to protect the franchisor's legitimate interest; (3) be reasonable and not impose undue hardship on the franchisee; and (4) not be injurious to the public.[125]

a. Violation of In-Term Covenants Not to Compete

In-term covenants not to compete prohibit the franchisee from having an ownership or business interest in a "competing business" while it is also a franchisee within the franchise system. For instance, in-term covenants not to compete protect franchisors from a situation where a franchisee seeks to transplant the business, under a different name to another location, and reap the benefits of the franchisor's knowledge and confidential information while still being a part of the franchise system.

In-term covenants not to compete are generally upheld and enforced, and are subject to less scrutiny than post-term covenants to compete. This is likely because their duration is limited (i.e. the term of the franchise agreement) and franchisors have a legitimate business interest in protecting the system's confidential information from competitors and to ensure franchisees' loyalty to the system they have agreed to join.

b. Violation of Post-Term Covenants Not to Compete

A post-term covenant not to compete clause restricts a franchisees ability to have an ownership or business interest in a "competing business" following the termination or expiration of the franchise agreement for a limited period of time. Post-term covenants not to compete are intended to protect the franchisor's interest in the goodwill built up at a location in or in a community. Accordingly, post-term covenants not to compete are usually limited in duration and limited in geographic scope.

Post-term covenants not to compete are generally subjected to more scrutiny as such clauses may be viewed as restraints on trade. However, in states where covenants not to compete are enforced, as long as the post-term covenants are reasonable, most courts will enforce them.[126] Post-term covenants to compete limited to one or two years and within a 25-mile radius of the franchisee's former franchised business or any other

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after the term of restrictive covenants, so long as such contracts are reasonable in time, area and line of business, is not prohibited."); Ga. Code. Ann. § 13-8-53 ("[E]nforcement of contracts that restrict competition during the time of a restrictive covenant, as long as such restrictions are reasonable in time, geographic area, and scope of prohibited activities, shall be permitted.").

[125] *Jiffy Lube Intern., Inc. v. Weiss Bros., Inc.*, 834 F. Supp. 683 (D.N.J. 1993); *Jackson Hewitt, Inc. v. Greene*, 865 F. Supp. 1199 (E.D. Va. 1994).

[126] *See e.g., Rita's Water Ice Franchise Corp. v. DBI Investment Corp.*, 1996 WL 165518 (E.D. Pa. 1996). (restrictive covenant providing that franchisee could not operate in a territory 1.5 miles from its existing location for 18 months after termination was reasonable when there was testimony that it took approximately 18 months to establish a new franchise, and market research showed that customers were drawn from an approximate three-mile radius)

franchised business of the system have generally been upheld.[127] As one court recently noted:

> A former franchisee who wishes to strike out on her own after the expiration of a franchise agreement may come to regret the limitations that her previous agreements, such as obligations to keep the franchisor's proprietary information confidential and not to compete with the former franchisor, may place on her new efforts. But that does not mean they are not legally enforceable.[128]

Importantly, franchisors should be prepared to put forth evidence to support the basis for the length of the restriction and the geographic area of the restricted activity, as well as the legitimate business interest the covenant is designed to protect.

Lastly, in many states, where post-term covenants not to compete are deemed overbroad, the court can modify or "blue pencil" the covenant by enforcing it to the extent the court deems reasonable. However, in a minority of states, if a covenant not to compete is overbroad in scope or duration, the court will not modify it, may strike the overly broad portions, and refuse to enforce it all together.[129] This is a further example why familiarity with state and common law is imperative when dealing with covenants not to compete.

5. Other Franchisor Claims

a. Trademark Infringement/Holdover Franchisee Litigation

It has been said that a trademark is "the cornerstone of the franchise system."[130] In fact, "it is this uniformity of product and control of its quality and distribution which causes the public to turn to franchise stores for the product."[131] Accordingly, it is unsurprising that one of the most common claims brought by franchisors against

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[127] *Ledo Pizza System, Inc. v. Singh*, 983 F. Supp. 2d 632 (D. Md. 2013) (franchisor seeking preliminary injunction against franchisee and restaurant operator to comply with post-termination obligations in franchise agreement had substantial likelihood of success on merits of claim to enforce franchise agreement's two year non-compete provision, which prohibited operation of a dine in or carry-out restaurant within 10 miles of the restaurant, where the non-compete provision's geographic and durational scope was reasonable on its face, and franchisee was allegedly a skilled worker, whom franchisor gave extensive training on how to run a pizza franchise); *Get In Shape Franchise, Inc. v. TFL Fishers, LLC*, 167 F. Supp. 3d 173 (D. Mass. 2016) (under Massachusetts law, covenant not to compete was reasonably limited in both time and space where franchise agreement prohibited franchisee from operating competing business within eight miles of studio location or any other franchised studio for two years following termination of the agreement).

[128] *Bar Method Franchisor LLC v. Henderhiser LLC*, 1:21-CV-03357-RMR, 2022 WL 174307, at *5 (D. Colo. Jan. 16, 2022) (applying Colorado law).

[129] For example, South Carolina, Nevada, and Kansas are striking states. If the covenant not to compete cannot stand without the stricken portion, the covenant will not be enforced. *Labor Finders International, Inc. v. Dove Enterprises, Inc.* Bus. Fran. Guide (CCH) ¶ 11,723 (D.S.C. 1999) (South Carolina); *H&R Block Tax Services, Inc. v. Circle A Enterprises, Inc.*, 693 N.W.2d 548, 553 (Neb. 2005) (Nebraska); H & R Block, Inc. Lovelace, 493 P.2d 205 (1972) (Kansas).

[130] *Susser v. Carvel Corp.*, 206 F. Supp. 636, 640 (S.D.N.Y 1962).

[131] *Id*.

franchisees is for trademark infringement.

When a franchise agreement terminates or expires, so does the franchisee's license to use the franchisor's name and trademarks. Franchise agreements, therefore, often contain provisions that require franchisees to cease use of the franchisor's trademarks as part of the de-branding process upon termination or expiration of the franchise relationship. Sometimes, despite such obligations, franchisees ignore these requirements and continue to operate the business using the franchisor's marks. Such franchisees are commonly referred to as "holdover franchisees." If this occurs, the franchisor will likely have a claim for infringement of its trademarks.

Section 32 of the Lanham Act, 15 U.S.C. § 1114(1), prohibits the use, "without the consent of registrant[,]" of "any reproduction, counterfeit, copy, or colorable imitation of a register mark" in connection with the sale, offering for sale, distribution, or advertising of any goods or services that "is likely to cause confusion, or to cause mistake, or to deceive," and imposes civil liability.[132] Similarly, Section 43(a) of the Lanham Act, 15 U.S.C. § 1125(a) imposes civil liability for unfair competition against a party for any false designation or origin likely to cause confusion as to the origin of the goods and products.[133]

In trademark infringement actions, as in other cases, a plaintiff is generally entitled to a preliminary injunction by establishing the following four factors:

(1) Substantial likelihood of success on the merits;
(2) Irreparable injury will be suffered unless the injunction issues
(3) The threatened injury to the movant outweighs the damage the proposed injunction might cause the opposing party;
(4) If issued, the injunction would not be adverse to the public interest.[134]

In a trademark case, one of the primary issues is whether the name used by the defendant creates a "likelihood of confusion" with the plaintiff's trademark. In fact, in the franchise context, if the franchisee continues to use the franchisor's trademarks after the franchise agreement terminates or expires, consumer confusion and irreparable harm are obvious (and for many years presumed). Courts have often found that the use of a franchisor's mark by a former franchisee creates a strong risk of consumer confusion.[135] As such, it

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[132] 15 U.S.C. § 1114(1).
[133] 15 U.S.C. § 1125(a).
[134] *McDonald's Corp. v. Robertson*, 147 F.3d 1301, 1306 (11th Cir. 1998).
[135] *See e.g., Burger King Corp. v. Mason*, 710 F.2d 1480, 1492-93 (11th Cir. 1983) (. . . "[c]ommon sense compels the conclusion that a strong risk of consumer confusion arises when a terminated franchisee continues to use the former franchisor's trademarks…consumers automatically would associate the trademark user with the registrant and assume that they are affiliated."); *TGI Friday's Inc. v. Great Nw. Restaurants, Inc.*, 652 F. Supp. 2d 763, 771 (N.D. Tex. 2009); *Buffalo Wild Wings Int'l, Inc. v. Grand Canyon Equity Partners, LLC*, 829 F. Supp. 2d 836, 846 (D. Minn. 2011).

is "well-settled doctrine that a terminated franchisee's continued use of its former franchisor's trademarks, by its very nature, constitutes trademark infringement."[136]

It should be noted that the U.S. Supreme Court in *eBay Inc. v. MercExchange* held that there is no presumption of irreparable harm in patent infringement cases, and several courts extended this same analysis and holding to trademark infringement actions, undoing the presumption of irreparable harm.[137] Notably, in 2020, however, Congress reinstated the presumption of irreparable harm for violations of the Lanham Act—effectively overruling *eBay*—by specifically including language in 15 U.S.C §1116(a) regarding the rebuttable presumption of irreparable harm.[138] It will be important for franchise attorneys to notify courts of this statutory amendment in moving for relief under the Lanham Act for trademark infringement.

For cases of trademark infringement, the Lanham Act provides several means of monetary recovery for trademark infringement including: (1) disgorgement of the defendant's profits (i.e. money the defendant made from the use of plaintiff's marks), (2) the actual damages sustained by the plaintiff, (3) attorney's fees ("in exceptional cases"), and (4) costs.[139] However, a prevailing plaintiff is not automatically entitled to monetary recovery.[140] Moreover, in the case of willful counterfeiting, the Lanham Act requires courts to treble either the actual damages or defendant's profits—whichever is greater—as a penalty for a defendant's knowing and willful sale of counterfeit merchandise, or award statutory damages ranging from $1,000 to $2,000,000.[141]

b. Confidential Information and Protection of Trade Secrets

Trade secrets and confidential information are important aspects of many franchise systems. Confidential information and trade secrets can take the form of operations manuals recipes, formulas, business process or methods of doing business, customer lists and information, software, marketing and promotional campaigns, as well as many other forms. Due to their importance, most franchise agreements contain provisions that require the franchisee to return all confidential and proprietary information of the franchisor in the franchisee's possession upon termination or expiration of the franchise

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[136] *Burger King Corp. v. Majeed,* 805 F. Supp. 994, 1006 (S.D. Fla. 1992).

[137] 47 U.S. 388 (2006); *see also North American Medical Corp. v. Axiom Worldwide, Inc*., 522 F.3d 1211 (11th Cir. 2008) ("Because the language of the Lanham Act . . . is so similar to the language of the Patent Act, we conclude that the Supreme Court's eBay case is applicable to the instant case."); *Herb Reed Enterprises, LLC v. Florida Entertainment Management, Inc.,* 736 F.3d 1239 (9th Cir. 2013) (same principle regarding irreparable harm applied to patent cases as to trademark cases)

[138] 15 U.S.C §1116(a); for a summary of Congress reinstatement of the presumption of irreparable harm in Lanham Act cases, *see* Kyle R. Kroll, *Trademark Litigators: Congress Reinstated the Presumption of Irreparable Harm in Lanham Act Cases*, https://www.americanbar.org/groups/litigation/committees/commercial-business/practice/2021/congress-presumption-irreparable-harm-lanham-act-cases/#:~:text=The%20key%20insight%20for%20practitioners,in%20support%20of%20their%20motions (last visited April 25, 2020).

[139] 15 U.S.C. § 1117(a).

[140] *Id*. (monetary relief awarded consistent with the principles of equity).

[141] 15 U.S.C. § 1117(b) and (c).

agreement. A former franchisee utilizing such information could have a substantial impact on a franchisor's business. Accordingly, courts generally hold the provisions in franchise agreements requiring the return of such information designated as confidential enforceable.[142]

Claims regarding trade secrets and confidential information can be brought as breach of contract claims, as well as violation of Trade Secrets Acts, both state and federal. Moreover, these claims may be the basis for injunctive relief and damage claims.

D. Common Franchisee Defenses to Franchisor Claims

Franchisees have many options when it comes to defending against franchisor claims. For example, if a franchisor threatens an improper termination, a franchisee might seek injunctive relief to stop the termination and/or declaratory relief specifying that the termination would be improper. In addition, if an improper termination occurs, a franchisee may seek damages or other relief against the franchisor. Finally, where a franchisor sues a franchisee for unpaid royalties, trademark infringement, or other wrongdoing, a franchisee may assert counterclaims against the franchisor, if it has legitimate grounds for doing so. The following are some examples of legal theories (both defenses and affirmative claims) that franchisees often pursue in actions against franchisors.

1. Failure to Comply with Franchise Agreement or State Law's Termination Requirements

As discussed above, franchise agreements and state laws have specific termination requirements, including notice and cure provisions. For example, any notice of default should provide at least the number of days to cure required under the agreement and any applicable statute. Further, any notice should be served upon the franchisee in the manner required by the franchise agreement or statute (e.g., certified mail or provided in the franchise agreement). Failure to comply with such requirements may invalidate a termination.[143] Practitioners should closely review state laws and notice and cure provisions of the franchise agreement in deciding whether one can use the failure to comply with such requirements as a defense to termination.

2. Materiality

A franchisee may argue "materiality" to attempt defend against many claims brought by franchisors, including failure to adhere to system standards or performance requirements. When asserting a materiality defense, a franchisee will likely argue that the violation was not "material" to justify default and/or termination. However, courts have held that failure to meet development requirements can constitute a material breach

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[142] *See e.g.*, *JTH Tax, Inc. v. Magnotte*, No. 19-cv-11607, 2020 WL 127949, at *4 (E.D. Mich. Jan. 10, 2020 (holding that franchisor likely to succeed on merits where contract obligated franchisee to return customer lists, operations manuals, and other confidential information and franchisee "did not perform these obligations, violating the legally enforceable requirements of the [f]ranchise [a]greements").

[143] *See e.g.*, *British Motor Car Distribs. v. New Motor Vehicle Bd.*, 194 Cal. App. 3d 81, 90 (1987).

justifying termination.[144] Issues regarding materiality are often fact specific inquiries requiring the parties and court to look at the relationship and course of dealings between the franchisee and franchisor.

3. Modification and Course of Dealing

Franchisees often argue that the parties' course of dealings, oral agreements, or conduct has modified the franchise agreement by introducing new terms, or canceling or amending existing terms. Notably, however, in order to effectively modify an agreement, there must be evidence of an actual intent to modify. Courts will generally look to the parties' mutual assent when analyzing modification by conduct; in other words, conduct that is based upon unilateral statements will likely not support modification.[145] Whether a modification is found may turn on whether the acts of the contracting parties are unequivocally inconsistent with the contract right in dispute.[146] And, a properly worded non-waiver clause in the franchise agreements makes such a defense more difficult to assert.

4. Waiver

Franchisees often use waiver as a defense in many different contexts. When a franchisor has not previously enforced a provision of the franchise agreement against the franchisee at issue or against other franchisees, franchisees often assert that the franchisor has waived the right to enforce that provision. Whether such argument will prevail is very fact specific.[147] However, most franchise agreements include some iteration of a non-waiver provision that franchisors often use to avoid waiver claims.[148]

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[144] *See Bennigan's Franchising Co., L.P. v. Swigonski,* CIVA 306-CV-2300-BH, 2008 WL 648936, at *4 (N.D. Tex. Feb. 26, 2008) (failure to develop restaurants in compliance with development agreement is material breach); *7-Eleven Inc. v. Puerto Rico-7 Inc.*, CIV.A. 3:08-CV-0140B, 2009 WL 4723199, at *1 (N.D. Tex. Dec. 9, 2009) (same); *See Seven-Up Bottling Co. Ltd. v. PepsiCo, Inc.*, 686 F. Supp. 1015, 1023 (S.D.N.Y. 1988) (holding that termination of license agreement was proper where bottler continually failed to meet minimum sales requirements and distribution levels required by agreement); *see also Brown Dog, Inc. v. Quizno's Franchise Co. LLC*, No. 04-C-18-X, 2005 WL 3555425, at *11 (W.D. Wis. Dec. 27, 2005).

[145] *See New Eng. Surfaces, Inc. v. E.I. DuPont de Nemours & Co.*, No. 06-cv-89-P-S, Bus. Franchise Guide (CCH) ¶ 13,713 (D. Me. Sept. 14, 2007).

[146] See Haynes Trane Serv. Agency, Inc. v. Am. Standard, Inc., 573 F.3d 947 (10th Cir. 2009) (manufacturer's pattern of terminating with cause was insufficient to find that the contractual right to terminate without cause had been modified).

[147] *LaGuardia Assocs. v. Holiday Hospitality Franchising*, 92 F. Supp. 2d 119 (E.D.N.Y. 2000) (franchisor waived its right to terminate a franchise agreement where the franchisor did not attempt to terminate until ten months after the franchisees' default on payment); *Can. Dry Corp v. Nehi Beverage Co., Inc.*, 723 F.2d 512 (7th Cir. 1983) (franchisor waived its right to terminate based on the franchisee's failure to renew in writing, as required by the franchise agreement, where the franchisor allowed the franchisee to continue to operate in the two territories and even retroactively granted a limited extension of these territorial rights); *Dunkin' Donuts Inc. v. Gav-Stra Donuts, Inc.*, 139 F. Supp. 2d 147, 157 (D. Mass. 2001) (franchisor did not waive its right to terminate the franchise agreement for criminal conduct even if it waited six years after learning of the conduct - at most, there was "mere silence" by the franchisor; and absent evidence that the franchisor took affirmative steps to waive its contractual right to terminate, there was no waiver).

[148] *See* Kerry L. Bundy, Scott H. Ikeda, *How Waiver, Modification, and Estoppel May Alter Franchise Relationships*, 30 Franchise L.J. 3, 5 (2010):

Such non-waiver clauses are both enforced and invalidated by courts based on applicable state laws and surrounding circumstances.

5. Ulterior Motive or Improper Purpose for Termination

When a franchisor terminates a franchise relationship, a franchisee might argue that the franchisor has an ulterior motive for termination. However, as long as there is adequate grounds to support the franchisor's termination of the agreement or relationship, courts generally will not consider the franchisor's motivation in terminating.[149] However, there have been instances where courts have found that pretextual reasons for termination were improper.[150]

VII. REMEDIES

Claims brought by franchisors and franchisees give rise to a variety of different remedies, including monetary damages, injunctive relief, rescission and restitution, declaratory relief, and specific performance. Moreover, depending on the case and the contracts at issue, attorneys' fees can be awarded in franchise disputes.

A. Contract Damages/Monetary Damages

Generally speaking, a party asserting a claim for breach of contract is entitled to recover damages that are directly and proximately caused by the breach of contract, and those damages are designed to restore the injured party to the position it would have been in but for the breach of the other party. The measure of recovery will vary depending on upon which interests are asserted. Compensation for a breach of contract is generally limited to money damages for losses that were reasonably anticipated by the parties at the time of contracting.

One of the most common contract damages that franchisors seek from franchisees is recovery of past due royalties and advertising fees. Once a franchisor proves a breach of the franchise agreement, recovery of past due royalties and/or advertising funds is fairly straightforward—requiring a calculation of the past due amounts. Interest, late fees,

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> This Agreement supersedes all prior agreements and discussions between the parties regarding the subject matter and may be modified only by a writing signed by both parties. No waiver, amendment, release, or modification of this Agreement shall be established by conduct, custom, or course of dealing, but solely by a written document executed by both parties.

[149] *See McDonald's Corp. v. Robertson*, 147 F.3d 1301, 1309 (11th Cir. 1998) (finding that "it does not matter whether McDonald's also possessed an ulterior, improper motive for terminating the [franchisee's] franchise agreement" where franchisees failure to comply with system food safety standards constituted a material breach of the franchise agreement).

[150] *See, e.g., Bronx Auto Mall, Inc. v. American Honda Motor Co., Inc.*, 113 F.3d 329 (2d Cir. 1997) (affirming judgment enjoining franchisor from terminating franchise agreement on pretextual grounds and noting that stating a false reason for termination of a dealership franchise violates New York's Franchised Dealer Act.); *see also Tuf Racing Products, Inc. v. American Suzuki Motor Corp.*, 223 F.3d 585 (7th Cir. 2000) (affirming verdict in favor of franchisee where franchisor's reasons for terminating franchisee were entirely pretextual).

and attorneys' fees might also be included in such calculation depending on the whether the franchise agreement provides for recovery of such amounts.

Franchisors and franchisees also seek to recover future lost profits. These damages are often characterized as lost profits, "benefit-of-the-bargain" damages, or expectation damages. For example, a franchisor might want to recover its lost future royalties, future advertising fees, or future marketing fees due to the breach. Specifically, these damages consist of monies that a party would have earned for the remainder of the franchise term had the relationship not been terminated, less any expenses that the party would save by no longer having to provide services under the agreement. Expectation damages, therefore, are the broadest form of compensatory damages and may include actual lost profits and future lost profits.

To establish entitlement to lost profits, a party must show that: (a) the profits were within the contemplation of the parties at the time the contract was entered into; (b) their loss was the probable result of the breach; and (c) they are not too remote or speculative. Once entitlement to lost profits is established, there are two common methodologies that parties use to calculate such damages. First, parties can calculate the profits the party expected to earn in the remainder of the franchise term had the relationship not been terminated. From the franchisor's perspective, these damages consist of the royalties that the franchisor would have earned had the franchisee operated its franchise business for the remainder of the franchised term, less any expenses that the franchisor would save by no longer having to provide operational support and other services to the franchisee. A franchisor's claim for future royalties must be reasonable and cannot be based on conjecture or speculation.

As an alternative, franchisees sometimes attempt to use a diminished "fair market" calculation in determining expectation damages. This calculation assesses the fair market value of the franchise at the time of the breach, and compares it with the value after the breach. The difference in the value is taken to represent the measure of damages. In order to establish the fair market value, franchisees generally must establish a track record of performance and profitability. Franchisees that have not been open long or have been historically unprofitable are not likely to be granted lost profits because such calculations would be inherently speculative. However, franchisees might be able to rely on the financial performance of other successful franchisees in the system to recover lost profit damages.

Some courts have held that the diminished "fair market" approach may be less speculative than a lost profits approach.[151] However, as a practical matter, it will likely be difficult to ascertain the market value of a franchise both before and after a breach. The valuation will likely require expert testimony regarding a franchisee's future performance that takes into account a number of variables, including projections of revenues and

[151] *First Fed. Lincoln Bank v. United States*, 518 F.3d 1308, 1317-18 (Fed. Cir. 2008) ("The market value of income-generating property reflects the market's estimate of the present value of the change to earn future income, discounted by the market's view of the lower future value of the income and the uncertainly of the occurrence and amount of any future property.").

expenses in the future, as well as the likelihood that the franchisee will remain in business for the balance of the term of the franchise agreement and any renewal terms thereafter. Therefore, lost future profits is likely the more practical damage measure available to franchisees and franchisors alike in termination cases.

Moreover, some franchise agreements contain liquidated damage provisions, which are contractual provisions that specify the amount of damages recoverable in the event of a breach of the agreement. Such clauses are often found in franchise agreements in the hotel industry. The validity of such provisions depends upon whether it reasonably forecasts the harm resulting from the breach, or it is an unenforceable "penalty clause." A liquidated damage provision becomes an unenforceable "penalty clause" only if there is no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from the breach.[152] Courts assess the reasonableness of liquidated damage provisions from a totality of the circumstances perspective.[153] Notably, however, the burden is on the party opposing enforcement of the liquidated damage provision to show that it is not reasonable.[154]

B. Rescission and Restitution

Rescission and restitution are companion remedies used to restore the parties to the same position that they would have been had they never entered into the agreement. Simply put, rescission is the unmaking of a contract. In addition, restitution damages aim to put the parties to a contract in status quo ante, i.e. their respective positions before the contract was formed.[155] Rescission and restitution often work in concert.

Specifically, rescission is an equitable remedy that severs the relationship between the parties. Rescission relieves all parties of their contractual duties and obligations. The remedy of rescission is not given as a matter of right. Rather, a court has the discretion to allow rescission based on each individual case, its facts, and in the interests of justice.[156] A party might seek the equitable remedy of rescission in cases of fraudulent inducement, material breach, mistake, impossibility of performance, among others.[157]

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[152] *See, e.g., Ganesh, Inc. v. Days Inns Worldwide, Inc.*, Bus. Franchise Guide (CCG) ¶ 12,341, at 10 (N.D. Ohio March 21, 2002).

[153] *See, e.g., Days Inn Worldwide, Inc. v. BFC Mgmt., Inc.* 544 Supp. 2d 401, 406 (D.N.J. 2008); *ERA Franchise Sys., Inc. v. Brager & Assocs., Inc.*, No. 1:06-cv-1861 LTD NEW (TAG), 2007 WL 2238161, at *8 (E.D. Cal. Aug. 2, 2007).

[154] *Holiday Hospitality Franchising, Inc. v. 174 W. St. Corp.*, Bus. Franchise Guide (CCH) ¶ 13,399 (N.D. Ga. July 19, 2006); *Ramada Franchise Sys., Inc., v. Jacobcart, Inc.,* Bus. Franchise Guide (CCH) ¶ 12,609 (N.D. Tex. Feb. 21, 2003).

[155] Restatement of Contracts, § 347 cmt. b (1932) ("In granting restitution as a remedy for breach. . . the purpose to be attained is the restoration of the injured party to as good a position as that occupied by him before the contract was made."); *Riess v. Murchison*, 503 F.2d 999, 1008 (9th Cir. 1974) (holding that the victim of a material breach "may seek restitution in which both he and the wrongdoer will be restored to the position they occupied at the time the contract was formed"), *cert. denied*, 420 U.S. 993 (1975*); Potter v. Oster*, 426 N.W.2d 148, 152 (Iowa 1988) ("Restoring the status quo is the goal of the restitutionary remedy of rescission.").

[156] *See Billian v. Mobil Corp.*, 710 So. 2d 984, 990 (Fla. Dist. Ct. App. 1998).

[157] *Final Cut, LLC v. Sharkey*, No. X05CV085007365S, 2012 WL 310752 (Conn. Super. Ct. 2012)

Notably, however, for rescission to be awarded, the breach of the franchise agreement must be substantial and concern the essential purpose of the contract. Moreover, a franchisor's failure to comply or register with statutory disclosure laws can also be grounds to rescind a franchise agreement.[158]

Restitution damages attempt to measure the benefit conferred on the breaching party, rather than measuring profits the aggrieved party would have made. In many jurisdictions, relief for rescission includes not only restitution damages of consideration provided, but also consequential damages, i.e. rescission includes complete relief to make the aggrieved party whole.[159] Where rescission is awarded, the proper measure of recovery is restitution of the consideration and other benefits received by the parties under the contract. For example, if a party rescinding a contract has received land, goods or other property, he is expected to return it. Importantly, parties seeking the equitable remedies of rescission and restitution should be aware that they must ultimately elect these remedies in lieu of other damages, such as expectation or reliance damages.

C. Specific Performance

The equitable remedy of specific performance allows a court to mandate continued performance of specific franchise agreement provisions. A common example of an action for specific performance might involve a franchisee seeking relief due to a franchisor's refusal to allow renewal as set forth in the franchise agreement.[160] On the other hand, franchisors may use the remedy of specific performance to bring franchisees into compliance with system standards, or to enforce buyout or non-compete provisions following franchise termination.

D. Declaratory Relief

As an alternative to specific performance, franchisors (and franchisees) can seek a declaration regarding whether a party's conduct under the franchise agreement constitutes a breach and whether the breach gives rise to a basis for termination. Declaratory judgment actions are also useful when the parties disagree as to the

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(franchisees entitled to rescission of purchase and franchise agreements and return of any monies paid to franchisor when franchisor made a number of material and deceptive misrepresentations which ultimately induced franchisees to purchase the franchises); *Manpower Inc. v. Mason*, 405 F. Supp. 2d 959, 976 (E.D. Wis. 2005) (District court determined that franchisee and principal shareholder materially breached and destroyed essential object of franchise agreement with franchisor by supplying temporary employees to other franchise locations outside its territories, failing to complete I-9 forms showing its employees were eligible to work in the United States, and misusing franchisor's name in violation of their agreement. Therefore, the district court granted rescission of the franchise agreement and ordered franchisee to refrain from using franchisor's trade name, trademarks and proprietary information until requisite security was provided.).

[158] *See e.g.,* Cal Corp. Code § 31300.

[159] *Runyan v. Pac. Air Indus.*, 2 Cal. 3d 304, 307 (Cal. 1970) (granting consequential damages for loss of income, less gross income realized from franchise operation, after franchisee's rescission of franchise contract).

[160] *See e.g., Prudence Corp. v. Shred-It Am., Inc.*, 365 Fed. Appx. 859, 861 (9th Cir. 2010) (district court did not abuse discretion when it ordered renewal of franchise agreement at the original royalty rate).

interpretation of a franchise agreement provision. Seeking a declaratory judgment from a court prevents a party from undertaking a course of action based on an specious reading of the franchise agreement.

Parties may seek declaratory relief pursuant to the Declaratory Judgment Act[161] or its state law counterparts. The Declaratory Judgment Act, however, provides district courts with significant discretion in granting declaratory relief.[162] A district court may grant declaratory relief when there is a substantial controversy with sufficient immediacy to warrant the relief,[163] but will not grant declaratory relief for future contingent events.[164] A district court will also not grant declaratory relief if the issues are already being directly adjudicated within the litigation or there is a substantial likelihood that a declaratory judgment will not end the controversy.[165]

E. Attorneys' Fees

Claims for attorneys' fees are front and center of many franchise litigation cases, since the majority of franchisors have standard agreements that contain either a reciprocal prevailing party attorneys' fee provision or a franchisor-specific attorneys' fee provision. However, in cases where the attorneys' fee provision is one-sided in favor of the franchisor, some state laws may require such provisions to be applied reciprocally.[166] Additionally, most state franchise statutes permit franchisees to recover attorneys' fees and expenses if it prevails on a statutory claim for rescission or damages. Attorneys' fees are also recoverable in claims under the Lanham Act, but only in "exceptional cases."[167] Courts have generally held that for attorneys' fees to be granted under the Lanham Act there must be some form of willful, deliberate, or fraudulent conduct.[168]

Such attorneys' fee provisions are worth considering at the outset of the litigation as a party can find itself responsible for its opponents' attorneys' fees and expenses, or being able to recover its attorneys' fees and expenses from its opponent.

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[161] 28 U.S.C. §§ 2201-2202 (2022).

[162] 28 U.S.C. § 2201(a) (district courts "may declare the rights and other legal relations of any interested party").

[163] *See e.g., Thompson v. DeWine*, 7 F.4th 521, 524 (6th Cir. 2021) ("To determine whether a request for declaratory relief is moot, we ask 'whether the facts alleged, under all the circumstances, show that there is a substantial controversy, between parties having adverse legal interests, *of sufficient immediacy and reality* to warrant the issuance of a declaratory judgment.'").

[164] *Wyatt, Virgin Islands, Inc. vv. Government of the Virgin Islands by and through the Virgin Islands Dep't of Labor*, 385 F.3d 801, 806 (3d Cir. 2018) ("The conflict between the parties must be ripe for judicial intervention; it cannot be 'nebulous or contingent' but 'must have taken on fixed and final shape so that a court can see what legal issues it is deciding, what effect its decision will have on the adversaries, and some useful purpose to be achieved in deciding them.'").

[165] *Compare Postal Instant Press v. Jackson*, 658 F. Supp. 739 (D. Colo. 1987), with *Astral Health & Beauty, Inc. v. Aloette of Mid-Miss., Inc.*, 895 F. Supp. 2d 1280 (N.D. Ga. 2012).

[166] *See e.g.,* Ca. Civ. Code § 1717.

[167] 15 U.S.C. § 1117(a).

[168] *Twin Peaks Productions, Inc. v. Publications Intern., Ltd.*, 996 F.2d 1366, 1383 (2d Cir. 1993) ("The relevant statute, 15 U.S.C. § 1117 (1988), allows recovery of a reasonable attorney's fee only in 'exceptional cases.' Such fees should be awarded only 'on evidence of fraud or bad faith.'").

VIII. CONCLUSION

As long as the business model of franchising exists, it is nearly guaranteed that there will be legal conflict between franchisees and franchisors. It is imperative for franchise practitioners to stay up to date on the latest legal developments, as well as an understanding of the franchise laws across a variety of states. As explained herein, franchise laws can vary by state and jurisdiction, and new decisions involving franchising are handed down from courts and arbitrators frequently. Unlike many other types of business litigation, franchise disputes and decisions can have far-reaching and system-wide consequences. This article has attempted to cover the most salient issues relating to franchise litigation, but rest assured the nature of the franchise relationship guarantees new issues are always present and will continue to arise. Ultimately, it is important to have a comprehensive understanding on established franchise laws, to know the current issues where the law may not be so settled or clear, and finally, to know that new arguments are always being made that might shape franchise litigation to come.