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BASICS TRACK: FRANCHISE LITIGATION

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

Page

BASICS TRACK: FRANCHISE LITIGATION

I. INTRODUCTION

In many ways, litigating a franchise case is not too far removed from commercial litigation matters. The aspects that make it unique are the federal and state laws that govern the franchise relationship and, at times, override the various provisions of the parties' franchise agreement. Franchise litigation crosses over into a multitude of other legal subject areas and is not just limited to representations made in the franchisor's franchise disclosure document or claims of fraudulent inducement as it pertains to the parties' franchise agreement. In any given dispute, franchise litigation can cross over into matters of employment law (including joint employer), tax fraud, immigration, trademark, antitrust, bankruptcy, and other legal subjects.

In addition, in today's franchise practice, franchise parties are increasingly including in their contracts the ground rules for resolving their differences. Franchise parties are including clauses that touch upon issues of jurisdiction, arbitration, and venue, and imputing those to the extent they are not upended by any of the various state franchise relationship laws. Some franchise agreements also require the parties to engage in pre-litigation mediation or mandate that parties arbitrate their differences before a panel of one or two arbitrators. These various clauses provide certainty to franchise parties as to which forum will resolve their dispute and which law will govern.

This paper provides background information on these issues and includes a discussion on typical claims that franchisors and franchisees are increasingly filing against each other, and the general legal remedies each party asserts in trying to rebut these claims.

II. FEDERAL AND STATE FRANCHISE LAWS

The Federal Trade Commission's Franchise Rule mandates that franchisors provide a prospective franchisee with a franchise disclosure document ("FDD") that is by designed intended to convey to the prospect the franchise opportunity. The FDD consists of 23 items of information a franchisor must provide to a prospect before offering and selling a franchise. In addition, fourteen states mandate that the FDD be registered in the state before a franchise can be offered or sold, and approximately twenty states and territories have enacted franchise relationship laws that set procedural and/or substantive requirements governing the parties' relationship, including termination. Generally, these laws require written notice to the franchisee and good cause before a franchisor can terminate a franchise. The statutes vary in their definitions of good cause, but it typically includes situations such as the franchisee failing to comply with the material provisions of the franchise agreement, the franchisee becoming insolvent, and the franchisee voluntarily abandoning the premises. In addition, state statutes require a franchisor provide an opportunity to cure in certain instances and provide 30 to 90 days' advance notice of termination. Beyond these requirements, some state franchise statutes supersede the parties' franchise contract in other ways, including voiding forum selection clauses requiring an in-state franchisee to litigate its dispute out-of-state. This federal and state regulatory framework substantially affects the parties' relationship and alters their contracts. So while franchise litigation is many ways similar to commercial litigation, franchise parties need to keep these federal requirements and state statutes in mind as they litigate their franchise dispute.

III. LITIGATING IN COURT: THE REQUIREMENT OF JURISDICTION

Most franchise agreements mandate that any dispute be governed by a preselected choice of law, require the franchisee to waive issues of jurisdiction, and mandate that any litigation be instituted in a particular forum, typically near the franchisor's headquarters. These provisions touch upon the issue of jurisdiction. In order to litigate a dispute in either federal or state court, a court must have personal jurisdiction over a party – *i.e.,* certain constitutional minimum contacts must be satisfied so that hailing this person or entity into court "does not offend traditional notions of fair play and substantial justice"[1] – and subject matter jurisdiction (federal question or diversity) – *i.e.,* the authority to hear the type of case.

A. Personal Jurisdiction

The requirements of personal jurisdiction come into play when a franchise dispute involves an out-of-state defendant, either franchisor or franchisee. The United States Constitution, as well as state law, requires that a party establish "certain minimum contacts with [the forum state] such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'"[2] Because most states' long-arm statute extend the boundaries of personal jurisdiction as far as the constitutional requirements, most courts combine the analysis into a single inquiry in determining if the requirements of due process are satisfied.[3]

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[1] *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945) (citation omitted).

[2] *Id.*

[3] *See Inamed Corp. Kuzmak*, 249 F.3d 1356, 1359-60 (Fed. Cir. 2001) ("Determining whether personal jurisdiction exists over an out-of-state defendant involves two inquiries: whether a forum state's long-arm statute permits service of process, and whether the assertion of personal jurisdiction would violate due process."); *Loyalty Conversion Sys. Corp. v. American Airlines, Inc.*, 66 F. Supp. 3d 813, 818 (E.D. Tex. 2014) ("Where, as here, the forum state's long-arm statute 'is coextensive with the limits of due process, the two inquiries collapse into a single inquiry: whether jurisdiction comports with due process.'").

1. General and Specific Jurisdiction

Courts categorize an out-of-state's defendant's contacts into "general" or "specific" in determining if there is general or specific jurisdiction.[4] Of the two types of jurisdiction, general jurisdiction is subjected to a higher due-process threshold and requires a more demanding showing.

Under *general jurisdiction*, a court may hear a lawsuit against a defendant who has "continuous and systematic" contacts with the forum state, even if the injuries at issue in the lawsuit did not arise out of the defendant's activities directed at the forum.[5] That is, the contacts between the defendant and forum state must be "substantial", and the inquiry here is on the quality and nature of those contacts.[6] As the United States Supreme Court has made clear, for a court to have general personal jurisdiction over a defendant the connection with the state at issue must be so "continuous and systematic as to render [it] essentially at home in the forum state."[7]

On the other hand, *specific jurisdiction* lies when a particular case "'relates sufficiently to, or arises from, a significant subset of contacts between the defendant and the forum.'"[8] "Specific jurisdiction . . . depends on an affiliation between the forum and *the underlying controversy*."[9] The seminal franchise case on the subject of specific jurisdiction is *Burger King Corp. v. Rudzewicz*,[10] where the Supreme Court made clear that personal jurisdiction in an interstate contract case need not be based on the defendant's physical presence in the forum state. As stated by the Supreme Court: "So long as a commercial actor's efforts are 'purposefully directed' toward residents of another state, we have consistently rejected the notion that an absence of physical presence can defeat personal jurisdiction there."[11]

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[4] *Cossart v. United Excel Corp.*, 804 F.3d 13, 20 (1st Cir. 2015) (citing *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 131 S.Ct. 2846, 2851 (2011)).

[5] *Helicopteros Nacionales de Colombia, S.A. v. Hall*, 466 U.S. 408, 415-16 (1984).

[6] *Id.* at 416.

[7] *Daimler AG v. Bauman*, 134 S. Ct. 746, 749 (2014) (internal citation and quotation omitted).

[8] *Baskin-Robbins Franchising LLC v. Alpenrose Dairy, Inc.*, 825 F.3d 28, 35 (1st Cir. 2016) (quoting *Phillips Exeter Acad. v. Howard Phillips Fund, Inc.*, 196 F.3d 284, 288 (1st Cir. 1999)).

[9] *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 131 S. Ct. 2846, 2851 (2011) (emphasis added) (internal quotation marks and alteration omitted).

[10] 471 U.S. 462, 479 (1985).

[11] *Id.* at 476 (citations omitted).

2. Franchise Cases On the Issue of Specific Jurisdiction

Issues of personal jurisdiction are fact-specific and arise in a number of contexts. The burden is on the plaintiff to establish that a court has personal jurisdiction over an out-of-state defendant. And the failure to meet this burden may result in dismissal. Two franchise cases illustrate the types of information a party must present in order to establish jurisdiction.

The first is *Baskin-Robbins Franchising LLC v. Alpenrose Dairy, Inc.*,[12] where the dispute centered on the franchisee's notice of non-renewal it had served on franchisor Baskin-Robbins and its subsequent decision retracting that notice. Baskin-Robbins sued in Massachusetts federal district court, near its headquarters, seeking a declaratory judgment that the parties' franchise agreement had expired, essentially beating the franchisee to the courthouse. The franchisee moved to dismiss claiming that there was no personal jurisdiction because it was based in the State of Washington. The federal district court agreed with the franchisee that personal jurisdiction was lacking and dismissed the lawsuit.

The franchisor appealed, with the First Circuit reversing the federal district court. The First Circuit reviewed the underlying record in finding there was personal jurisdiction. The appellate court found compelling the many visits over the years by the franchisee to Massachusetts—a few times to attend brand advisory meetings and to meet Baskin-Robbins' new owners. In addition, the franchisee had been directing its royalty payments to Massachusetts ever since the franchisor had moved to that state. Finally, according to the First Circuit, the "sockdolager" fact pertained to the services being provided, with one of them being the ice cream samples the franchisee was sending for testing four times a year to Baskin-Robbins. These services, according to the First Circuit, showed that the franchisee availed itself of the forum and it was certainly foreseeable that it would have to litigate in the state.[13]

Similarly, the case of *Red Robin Int'l, Inc. v. Lehigh Valley Restaurant*, involved a similar set of facts. The parties had entered into a franchise agreement in 1995. At the time of contracting, Red Robin was a Nevada company headquartered in California. One year after entering into the contract, the franchisor moved its headquarters to Colorado. The lawsuit centered on the termination of the franchise and the franchisee's obligation to comply with its post-termination obligations, which the franchisor sought to enforce in Colorado federal district court. The franchisor named the franchisee and three individuals in the lawsuit, and all of them filed a motion to dismiss claiming there was no personal jurisdiction over them. They contended that there was no nexus to Colorado, since the parties' contract did not provide any notice that it would be subject to suit in that state. The federal district court disagreed, and focused on the parties' course of dealing in the twenty years since the parties' first entered into the franchise agreement. The federal district court found that the visits to Red Robin's headquarters

[12] 825 F.3d 28 (1st Cir. 2016).

[13] *Id.*

in Colorado, coupled with the services provided by Red Robin and payment of royalty and advertising fees to the state, were sufficient to confer personal jurisdiction over the franchisee entity. However, because the franchisor had failed to include any information regarding the three individual defendants, the federal district court granted the motion to dismiss for lack of personal jurisdiction as to them.

Franchise attorneys can glean a few lessons from these cases. Simply pointing to the franchise case of *Burger King Corp. v. Rudzewicz* is not enough to defeat a motion challenging personal jurisdiction. Jurisdictional issues are fact-specific, and a party must develop the record to prove up jurisdiction. In the *Baskin-Robbins* case, had the franchisor not demonstrated that it had provided significant services to the franchisee, it likely would have had a difficult time on appeal. Therefore, a party must creatively show that the contacts meet the minimum requirements.

To lessen jurisdictional challenges, oftentimes a franchise agreement will contain a waiver clause in which a party agrees to waive jurisdiction at the time of contracting. These clauses typically state: "You consent to the jurisdiction and venue of . . . . " or "Franchisee hereby waives all questions of personal jurisdiction." Courts do recognize this type of clause and will give them great weight in finding there is personal jurisdiction, even if a party's contacts with the forum state are minimal.[14] The clause, however, is not bullet proof, and a party will often challenge the issue of jurisdiction from the outset. While these types of contractual provisions may not be enforceable in every state, especially those states with franchise relationship laws,[15] the clause should provide a party some support in the event of a dispute.

B. Subject Matter Jurisdiction

While personal jurisdiction is focused on the "person," subject matter jurisdiction is focused on the type of claim at issue. Federal or state courts must have the power to hear the specific kinds of claims at issue. Except for those claims that are specifically reserved to federal courts, state courts generally maintain general jurisdiction over a person and may hear any type of claim arising under state or federal law.

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[14] *See, e.g., GreatAmerica Leasing Corp. v. Telular Corp.*, No. C 98-127, 1999 WL 33656867, at *3 (N.D. Iowa Apr. 20, 1999) ("Even if a district court lacks the 'minimum contacts' necessary to exercise personal jurisdiction, it is possible for a party to waive the personal jurisdiction requirements.") (citing *RAR, Inc. v. Turner Diesel, Ltd.,* 107 F.3d 1272, 1280 (7th Cir.1997) (personal jurisdiction is waivable through, *inter alia,* forum selection clauses); *J.V. Edeskuty & Assoc. v. Jacksonville Kraft Paper,* 702 F. Supp. 741, 745 (D. Minn.1988) ("Personal jurisdiction involves an individual right which, like other individual rights, can be waived.")).

[15] *See* Cal. Bus. and Professions Code § 20040.5 (stating: "A provision in a franchise agreement restricting venue to a forum outside this state is void with respect to any claim arising under or relating to a franchise agreement involving a franchise business operating within this state.").

Unlike state courts, federal courts have limited jurisdiction to hear a case, as promulgated by Article III of the United States Constitution and 28 U.S.C. §§ 1331 and 1332. Franchisors or franchisees wishing to litigate in federal court must either show that there is diversity of citizenship or the lawsuit arises under a federal question; that is, it arises pursuant to a question concerning the Federal Constitution, a federal law, or treaty of the United States. A party's lawsuit in federal court must be premised on one, although oftentimes a lawsuit is based on both grounds given that a typical franchisor claim will include a trademark or trade name violation that arises under federal law.

1. Diversity Jurisdiction

Diversity of citizenship pursuant to 28 U.S.C. § 1332(a) requires that parties to a lawsuit must be citizens of different states and the amount in controversy must exceed $75,000, exclusive of interest and costs.[16] 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."[17] If parties are not diverse, then a federal court is not able to hear the case and must dismiss it.

a. The Citizenship of Individuals

The citizenship of an individual is the same as that person's domicile. To establish domicile in a state, an individual must be both physically present in the state and have the intent to make his or her home there indefinitely, with no present or fixed intent to move to another state upon the happening of a reasonably certain event. However, intention to remain in a state permanently is not necessary to establish citizenship in that state. Once an individual has established domicile in a state, domicile remains in that state until the person acquires a new domicile. The burden is on the party seeking a federal forum, if challenged, to prove by a preponderance of the evidence that the parties are citizens of different states.

b. The Citizenship of Entities

Matters of diversity jurisdiction can be tricky when it comes to identifying an entity's citizenship. By statute, a corporation is a citizen of where it is incorporated and where its principal place of business is located.[18] For the most part, state corporate records and the Internet are helpful in identifying a company's headquarters and

[16] *See* 28 U.S.C. § 1332(a) ("The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of $75,000, exclusive of interest and costs, and is between . . . citizens of different States.").

[17] *Reid v. The Wailers*, 606 F. Supp. 2d 627, 629 (E.D. Va. 2009) (citing 28 U.S.C. § 1332(a)); *Baltimore Cty. v. Cigna Healthcare*, 238 Fed. Appx. 914, 920 (4th Cir. 2007)).

[18] 28 U.S.C. § 1332(c)(1). The United States Congress has not extended this test to other types of entities, such as a limited liability company.

principal location, since they will provide information concerning a company's incorporation and principal place of business.

A much more difficult task pertains to other entities, such as a limited liability company (LLC or LLCs), a limited partnership, or similar entity. For purposes of diversity, it is the citizenship of the entity's members (*all* of its members) that determine the issue of citizenship, and a party in federal court must disclose in its initial pleading the citizenship of all members of the LLCs or other limited partnership entity, or risk dismissal.

The problem arises when a party is uncertain of an entity's members. State corporation records are not helpful, since they do not keep track of this information. Incorporating an LLC or other entity minimally requires an application, the payment of a fee, and the submission of articles of incorporation that often do not identify an LLC's members. There are also no online databases that provide this type of information. So, if a party is unable to show complete diversity of an LLC in its complaint, the court is unable to accept jurisdiction of the case and the result is immediate dismissal.

Even if a party is able to pass the diversity hurdle, the problem can become more pronounced later when, after having filed suit, it discovers the citizenship of an LLC's member that completely destroys diversity between the parties. The cure in that instance is not to amend, even if a member can be eliminated from the litigation. The cure, unfortunately, is to dismiss as pronounced in the United States Supreme Court's decision in *Grupo Dataflux v. Atlas Global Group*, where the case was at the tail end when the parties learned of a member's citizenship that destroyed diversity.[19] Because diversity is measured at the time of filing, the proper course of action, according to the United States Supreme Court in *Grupo Dataflux*, is for dismissal of the action and re-filing of the litigation to ensure complete diversity.[20]

Litigants should therefore ensure diversity jurisdiction at the time of filing. In addition, franchisors should keep good records of its franchisees' members, if it is an LLC or other type of entity, to avoid having to search for members' citizenship at the time it is contemplating a lawsuit in federal court.

c. The $75,000 Monetary Threshold

The other requirement of diversity jurisdiction is a showing that the amount in controversy exceeds $75,000, exclusive of interests and costs. Oftentimes a statement in the complaint based on a good faith estimate that the amount in controversy exceeds

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[19] 541 U.S. 567, 574-575 (2004) (holding change in plaintiff's partnership composition after commencement of action did not remedy absence of complete diversity at time of filing).

[20] *Id.* at 581 (observing that the "obvious course" is to refile an action where the absence of diversity at the time of filing is remedied by a subsequent change in a party's composition).

$75,000 satisfies this requirement. But sometimes satisfying the $75,000 threshold is a trickier proposition when a party seeks only equitable relief and no monetary damages; for example, a complaint seeking to enforce the parties' covenant not to compete or seeking a declaratory judgment. In that instance, the amount in controversy is measured by the value of the object of the litigation.[21] Courts recognize that in equitable actions precise determination of monetary damage is not easily determinable.[22] Instead, courts simply look to the value of the right being protected or the injury being averted in determining the amount in controversy.[23]

One way to satisfy the jurisdictional amount is to show a party's past sales as an indicator of future sales and profits. For example, in *Grow Biz Int'l, Inc. v. MNO, Inc.*,[24] the franchisor sought an injunction to prohibit its franchisee from violating its post-termination covenant not to compete. The franchisee alleged that the $75,000 amount in controversy was not satisfied. But the court disagreed, relying on the fact that the franchisee generated well over $500,000.00 in yearly revenues, other nearby franchisees generated in excess of $500,000.00 in average yearly revenues, and the franchisor recovered royalty payments and earned $20,000.00 in franchise fees.[25] These amounts, according to the court, satisfied the amount in controversy requirement.

2. Federal Question Jurisdiction

Federal question jurisdiction exists when a party's claim arises under the United States Constitution, federal law, or treaty of the United States. Lanham Act claims are the most typical claims a franchisor can file against its franchisee, especially in cases of termination where a franchisor is trying to stop the unauthorized use of its trademarks and name. On the other hand, for franchisees, the most typical federal question claim arises under antitrust or RICO laws, and either of these laws confer a franchisee with federal question jurisdiction.

IV. ARBITRATION IN FRANCHISE DISPUTES AS AN ALTERNATIVE TO LITIGATION IN COURT

Looking at any franchise agreement, odds are that it contains a provision, in one form or another, requiring that disputes between the parties be resolved through binding arbitration. Whether correctly or incorrectly, many franchisors perceive certain

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[21] *Hunt v. Washington State Apple Adver. Comm'n*, 432 U.S. 333, 347 (1977). *See also The Cincinnati Ins. Co. v. Zen Design Group, Ltd.,* 329 F.3d 546, 548 (6th Cir. 2003).

[22] *See Premier Ind. Corp. v. Texas Ind. Fastener Co.*, 450 F.2d 444, 446-47 (5th Cir. 1971).

[23] *See Viacom*, *Inc. v. Zebe*, 882 F. Supp. 1063, 1064-65 (S.D. Fla. 1995) (citing *Hunt v. Washington State Apple Advertising Com'n*, 432 U.S. 333, 347 (1977)).

[24] No. 01-1805, 2002 WL 113849, at *2 (D. Minn. Jan. 24, 2002).

[25] *Id.* at *5-6.

advantages in requiring disputes among the parties to be held in an arbitral forum rather than in open court (including, among other things, avoiding jurisdictional issues as discussed above). Thus, over the last couple of decades, arbitration has become a heavily used alternative to litigation in court.

At its core, the purpose of arbitration is to afford the parties an opportunity for a fair, expeditious, and cost-effective resolution of their dispute, in accordance with the rights and obligations set out in the parties' respective agreement.[26] An arbitrator (or arbitrators) acts as a judge, deciding pre-trial issues, hearing evidence, and ultimately deciding the case. It seems easy enough, though there are a number of issues that arise in the context of arbitration that can bring about all manner of disputes and make arbitration take on the feel of more traditional litigation.

The traditionally held belief that arbitration is a quick, easy, cost-effective alternative to in-court litigation is certainly debatable. Many franchisors perceive certain advantages in requiring disputes between the parties to be held in an arbitral forum rather than in open court. Due to the evolving nature of arbitration, including the incorporation of many of the same "rules" that apply in traditional in-court litigation, the real value in arbitration may not be as it once was thought. Rather, the true benefits of arbitration may be found more so in its flexible approach to litigation, allowing the parties the ability to control the entire litigation process, within reason, and oftentimes, within an arbitrator's discretion.

A. Costs of Arbitration

Proponents of arbitration will frequently cite to the perceived efficiencies of arbitration as a cost-saving measure and, thus, a benefit to arbitration. Despite (or in some cases, because of[27]) the significant initial outlay in the form of larger filing fees,

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[26] *See, e.g., AT&T Mobility LLC v. Concepcion,* 563 U.S. 333, 344 (2011) (the Federal Arbitration Act's (the "FAA") purpose is "to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings."); *but see Dominium Austin Partners, L.L.C. v. Emerson*, 248 F.3d 720, 728-29 (8th Cir. 2001) ("[T]he goal of the FAA is to enforce the agreement of the parties, not to effect the most expeditious resolution of claims.").

[27] As discussed more fully below, franchise agreements often contain class action waiver provisions requiring franchisees to bring their claims against a franchisor on an individual basis as opposed to on a consolidated or class-wide basis. Franchisees frequently contest these waivers as being unconscionable in that they serve as an economic bar to pursuing a claim, usually involving small dollar amounts, affecting similarly situated franchisees as a group or class. Recent case law, however, has sided with the enforcement of class action waivers in arbitration. *AT&T Mobility LLC v. Concepcion,* 563 U.S. 333, 343, 352 (2011) (FAA preempted state rule that found class arbitration waivers in consumer contracts of adhesion involving small amounts of damages to be unconscionable); *Am. Exp. Co. v. Italian Colors Rest.,* 133 S.Ct. 2304 (2013). As a result, franchisors include these provisions in their franchise agreements as a way to restrict class or consolidated actions.

franchisors consider arbitration to be an attractive alternative to in-court litigation. Notwithstanding their perceived efficiencies, arbitrations can be very costly. Even the minimum filing fee in arbitration vastly exceeds the filing fee in courts.[28] Moreover, parties must pay ongoing arbitrator fees, which can reach tens of thousands of dollars as the case progresses.[29] Those fees are in addition to the parties' attorneys' fees and costs. In contrast, in traditional litigation, the parties do not pay for a judge's time spent hearing the case.

The default rule in arbitration is that the parties will split the arbitration costs, including arbitrator fees, evenly, but the parties may agree to other methods of distribution in the franchise agreement.[30] The question often arises, what happens if your opponent, despite agreeing to arbitration in the franchise agreement, decides it does not want to pay for its share of the costs of arbitration? Generally, an arbitrator, upon being informed that the required payments have not been paid by a party (the American Arbitration Association ("AAA")[31] usually will not inform the arbitrator which specific party is delinquent), may suspend the action.[32] Typically what happens in this scenario is that prior to any suspension of the action, the AAA will provide the non-delinquent party the opportunity to "front" payment on behalf of the delinquent party as a

[28] The initial filing fees at the American Arbitration Association range from $750 to over $10,000, exceeding by any measure the filing fees in courts, which are often in the range of a few hundred dollars.

[29] Traditionally, parties in arbitration receive "strike and rank" lists from the arbitral body in which they can review biographies and "strike and rank" their choices for arbitrators. The arbitrators' biographies include the amounts charged by the arbitrators, typically on an hourly basis. In a recent "strike and rank" list received by the author, the rates charged by the arbitrators ranged from $400 to $800 per hour. If your arbitration agreement requires a panel of three arbitrators, the fees for arbitrator time alone can be shockingly high.

[30] *See, e.g.,* AAA Commercial Rules R-54; JAMS Rule 31(a).

[31] Parties are free to agree on using any arbitral body to govern their dispute. The most well-known arbitration organizations are the AAA (https://www.adr.org/), JAMS (https://www.jamsadr.com/), and USA&M (https://usam.com/). Each of these organizations has its own set of rules and guidelines for conducting arbitrations. Parties are advised to review and become familiar with the rules applicable to their arbitration in their entirety.

[32] *See* AAA Commercial Rules R-57.

means to continue the case. If the non-delinquent party makes the required payment, the action can continue; if it does not, the arbitrator may terminate the proceedings.[33]

If the non-delinquent party "fronts" the required payment, the non-delinquent party then has the ability to seek "specific measures" from the arbitrator as a "sanction" for non-payment. However, those "specific measures" are limited in scope and applicability.[34] For example, if the delinquent party has a pending counterclaim, the arbitrator might order that the delinquent party may not pursue its counterclaim unless and until payment is made in full. If the delinquent party does not have a pending counterclaim, unless there is specific language in the franchise agreement that provides for determined "sanctions" (usually not the case), the arbitrator has wide discretion in crafting appropriate relief. By rule, however, and more so as provided for in the parties' franchise agreement, which likely contains a fees and costs provision, recovery of the "fronted" amounts can be requested as part of any arbitration award.[35]

In a similar vein, unlike in court litigation, where a default judgment is available for a parties' failure to participate in the case, "default" is generally not available in arbitration:

> Unless the law provides to the contrary, the arbitration may proceed in the absence of any party or representative who, after due notice, fails to be present or fails to obtain a postponement. *An award shall not be made solely on the default of a party.* The arbitrator shall require the party who

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[33] *See* AAA Rule R-57(f); *see also Tillman v. Tillman,* 825 F.3d 1069 (9th Cir. 2016). In *Tillman*, the plaintiff/claimant originally filed a malpractice lawsuit in court. The defendant/respondent law firm moved to compel arbitration pursuant to the parties' agreement. The motion to compel was granted and the action was moved to arbitration. However, the plaintiff/claimant was not able to pay the initial arbitration deposit. The defendant/respondent refused to "front" payment on behalf of the plaintiff/claimant. The arbitrator terminated the action and the plaintiff/claimant then took the action back to court. The trial court again refused to entertain the plaintiff's/claimant's case on the basis that it lacked authority to hear the case in light of the FAA and the parties' agreement to arbitrate any disputes. The plaintiff/claimant appealed the decision to the Ninth Circuit where the Court of Appeals reversed the district court's dismissal, stating that the defendant/respondent could have fronted payment, but chose not to do so and the resulting dismissal did "not merit a harsh penalty, particularly given the public policy favoring disposition of cases on their merits." *Id.* at 1074 (citation and quotation omitted). The Ninth Circuit allowed the case to proceed *in court*, despite the mandatory arbitration provision, on the basis that it was the only way the plaintiff/claimant would be able to seek relief.

[34] *See* AAA Commercial Rules R-57 (a), (b) ("Such measures may include, but are not limited to, limiting a party's ability to assert or pursue their claim. In no event, however, shall a party be precluded from defending a claim or counterclaim.").

[35] *See, e.g.,* JAMS Rule 31(c).

> is present to submit such evidence as the arbitrator may require for the making of an award.[36]

Similarly, under JAMS Comprehensive Arbitration Rules & Procedures:

> The Arbitrator may proceed with the Hearing in the absence of a Party that, after receiving notice of the Hearing pursuant to Rule 19, fails to attend. *The Arbitrator may not render an Award solely on the basis of the default or absence of the Party, but shall require any Party seeking relief to submit such evidence as the Arbitrator may require for the rendering of an Award.* If the Arbitrator reasonably believes that a Party will not attend the Hearing, the Arbitrator may schedule the Hearing as a telephonic Hearing and may receive the evidence necessary to render an Award by affidavit. The notice of Hearing shall specify if it will be in person or telephonic.[37]

Thus, a party in arbitration will invariably be required to appear and present evidence in an arbitration, even if it is to an "empty chair." Given the lack of any default judgment type mechanism in arbitration, it can prove costly and time-consuming to prosecute a claim in arbitration as opposed to appearing in court where default is a possibility.

B. Confidentiality In Arbitration

The "confidential" nature of arbitration is often cited as a significant benefit in that it hides the entire arbitration process behind a cloak of confidentiality. It is generally assumed that arbitration is confidential in its entirety and most arbitral bodies have rules regarding the confidential nature of the arbitration proceedings. However, those rules offer only limited protections to the parties.[38] Some state laws go further in ensuring

[36] AAA Rule R-31 (emphasis added).

[37] JAMS Rule 22(j) (emphasis added).

[38] *See, e.g.,* JAMS Rule 26 ("JAMS and the Arbitrator shall maintain the confidential nature of the Arbitration proceeding and the Award, including the Hearing, except as necessary in connection with a judicial challenge to or enforcement of an Award, or unless otherwise required by law or judicial decision."); AAA Rule R-25 ("The arbitrator and the AAA shall maintain the privacy of the hearings unless the law provides to the contrary.").

confidentiality of the arbitration process.[39] Additionally, some franchise agreements specifically address the issue of confidentiality in the arbitration context, but many do not. However, barring specific state laws or terms of the franchise agreement addressing the issue, it may be best to say that the arbitrations are *private*, but not necessarily *confidential*. This becomes problematic when an arbitration involves sensitive business information, such as customer lists, trade secrets, and financial information, to name a few, as often arises in franchise disputes.

The AAA's Statement of Ethical Principles makes this point clear:

> An arbitration proceeding is a private process. In addition, AAA staff and AAA neutrals have an ethical obligation to keep information confidential. However, the AAA takes no position on whether parties should or should not agree to keep the proceeding and award confidential between themselves. The parties always have a right to disclose details of the proceeding, unless they have a separate confidentiality agreement.[40]

Because confidentiality in arbitration is often misunderstood, or at a minimum, taken for granted, it is imperative that parties wanting to protect confidential information take the necessary steps to ensure protection. In this regard, it is advised that parties looking to ensure confidentiality of the arbitration process as a whole, including all pleadings, motions, discovery, hearings, and the final award, insert language in the franchise agreement requiring confidentiality of the entire arbitration process. Additionally, to provide teeth to an otherwise toothless confidentiality provision, some franchisors include a liquidated damages clause as a deterrent to the use and disclosure of confidential information revealed in arbitration.

However, even with the appropriate protections, franchisors and franchisees alike must always keep in mind that arbitration awards are not self-effectuating and,

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[39] *See, e.g.,* MO Rev. Stat. § 435.014 ("Arbitration, conciliation and mediation proceedings shall be regarded as settlement negotiations. Any communication relating to the subject matter of such disputes made during the resolution process by any participant, mediator, conciliator, arbitrator or any other person present at the dispute resolution shall be a confidential communication. No admission, representation, statement or other confidential communication made in setting up or conducting such proceedings not otherwise discoverable or obtainable shall be admissible as evidence or subject to discovery.").

[40] AAA Statement of Ethical Principles at Confidentiality.

thus, must be confirmed in a court of law, making the end result publicly available.[41] Similarly, arbitration actions filed by or against the franchisor must be accurately represented in Item 3 of the FDD.[42] Thus, despite the relative private nature of arbitration, a franchisor (and to a lesser extent, a franchisee) must, nevertheless, be prudent in deciding when to file an action with an eye toward the potential affect it may have on the current system as well as in the eyes of prospective franchisees.

C. Scope of an Arbitration Provision

Litigation over the enforceability or interpretation of the arbitration provision can eliminate many of the perceived benefits of arbitration right off the bat, requiring the expenditure of significant sums in attorneys' fees and costs before an arbitration action even begins. This often arises in cases where, notwithstanding the arbitration provisions, franchisees (and to a lesser extent, franchisors) file actions in court instead of pursuing arbitration.

Arbitration is a matter of contract, with the Federal Arbitration Act ("FAA") ensuring that arbitration agreements are enforced according to their terms.[43] The Supreme Court has explained that, save for any traditional defense to a contract as exists in law or equity, "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to

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[41] Parties in arbitration usually have a choice between a "standard" award and a "reasoned" award. A "standard" award simply announces the result of the arbitration whereas a "reasoned" award requires a more detailed explanation of the arbitrator's decision, akin to findings of fact and conclusions of law in traditional litigation. Some suggest that where confidential information is a necessary part of deciding the case, parties should consider whether a "reasoned" award is appropriate.

[42] The FTC's Rule on Franchising (16 C.F.R. § 436.5(c)(1)(ii)) states that a franchisor must disclose litigation, including arbitration actions, in which it:

> Was a party to any material civil action involving the franchise relationship in the last year. For purposes of this section, "franchise relationship" means contractual obligations between franchisor and franchisee directly relating to the operation of the franchised business (such as royalty payments and training obligations). It does not include suits involving suppliers or other third parties, or indemnification for tort liability.

[43] *See Volt Info. Scis., Inc. v. Bd. of Trustees of Leland Stanford Junior Univ.,* 489 U.S. 468, 469 (1989) (indicating that the principal purpose of the Federal Arbitration Act is to "ensure that private arbitration agreements are enforced according to their terms."); *Am. Exp. Co. v. Italian Colors Rest.*, 133 S. Ct. 2304, 2309 (2013) ("[C]ourts must 'rigorously enforce' arbitration agreements.").

arbitrability."[44] This presumption in favor of arbitration is borne out further in the fact that any ambiguities are also to be resolved in favor of arbitration.[45] In fact, arbitration should only be denied where "it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute."[46] Despite the liberal policy in favor of arbitration, disputes often arise regarding the permissible *scope* of an arbitration clause—i.e. does the clause cover the specific dispute at issue.

Under the FAA, the general rule is that the arbitrability of a dispute is to be determined by a court.[47] However, parties may delegate threshold or gateway issues, including arbitrability questions, to an arbitrator when they "clearly and unmistakably" agree to do so.[48] Such threshold issues include whether a court or arbitrator determines if a particular matter falls within the scope of an arbitration agreement.[49] In this regard, the issue that is often litigated is what then constitutes a "clear and unmistakable" agreement to permit an arbitrator to determine the scope of an arbitration provision.

Language in an arbitration provision providing that an arbitrator is to decide all disputes, including the applicability, enforceability, and/or validity of an arbitration provision are routinely upheld by courts, kicking the issue of arbitrability to an arbitrator

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[44] *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983).

[45] *See Stein v. Burt-Kuni One LLC,* 396 F. Supp. 2d 1211, 1214 (D. Colo. 2005) ("Unlike the general rule that ambiguities in a contract must be construed against the drafter, ambiguities in an arbitration agreement must be construed in favor of arbitration.").

[46] *AT&T Techs., Inc. v. Commc'ns Workers of Am.*, 475 U.S. 643, 650 (1986).

[47] *Apollo Computer, Inc. v. Berg,* 886 F.2d 469, 472 (1st Cir.1989).

[48] *Rent-A-Center, West., Inc. v. Jackson*, 561 U.S. 63 (2010) (enforcing delegation provision in arbitration agreement); *Momot v. Mastro,* 652 F.3d 982, 988 (9th Cir. 2011) ("We hold that this language, delegating to the arbitrators the authority to determine 'the validity or application of any of the provisions of' the arbitration clause, constitutes 'an agreement to arbitrate threshold issues concerning the arbitration agreement.' In other words, the parties clearly and unmistakably agreed to arbitrate the question of arbitrability.") (internal citation omitted); *Awuah v. Coverall N. Am., Inc.,* 554 F.3d 7, 10 (1st Cir. 2009) ("Thus, where the parties have themselves 'clearly and unmistakably agreed' that the arbitrator should decide whether an issue is arbitrable, the Supreme Court has held that this issue is to be decided by the arbitrator.").

[49] *Oracle Am., Inc. v. Myriad Group A.G.*, 724 F.3d 1069, 1072, 1077 (9th Cir. 2013) (where court determined that "the dispute in this case centers on *who* decides whether a claim is arbitrable," holding that arbitrator would decide because parties delegated arbitrability to the arbitrator).

to decide.[50] Even where such explicit language is not present in the parties' agreement, incorporation of an arbitral bodies' rules has been found to "clearly and unmistakably" represent an agreement by the parties to delegate arbitrability determinations to an arbitrator.[51] To that end, the AAA rules provide that the "arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope, or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim."[52] As a result, where the parties clearly and unmistakably delegate questions of arbitrability to an arbitrator, a court must enforce the parties'

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[50] *Momot,* 652 F.3d at 988*; see also Gilbert v. Bank of Am.*, No. C 13-01171 JSW, 2015 WL 1738017, at *4 (N.D. Cal. Apr. 8, 2015) (language in agreement stating that "disputes" includes "all claims, disputes, or controversies arising from or relating directly or indirectly to the signing of this Arbitration Provision, the validity and scope of this Arbitration Provision" clearly and unmistakably delegated the issue of validity of the Arbitration Provision to the arbitrator); *Gillette v. First Premier Bank*, No. 3:13-CV-432-LAB-RBB, 2013 WL 3205827, at *2 (S.D. Cal. June 24, 2013) (language that claims subject to arbitration include "claims regarding the applicability, enforceability or validity of this [Arbitration] Provision" "couldn't be more clear: Gillette and First Premier agreed to arbitrate arbitrability.").

[51] *Brennan*, 796 F.3d at 1130; *Oracle Am.,* 724 F.3d at 1074 ("Virtually every circuit to have considered the issue has determined that incorporation of the [AAA] arbitration rules constitutes clear and unmistakable evidence that the parties agreed to arbitrate arbitrability."); *Zenelaj v. Handybook Inc.,* 82 F. Supp. 3d 968, 974 (N.D. Cal. 2015) ("Consequently, regardless of their sophistication, the Court finds that the Parties in this case clearly and unmistakably delegated the question of arbitrability to the arbitrator when they expressly incorporated the AAA Rules into their Agreement. As a result, any questions regarding the arbitration provision's validity, scope, or application to this dispute must be decided by the arbitrator."); *Awuah*, 554 F.3d at 10 (AAA Rule R-7(a) "is about as 'clear and unmistakable' as language can get" for purposes of showing that parties agreed to have questions of arbitrability decided by an arbitrator); *Apollo Computer*, 886 F.2d at 473 (where arbitration agreement incorporated rules authorizing arbitrator to determine validity of arbitration agreement, it was up to arbitrator to decide whether valid arbitration agreement existed between the parties).

[52] *See* AAA Rule R-7(a).

agreement by compelling arbitration and reserving any other issues of arbitrability for the arbitrator.[53]

Even if a court finds that it—not an arbitrator—should decide arbitrability under the arbitration provision "[t]he court's role under the [FAA] is . . . limited to determining (1) whether a valid agreement to arbitrate exists and, if it does, (2) whether the agreement encompasses the dispute at issue. . . . If the response is affirmative on both counts, then the [FAA] requires the court to enforce the arbitration agreement in accordance with its terms."[54] Moreover, even where franchisees argue that the franchise agreement as a whole is unconscionable, courts refuse to address the issue where the parties agreed to delegate threshold issues to an arbitrator.[55] In light of the strong presumption in favor of arbitration, courts "generously construe[] [arbitration provisions] in favor of arbitration."[56]

D. Discovery in Arbitration

The discovery phase of litigation is often the most time-consuming and expensive part of any case, especially in cases before a court with a liberal attitude towards discovery. It is generally assumed by parties that discovery in arbitration operates the same as in traditional litigation, affording them the full panoply of discovery vehicles available in court. Nothing could be further from the truth. Absent a provision in a

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[53] *See Doctor's Assocs., Inc. v. Repins,* No. 17-CV-323 (JCH), 2018 WL 513722, at *6 (D. Conn. Jan. 22, 2018) (where franchise agreement provided that "[a]ny disputes concerning the enforceability or scope of the arbitration clause shall be resolved pursuant to the [FAA], and the parties agree that the FAA preempts any state law restrictions (including the site of the arbitration) on the enforcement of the arbitration clause in this Agreement" the court was required to enforce the arbitration provision as drafted and require the dispute to be determined by an arbitrator); *In re Toyota Motor Corp. Unintended Acceleration Mktg., Sales Practices, & Products Liab. Litig.*, 838 F. Supp. 2d 967, 982 (C.D. Cal. 2012) (court "must enforce the delegation provision by compelling arbitration and reserv[e] for the arbitrator issues that implicate the agreement to arbitrate as a whole").

[54] *Chiron Corp. v. Ortho Diagnostic Sys., Inc.*, 207 F.3d 1126, 1130 (9th Cir. 2000) (citations omitted).

[55] *Fatt Katt Enterprises, Inc. v. Rocksolid Granit (USA), Inc.,* No. 1:17-CV-1900-MHC, 2018 WL 482461, at *4 (N.D. Ga. Jan. 11, 2018) ("When parties do clearly and unmistakably delegate those issues, courts 'require the basis of challenge to be directed specifically to the agreement to arbitrate before the court will intervene.'") (quoting *Rent-A-Center,* 561 U.S. at 71; *see also Prima Paint Corp. v. Flood & Conklin Mfg. Co.,* 388 U.S. 395, 406 (1967); *Richardson v. Coverall N. Am., Inc.,* 2017 WL 6059208, at *5 (N.D. Ga. Dec. 7, 2017) ("Since these arguments do not challenge the validity of the delegation provision itself, the arbitrator, and not this Court, should review them.").

[56] *Fatt Katt Enterprises, Inc. v. Rocksolid Granit (USA), Inc.,* No. 1:17-CV-1900-MHC, 2018 WL 482461, at *3 (N.D. Ga. Jan. 11, 2018).

franchise agreement addressing the scope of discovery,[57] discovery in arbitration is primarily limited to document discovery, including electronic discovery or electronically stored information ("ESI"), with a sprinkling of third-party discovery by way of subpoena.[58] As a result, arbitration's general relaxed approach to dispute resolution offers parties the potential to forego the breadth of discovery commonplace in traditional litigation.

That is not to say, however, that discovery is non-existent in arbitration; indeed, it is often of paramount importance to the success or failure of any case and can be grounds to vacate an arbitration award if not properly addressed by an arbitrator.[59] In light of this, arbitrators will usually work with the parties to develop an appropriate discovery plan that addresses the needs of the case while keeping to the core principles of arbitration that proceedings are to be conducted as efficiently and expeditiously as possible.[60]

E. Dispositive Motions in Arbitration

Dispositive motions—e.g., motions to dismiss and motions for summary judgment, to name a couple—are very important weapons in any litigator's arsenal. Dispositive motions are an efficient means of limiting the scope of certain claims or eliminating claims altogether, thus saving time and money and, oftentimes more importantly, the risk of an adverse judgment. Until recently, pre-hearing motion practice in arbitration was limited primarily to discovery disputes, though courts have considered the issue and concluded that arbitrators likely possessed the inherent authority to

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[57] Because arbitration is a matter of contract, parties are free to designate the applicable scope of discovery in their arbitration provision. For example, the parties may designate generally that the Federal Rules of Civil Procedure apply, which could provide for the argument that the Federal Rules concerning discovery are required.

[58] *See* AAA Rule R-22.

[59] *See* FAA § 10(a)(3) (noting that an arbitration award may be vacated where "the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.") *But see Bain Cotton Co. v. Chesnutt Cotton Co.,* 531 Fed. Appx. 500 (5th Cir. 2013) ("[T]he district court or this court—or both—might disagree with the arbitrators' handling of Bain's discovery requests, that handling did not rise to the level required for vacating under any of the FAA's narrow and exclusive grounds.") Given the potential for vacatur based on the failure to consider evidence introduced at trial, arbitrators frequently allow nearly everything into evidence.

[60] *See* AAA Rule R-22 (""The arbitrator shall manage any necessary exchange of information among the parties with a view to achieving an efficient and economical resolution of the dispute, while at the same time promoting equality of treatment and safeguarding each party's opportunity to fairly present its claims and defenses.").

consider dispositive motions in arbitration.[61] Indeed, without a "rule" expressly permitting dispositive motions, arbitrators frequently avoided summary adjudication efforts.[62] This highlighted a perceived significant shortcoming in arbitrations in that parties were almost always required to go to hearing, even if an asserted claim was entirely meritless. Parties could assert meritless claims, taking extensive and costly discovery along the way, knowing full well that they would be afforded their "day in court."

The lack of any summary disposition mechanism in arbitration was of particular concern to franchisors and has been cited as a primary drawback to the mandatory arbitration process. Oftentimes, franchise disputes are particularly ripe for summary adjudication. For example, as discussed more fully below, claims of fraud or negligent misrepresentation brought by a franchisee can many times be disposed of when considering integration, waiver, and non-reliance provisions in the franchise agreements.[63] In the recent past, the parties would be required to proceed to a final hearing on such claims. However, dispositive motions are now available under many arbitral bodies' rules.[64] For example, in 2013, the AAA amended its Rules to allow for dispositive motions. Under the AAA Rules, an arbitrator may allow a party to file a dispositive motion if it can first show that "the motion is likely to succeed and dispose of

[61] *Sherrock Brothers, Inc. v. DaimlerChrysler Motors Co., LLC,* 260 Fed. Appx. 497, 502 (3rd Cir. 2008) ("Granting summary judgment surely falls within this standard [of broad discretion to the arbitrator] and fundamental fairness is not implicated by an arbitration panel's decision to forego an evidentiary hearing because of its conclusion that there were no genuine issues of material fact in dispute. An evidentiary hearing will not be required just to find out whether real issues surface in a case.").

[62] It is also important to note that some of the reluctance by arbitrators to permit dispositive motions rests with the pleading standards applicable in arbitration. For example, absent a requirement in the franchise agreement that the Federal Rules of Civil Procedure apply, arbitration demands are not subject to the same type of pleading standard as arbitration demands. Thus, a party asserting a fraud claim in arbitration is not held to the *Twombly/Iqbal* standards as they may otherwise be if in federal court, but instead, only needs to provide a "bare bones" statement setting forth the nature of the claim, including the relief sought. *See* AAA Rule R-4.

[63] *See, e.g., Steak n Shake Enterprises, Inc. v. Globex Co., LLC,* No. 13-CV-01751-RM-CBS, 2015 WL 3883590 (D. Colo. June 23, 2015) (holding that, under Colorado law, "[i]ntegration clauses generally permit contracting parties to limit future contractual disputes to issues relating to the reciprocal obligations expressly set forth in the executed document. . . . Thus the terms of a contract intended to represent a final and complete integration of the parties' agreement are enforceable and parol evidence offered to establish the existence of prior or contemporaneous agreements is inadmissible to vary the terms of such contract.") (internal quotation and citation omitted).

[64] *See* JAMS Rule 18; AAA Rule R-33.

or narrow issues in the case."[65] Arbitrators may still be wary of the potential for vactur of an arbitration award where a party's case is not fully heard. Thus, the willingness of arbitrators to permit dispositive motions has yet to be determined; only time will tell.

F. Class Action Waivers In Arbitration

As a means to reduce individual allocation of costs, franchisees may prefer to arbitrate their claims with others, in a joint or consolidated action, or, if the required class criteria are met, on a class-wide basis. Franchisors typically prefer to avoid such actions and will frequently include provisions requiring the franchisee to bring any claim in its individual capacity. The enforceability of class waivers in the arbitration context has been a hot button issue in recent years. However, courts, including the United States Supreme Court, have concluded that such class waivers provisions are generally enforceable.[66]

G. Who Can Enforce An Arbitration Provision

Since arbitration is a matter of contract, the general rule is that only those who are signatory parties to the agreement may enforce an arbitration provision.[67] In fact, "nothing in the [FAA] authorizes a court to compel arbitration of any issues, *or by any parties*, that are not already covered in the agreement."[68] As parties to the franchise agreement, it is axiomatic that both the franchisee and franchisor have standing to

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[65] *See* AAA Rule R-33. JAMS Rule 18 also affords parties the ability to file a dispositive motion, but JAMS Rule 18 does not provide any "standard" for parties to consider.

[66] *AT&T Mobility LLC v. Concepcion,* 563 U.S. 333, 343, 352 (2011) (FAA preempted state rule that found class arbitration waivers in consumer contracts of adhesion involving small amounts of damages to be unconscionable); *Am. Exp. Co. v. Italian Colors Rest.,* 133 S.Ct. 2304, 2312 (2013) ("Truth to tell, our decision in *AT&T Mobility* all but resolves this case. There we invalidated a law conditioning enforcement of arbitration on the availability of class procedure because that law 'interfere [d] with fundamental attributes of arbitration.' '[T]he switch from bilateral to class arbitration,' we said, 'sacrifices the principal advantage of arbitration—its informality—and makes the process slower, more costly, and more likely to generate procedural morass than final judgment.' We specifically rejected the argument that class arbitration was necessary to prosecute claims 'that might otherwise slip through the legal system.'") (internal citations omitted).

[67] *See AT&T Technologies, Inc. v. Communications Workers of America,* 475 U.S. 643, 648 (1986); *Genberg v. Porter,* 935 F. Supp. 2d 1094, 1100 (D. Colo. 2013), *aff'd in part, appeal dismissed in part,* 566 F. App'x 719 (10th Cir. 2014) (quoting *Smith v. Multi–Financial Secs. Corp.,* 171 P.3d 1267, 1272 (Colo. App. 2007) (citation omitted)) ("'[W]hen the requirement to arbitrate is created by an agreement, it can be invoked only by a signatory of the agreement, and only against another signatory."').

[68] *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.,* 559 U.S. 662, 683 (2010) (quoting *EEOC v. Waffle House, Inc.,* 534 U.S. 279, 289 (2002)) (emphasis in original).

enforce or challenge arbitration provisions. However, what happens when a signatory party attempts to enforce an arbitration provision on a non-signatory, and vice versa? SPOILER ALERT: there are exceptions to the general rule.

Depending on what court you ask, there are either five or six “exceptions” to the general rule that non-signatory parties are immune from arbitration agreements. Non-parties may be compelled (and compel signatory parties[69]) to arbitrate where the non-signatory party is: (1) receiving a direct benefit from the underlying agreement (i.e. estoppel); (2) a party to another agreement, which incorporates by reference an agreement that contains an arbitration provision; (3) found to be an agent of the signatory party; (4) the mere alter ego of a signatory party; (5) deemed to have manifested its intent to arbitrate a dispute (i.e. assumption); and (6) an intended third-party beneficiary of the contract containing the arbitration provision.[70]

Because state contract law principles generally determine whether a non-signatory may compel (or be compelled) to arbitrate based on a contract it is not a party to, it is important that practitioners review the applicable state law governing the dispute. Regardless, the important takeaway is that the facts of the case often dictate whether the traditional “exceptions” to the general rule that only signatories to a contract may compel or be compelled to arbitration.[71]

H. Judicial Carve Outs

Franchise agreements often contain carve outs, or exceptions, to otherwise mandatory arbitration provisions. For example, a franchisor may want the ability to seek

[69] *See, e.g., Int’l Paper Co. v. Schwabedissen Maschinen & Anlagen GMBH,* 206 F.3d 411 (4th Cir. 2000).

[70] *See Arthur Andersen LLP v. Carlisle,* 556 U.S. 624 (2009) (listing state law contract principles used to determine whether an arbitration agreement can be enforced by or against a non-signatory as “assumption, piercing the corporate veil, alter ego, incorporation by reference, third-party beneficiary theories, waiver and estoppel.”); *Sapic v. Gov’t of Turkmenistan,* 345 F.3d 347, 360-61 (5th Cir. 2003) (“Six theories for binding a nonsignatory to an arbitration agreement have been recognized: (a) incorporation by reference; (b) assumption; (c) agency; (d) veil-piercing/alter ego; (e) estoppel; and (f) third-party beneficiary.”).

[71] *See, e.g., Van Zanten v. Energy Transfer Partners, L.P.,* 320 S.W.3d 845, 848-9 (Tex. App. 2010) (refusing non-signatory plaintiff’s attempt to “offensively invoke the contract’s arbitration clause against a signatory” holding that non-signatory plaintiff “owners” could not require signatory defendant to arbitrate dispute); *Long John Silver’s Inc. v. Nickleson,* 923 F. Supp. 2d 1004, 1011 (W.D. Ky. 2013) (“Accordingly, with respect to Defendants’ common law fraud claim, only the signatory, Defendant Patricia Nickleson, LCC, has standing.”); *Invista S.à.r.l. v. Rhodia, S.A.,* 625 F.3d 75, 85 (3rd Cir. 2010) (“Not surprisingly, Rhodia, S.A. offers no authority for its contention that a non-signatory to an arbitration agreement can compel another non-signatory to arbitrate certain claims, and we have found none.”).

immediate injunctive relief or other equitable relief in the event a franchisee is using the franchisor's intellectual property unlawfully. Additionally, a franchisor, in light of the lack of any default mechanism in arbitration, may wish to reserve its right to pursue monetary defaults in court. Carve outs are effective, but they often lead to litigation over the scope of the arbitration provision and whether certain aspects of a claim are properly covered by the arbitration clause. Thus, when drafting an arbitration agreement, any carve outs should be explicitly and specifically stated, addressing the dispute resolution mechanisms and any and all requirements necessary to carry out the intent of the carve out.

While expedited procedures exist in arbitration for consideration of such things as requests for preliminary injunctions,[72] a franchisor will generally include certain carve outs to the arbitration provision allowing the franchisor to seek interim relief from a court. It was a long-held view that arbitration was ill-equipped to handle expedited relief. Moreover, like any arbitration award, an award of some emergent relief, such as a preliminary injunction requiring a franchisee to cease competition and/or using a franchisor's trademarks, is not self-effectuating and must be confirmed by a court. Nevertheless, emergency relief is available in arbitration,[73] though the extra step of needing to have the interim award confirmed in court may negate any benefit of pursuing expedited relief in arbitration.

I. Enforcement of Arbitration Awards

As noted throughout, there is a well-established policy in the United States in favor of arbitration. However, while binding on the parties involved in the arbitration, an arbitration award cannot be enforced until it has been confirmed by an appropriate *court* (state or federal). Although the process of confirming an arbitration award is, for all intents and purposes, straightforward, there are several issues that must be taken into consideration prior to running to the courthouse.

Oftentimes, franchise agreements lack any specific post-award guidance, including where and how to confirm an arbitration award. Where the agreement does provide for a confirmation mechanism, parties must adhere to those terms. Where the agreement is silent on the issue, assuming the relationship involves "commerce" (which most franchise relationships do), the FAA will control.[74]

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[72] *See, e.g.,* AAA Rule R-38 "Emergency Measures of Protection". Within one business day of filing a request for emergency relief, the AAA will appoint an emergency arbitrator to set a schedule to resolve a party's request. The emergency arbitrator has the authority to issue interim relief.

[73] For example, in 2013, the AAA amended its Commercial Arbitration Rules to allow parties to seek emergent relief on an expedited basis. *See* AAA Rule R-38.

[74] *See Jenkins v. First Am. Cash Advance of Ga., LLC,* 400 F.3d 868, 874 (11th Cir. 2005) ("The FAA makes enforceable a written arbitration provision in 'a contract evidencing a transaction involving commerce.'") (quoting 9 U.S.C. § 2).

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. Under the FAA, an arbitration award may be vacated only 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; refusing to hear evidence pertinent and material to the controversy; or any other behavior by which the rights of any party have been prejudiced; or (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.[75] Similarly, a court may modify or otherwise correct an arbitration award: (a) where 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) where the arbitrators 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) where 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.[76]

In light of the limited grounds for vacating, modifying, or correcting an arbitration award, the scope of judicial review is very narrow. Recognizing this issue, as part of its 2013 amendments to its Rules, the AAA implemented a new program allowing for appeals of arbitration decisions to an AAA panel of appellate arbitrators.[77] The new AAA appellate procedures appear to allow the AAA appellate panel to take a deeper dive into the arbitration award that may otherwise have been unavailable for courts. In the AAA, parties may appeal an award: (1) where an error of law was made that is material and prejudicial; or (2) where determinations of fact are clearly erroneous.[78] This is still a very high bar to meet, but less than the ultimate "deference" courts usually afford arbitrator decisions.

Unlike appeals of arbitration awards in court, however, a party may not unilaterally seek an appeal from the AAA as part of its optional appellate procedures. Parties must *expressly agree* to the appellate procedures of the AAA. Such agreement can be included in a parties' arbitration provision. Additionally, the AAA's appellate process is not cheap, requiring a non-refundable $6,000 administrative fee to be paid to the AAA in addition to the appellate arbitrators' fees. Nevertheless, the AAA's optional appellate program provides parties with an additional safeguard in the arbitration process.

Typically, what happens in practice is that the winning party in arbitration will wait out the three-month modification/vacatur period to ensure that the losing party "waived"

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[75] 9 U.S.C. § 10.

[76] 9 U.S.C. § 11.

[77] *See* AAA Optional Appellate Arbitration Rules.

[78] *See* AAA Optional Appellate Arbitration Rules, Rule A-10.

its ability to dispute the arbitration award. Thereafter, and within one year following the issuance of the arbitration award, the winning party will file a motion (or application in some jurisdictions) to confirm the arbitration award in the appropriate court. The motion is simple and straightforward, setting forth the basis for confirmation and including a copy of the arbitration agreement and the resulting award.[79]

Once an arbitration award has been confirmed by a court, it "shall have the same force and effect, in all respects, as, and be subject to all the provisions of law relating to, a judgment in an action; and it may be enforced as if it had been rendered in an action in the court in which it is entered."[80] The judgment can thereafter be enforced under the standard procedures for enforcing judgments, as if the arbitration award had been rendered by a court.

V. PROCEDURAL MATTERS

The first question many litigants ask when they find themselves in court is "how do I get out?" There are several procedural mechanisms available to a party.

A. Motion to Stay for Mediation or Arbitration

One potential way out is to ensure that the franchise agreement contains an agreement to mediate or arbitrate and to ask the court to enforce that agreement by compelling arbitration or staying the matter to permit mediation. In asking a court to require arbitration in accordance with such an agreement, a party is essentially asking the court to transfer the case to an arbitrator.[81]

As discussed above, federal statute provides for the enforceability of arbitration agreements absent some specific problem with the agreement.[82] The potential problems are categorized into procedural and substantive unconscionability. Procedural unconscionability concerns the formation of the agreement. The Sixth Circuit, for instance, has formulated a requirement that waiver of the right to sue in court be made "knowingly and voluntarily."[83] In reaching this determination, a court will examine "(1)

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[79] 9 U.S.C. § 13 ("The party moving for an order confirming, modifying, or correcting an award shall, at the time such order is filed with the clerk for the entry of judgment thereon, also file the following papers with the clerk: (a) The 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; (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.").

[80] 9 U.S.C. § 13.

[81] *See Mitsubishi Motors Corp. v. Soler Chrysler–Plymouth, Inc.,* 473 U.S. 614, 628 (1985); *Jackson v. Payday Fin., LLC,* 764 F.3d 765, 773 (7th Cir.2014) (motion to compel arbitration properly brought as a 12(b)(3) motion for improper venue).

[82] 9 U.S.C. § 2.

[83] *Morrison v. Circuit City Stores, Inc.*, 317 F.3d 646, 668 (6th Cir. 2003).

plaintiff's experience, background, and education; (2) the amount of time the plaintiff had to consider whether to sign the waiver, including whether the franchisee or plaintiff? had an opportunity to consult with a lawyer; (3) the clarity of the waiver; (4) consideration for the waiver; and (5) the totality of the circumstances."[84] Other examples of procedural unconscionability include fraud and duress.[85]

Substantive unconscionability concerns the content of the agreement. An arbitration agreement will be unenforceable if it constitutes a "prospective waiver of a party's *right to pursue* statutory remedies."[86] Courts have, for instance, refused to enforce arbitration agreements that waived rights to attorneys' fees, trebled or punitive damages where these were specifically permitted by statute.[87] A court will also examine terms that seem to unreasonably favor the more powerful party.[88] Finally, payment terms that require parties to bear their own costs might be so burdensome on a party with less ability to pay as to "preclude effective vindication" of its rights, rendering the agreement substantively unconscionable.[89]

B. Removal to Federal Court

Short of getting out of court altogether to an arbitral forum, many defendants prefer to litigate in federal court if possible. This preference is based on a number of factors, including the perception that the federal judiciary has a higher level of expertise and is less inclined to favor sympathetic litigants.

Removal to federal court requires the consent of all defendants.[90] A defendant must file its notice of removal with the state court within thirty days of receiving a copy of (*not* being served with) the plaintiff's initial pleading.[91] A defendant files a "notice" of removal with the state court, because the state court does not grant removal. Rather, the federal court will remand the action to state court if it finds that the case is not properly removable.

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[84] *Id.*

[85] *See Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 687 (1996).

[86] *Am. Exp. Co. v. Italian Colors Rest.*, 570 U.S. 228, 235 (2013).

[87] *See, e.g., Kristian v. Comcast Corp.*, 446 F.3d 25, 48 (1st Cir. 2006) (treble damages under antitrust law); *Booker v. Robert Half Int'l, Inc.*, 413 F.3d 77, 83 (D.C. Cir. 2005) (exemplary and punitive damages under Title VII); *McCaskill v. SCI Mgmt. Corp.,* 285 F.3d 623, 626 (7th Cir. 2002) (attorney's fees under Title VII).

[88] *See, e.g., Nino v. Jewelry Exch., Inc.*, 609 F.3d 191, 204 (3d Cir. 2010) (granting employer more say over the choice of arbitrator than the employee); *Bencharsky v. Cottman Transmission Sys., LLC*, 625 F. Supp. 2d 872, 881–82 (N.D. Cal. 2008) (permitting franchisor, but not franchisee, to seek injunctive relief).

[89] *Green Tree Fin. Corp.-Alabama v. Randolph*, 531 U.S. 79, 90 (2000).

[90] 28 U.S.C. § 1446(b)(2)(A).

[91] 28 U.S.C. § 1446(b)(1).

While there are several categories of removable cases, the primary requirements are those normally required in filing an action in federal court.[92] Federal question jurisdiction can always serve as a basis for removal; however, diversity jurisdiction can only serve as a basis for removal if none of the defendants are citizens of the state in which the action was brought.[93]

Oftentimes, a party will "fraudulently join" an in-state defendant to preclude the removal of a case. An example is when a franchisee sues in state court and names a franchisor's in-state employee or representative as a party to the case in order to preclude diversity jurisdiction and prohibit removal of the litigation to federal court. In this situation, courts may disregard the citizenship of these "fraudulently joined" parties, if a litigant is able to show there is no real intention of prosecuting the case against the in-state defendant or there is no reasonable basis for the claim filed against this party.[94]

C. Venue and *Forum Non Conveniens*

Once in federal court, a litigant may move to transfer venue from one federal district court to another on the basis that the receiving court is a more appropriate forum. The general federal civil venue statute permits an action to be brought in a district where any defendant resides, if all defendants are residents of the same state, a district where the events that gave rise to the claim occurred, or a district where the property that is the subject of the claim is located.[95] If none of these can be satisfied, then venue is proper in any district that has personal jurisdiction over a defendant.[96] It is common enough for venue to be proper in more than one federal district court. In such a case, the court in which the case was filed can transfer the case to another district court "for the convenience of parties and witnesses, in the interest of justice."[97]

1. The Relationship Between Transfer of Venue and *Forum Non Conveniens*

There is no mechanism for transferring cases from federal court to state or foreign courts. When the more appropriate court falls into one of these categories, the party desiring transfer must move to dismiss the case based on *forum non conveniens*. This allows the plaintiff to file again in a more appropriate location. A federal court may dismiss a case on *forum non conveniens* grounds when, having considered the interests of the parties and witnesses and the public interests of the jurisdictions concerned, it

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[92] 28 U.S.C. § 1441(a).

[93] 28 U.S.C. § 1441(b)(2).

[94] *Tolia v. Dunkin' Brands, Inc.*, No. 11-3656, 2011 WL 6132271, at *2-3 (D.N.J. Dec. 7, 2011) (discussing fraudulent joinder).

[95] 28 U.S.C. § 1391(b)(1)–(2).

[96] 28 U.S.C. § 1391(b)(3).

[97] 28 U.S.C. § 1404(a).

finds that another forum would be significantly better situated to hear the case.[98] The Supreme Court has commented that a motion to transfer venue pursuant to 28 U.S.C. § 1404 is and is not a codification of the doctrine of *forum non conveniens*.[99] Since each motion presumes (either the motion to transfer venue or for *forum non conveniens*) that the court has jurisdiction, granting either lies within the discretion of the court.[100]

D. Forum Selection Clauses and Venue

There are two types of forum selection clauses – (1) mandatory clauses that require the parties to litigate their claims exclusively in a particular forum; and (2) permissive clauses that "may" require the parties to resolve their dispute in a specific forum. The distinction is important since a court's decision to grant a motion to dismiss based on a venue selection clause turns, in the first instance, on whether the clause is permissive or mandatory.[101] In a permissive clause, parties consent to suit being brought in a designated venue, but the language of the clause does not bind the parties to litigate there. In contrast, a mandatory clause requires that any litigation take place in a particular venue.[102] Mandatory clauses contain words such as "shall" and "exclusively" and carry a strong presumption of enforceability.

The United States Supreme Court's unanimous decision in *Atlantic Marine Const. Co. v. U.S. Dist. Court for W. Dist. of Texas*[103] clarifies the weight to be given to a contractual forum selection clause*.* In that case, a valid forum selection clause provides conclusive evidence that the parties' interests favor transfer in accordance with the

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[98] *Sinochem Int'l Co. v. Malaysia Int'l Shipping Corp.*, 549 U.S. 422, 429 (2007).

[99] *See Atlantic Marine Const. Co. v. U.S. Dist. Court for W. Dist. of Texas*, 134 S. Ct. 568, 580 (2013) (Section 1404(a) is "merely a codification of the doctrine of *forum non conveniens*."); *Piper Aircraft Co. v. Reyno*, 454 U.S. 235, 253 (1981) (Section 1404(a) "was intended to be a revision rather than a codification of the common law.").

[100] *See Piper Aircraft Co. v. Reyno*, 454 U.S. 235, 253 (1981).

[101] *See, e.g., Johnny Rockets, Inc. v. DDR Del Sol LLC,* No. 10-2062CC, 2012 U.S. Dist. LEXIS 12351, at *6-7 (D.P.R. Jan. 31, 2012) ("Under federal law, 'the threshold question in interpreting a forum-selection clause is whether the clause is permissive or mandatory.'") (quoting *Rivera v. Centro Medico de Turabo*, *Inc.*, 575 F.3d 10, 15 (1st Cir. 2009)). *See also See Carl's Jr. Rest. LLC v. 6Points Food Servs. Ltd.*, No. CV 15-9827-GHK (ASX), 2016 WL 3671116, at *4 (C.D. Cal. July 7, 2016), *judgment entered,* No. CV 15-9827-GHK (ASX), 2016 WL 3660191 (C.D. Cal. July 7, 2016) (distinguishing permissive from mandatory forum selection clauses); *Cheney v. IPD Analytics, LLC*, 583 F. Supp. 2d 108, 121–22 (D.D.C. 2008) (construing the reach of a forum selection clause).

[102] *See, e.g., Miro Gonzalez v. Avatar Realty, Inc.*, 177 F. Supp. 2d 101, 104 (D.P.R. 2001).

[103] *Atlantic Marine Const. Co. v. U.S. Dist. Court for W. Dist. of Texas*, 134 S. Ct. 568, 581–83 (2013).

clause. Therefore, a 28 U.S.C. § 1404(a) motion to transfer should be denied "only under extraordinary circumstances unrelated to the convenience of the parties" when they have agreed to a forum selection clause.[104] The Court concluded that because public interest factors will rarely outweigh the parties' private expression of their venue preferences, "the practical result is that forum-selection clauses should control except in unusual cases."[105]

1. Challenges to Forum Selection Clauses

Nevertheless, courts have explored several methods for avoiding the effect of forum selection clauses. Some are straightforward: just as an arbitration clause is invalid if procedurally unconscionable, a forum selection clause is invalid if procured by fraud or overreaching.[106] As an arbitration clause must be substantively conscionable, a forum selection clause must be "reasonable" to be enforced, which is to say that it cannot effectively deny a party its "day in court" or deprive the plaintiff of a potential remedy.[107]

The most common basis for rejecting a forum selection clause is a finding that the clause is unenforceable on the basis of state statute or public policy. The holding by the Supreme Court in *Stewart Org., Inc. v. Ricoh Corp.*[108] that a 28 U.S.C. § 1404 motion to transfer venue preempts state law has not kept courts from following Justice Scalia's dissent in that case when he observed that "issues of contract . . . are nearly always governed by state law."[109] State-law provisions relevant to forum selection clauses in the franchise context include general anti-waiver rules in addition to forum or venue-specific rules. The franchise anti-waiver rules restrict a franchisee's waiver of rights under a franchise agreement and may prevent recognition of a forum selection clause deemed to waive the franchisee's right to proceed in the courts of the state.

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[104] *Id.* at 581; *accord Collins On behalf of herself v. Mary Kay, Inc.*, 874 F.3d 176, 186 (3d Cir. 2017); *Corizon Health, Inc. v. CorrecTek Inc.*, No. 116CV00120EJLCWD, 2017 WL 3091456, at *3 (D. Idaho Feb. 3, 2017); *Brava Salon Specialists, LLC v. Label.M USA, Inc.*, No. 15-CV-631-BBC, 2016 WL 632649, at *1 (W.D. Wis. Feb. 17, 2016).

[105] *Atlantic Marine* at 583.

[106] *See M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972).

[107] *Id.* at 12–13; *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 589 (1991).

[108] 487 U.S. 22 (1988).

[109] 487 U.S. at 36.

Twenty-six states and Puerto Rico have some combination of anti-waiver, forum or venue provisions in their franchise or business opportunities laws.[110]

Courts examining state law typically seize on the distinction between the validity and enforceability of the forum selection clause. As stated above, issues regarding the formation of the clause would generally go to its validity, whereas issues regarding its substance would go to its enforceability. Interestingly, the *Stewart* majority spoke entirely in terms of enforceability in considering Alabama's anti-forum selection clause's public policy, whereas Justice Scalia, discussing the same issues in his dissent, spoke of the clause's "validity."[111]

Many state statutes pronounce forum selection clauses "void", rather than the more appropriate word "unenforceable."[112] Where the state law on its face addresses the *validity* rather than the *enforceability* of the clause, it escapes the sweep of the majority opinion in *Stewart*, so the argument would go. Some courts suggest that, before consulting federal law on the enforceability of the clause, one must first consult state law on the validity of the clause.[113] There are, however, persuasive arguments that this approach is completely contrary to the intent and the language of the *Stewart* decision, which held that federal law occupies the area to the exclusion of state law.[114] Nevertheless, any litigant hoping to enforce a forum selection clause must be aware of courts' capacity and tendency to insert state law into the question.

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[110] *See* Earsa Jackson and Jim Meaney, *Forum Selection Clauses After* Atlantic Marine, ABA 37TH ANNUAL FORUM ON FRANCHISING (Oct. 2014), available at https://www.americanbar.org/content/dam/aba/administrative/franchising/materials2014/w4.authcheckdam.pdf. The *Stewart* majority would seem to make this irrelevant, and yet it has not.

[111] *See generally Stewart*.

[112] *See* Cal. Bus. & Prof. Code § 20040.5; 815 Ill. Comp. Stat. Ann. 705/4; Iowa Code Ann. § 523H.3; Mich. Comp. Laws Ann. § 445.1527; N.C. Gen. Stat. Ann. § 22B-3; 19 R.I. Gen. Laws Ann. § 19-28.1-14.

[113] *See, e.g., Frango Grille USA, Inc. v. Pepe's Franchising Ltd.*, No. CV 14-2086 DSF (PLAx), 2014 WL 7892164 (C.D. Cal. Jul. 21, 2014); *see also Rogovsky Enter., Inc. v. Masterbrand Cabinets, Inc.*, 88 F. Supp. 3d 1034, 1041 (D. Minn. 2015) (commenting that the *Frango Grille* decision "merges" the analyses of validity and enforceability); *but see Fraser v. Brightstar Franchising LLC*, No. 16-CV-01966-JSC, 2016 WL 4269869, at *1 (N.D. Cal. Aug. 15, 2016) (declining to extend the protection of California law to a California franchisee whose franchises were located in another state); *Allegra Holdings, LLC v. Davis*, No. 13-CV-13498, 2014 WL 1652221, at *3 (E.D. Mich. Apr. 24, 2014) (announcing that a franchisor who brings suit outside of Minnesota, in accordance with a forum selection clause, does not run afoul of Minnesota law barring a franchise agreement from "requir[ing] litigation to be conducted outside of Minnesota").

[114] *See* Matthew J. Sorensen, *Enforcement of Forum-Selection Clauses in Federal Court after* Atlantic Marine, 82 FORDHAM LAW REVIEW 2521, 2552–2558 (2014).

Litigants also contribute to keeping state law in play when they concede to courts that state law will override their forum selection clauses.[115] While other litigants write into their franchise agreements anti-waiver provisions that have the effect of undermining the forum selection clause.[116] An example is a provision providing that: "Any legal proceeding arising from or related to this agreement shall be brought only in the courts of Pennsylvania, provided, however, that this forum-selection clause shall not be interpreted to waive any right of Franchisee under a state law to bring a legal proceeding in that state."

The bottom line for litigants is that the Supreme Court precedent in this area has not proven to be the trump card it might initially seem. Particularly in the context of state rule purporting to "void" all forum selection clauses, courts have had little difficulty finding a basis for avoiding enforcement. A litigant therefore has to carefully research its jurisdictions before deciding to file a motion to transfer venue or for *forum non conveniens*.

E. Moving for an Injunction

One of the important reasons why parties seek to litigate in federal court has to do with a court's injunction powers. Oftentimes the rush to seek an injunction starts a race to the courthouse, with each party seeking this emergency relief in its home court (for the franchisee that means filing in its home state court). Oftentimes the grant of an injunction effectively terminates the litigation, especially in those cases where a franchisor is seeking to terminate its franchisee who continues to operate the franchise business in violation of the franchise agreement's post-termination obligations and in violation of applicable trademark or trade dress law.

Whether a court will grant an injunction depends on these typical factors: a party affirmatively moving for injunctive relief must establish the following: (1) that it is likely to succeed on the merits of its claims; (2) that it is likely to suffer irreparable harm in the absence of preliminary injunctive relief; (3) that the balance of equities tips in its favor; and (4) that an injunction is in the public interest.[117] The factors that are hotly at issue

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[115] *See, e.g., Family Wireless #1, LLC v. Auto. Techs., Inc.*, No. 15-11215, 2015 WL 5142350, at *2 (E.D. Mich. Sept. 1, 2015) ("the parties agree that the Michigan and Indiana Plaintiffs' clauses are not valid."). *See also* Mich. Comp. Laws § 445.1527(f); Ind.Code § 23–2–2.7–1(10)"); *Sojka v. DirectBuy, Inc.*, No. 12 C 9809, 2014 WL 1089072, at *4 (N.D. Ill. Mar. 18, 2014) ("as DirectBuy acknowledges . . . Illinois and California law would override the franchise agreements' forum selection clauses").

[116] *See, e.g., Get In Shape Franchise, Inc. v. TFL Fishers, LLC*, 167 F. Supp. 3d 173, 186 (D. Mass. 2016) (describing Indiana addendum to franchise agreement voiding forum selection clause where it conflicts with Indiana franchise law).

[117] *See, e.g., Int'l Refugee Assistance Project v. Trump*, 883 F.3d 233 (4th Cir. 2018), *as amended* (Feb. 28, 2018) (citing and applying *Winter v. Natural Res. Def. Council, Inc.,* 555 U.S. 7, 20 (2008)); *Centro Tepeyac v. Montgomery Cty.*, 722 F.3d 184, 188 (4th Cir. 2013) (same).

are the first and second prongs: whether the party moving for an injunction is likely to succeed on the merits and whether there has been a showing of irreparable harm. Certain jurisdictions have yet to address whether a presumption of harm still applies after *eBay, Inc. v. MercExchange LLC*,[118] in which the United States Supreme Court held irreparable harm cannot be presumed following a finding of infringement in a patent case seeking a permanent injunction. Some jurisdictions have applied the reasoning of *eBay* to franchise cases. Litigants therefore need to be mindful of their jurisdiction before proceeding to file for an injunction.

VI. TYPICAL FRANCHISOR CLAIMS AND FRANCHISEE DEFENSES

Most claims filed by a franchisor against its franchisee either occur during the parties' normal course of operations, such as a franchisee's failure to pay royalties or comply with system standards, or at the time of termination, either to enforce the post-termination obligation to stop using the trademarks. This section discusses a few of these claims.

A. Non-Payment Cases

Non-payment, also known as monetary default, cases are by far and away the most typical type of claim brought by franchisors. Non-payment cases are normally brought as straightforward breach of contract claims, alleging that the franchisee has failed to pay certain amounts (e.g., royalties, advertising/marketing fund fees, etc.) required to be paid under the parties' franchise agreement. Most franchise agreements contain provisions explicitly stating that failure to pay fees when due is a material breach of the franchise agreement, warranting termination. Because accounting for payments made (or not made) to a franchisor is easily verifiable, especially with electronic systems tracking sales, non-payment cases are usually easy for franchisors to prove.

In the face of a non-payment case, franchisees will often argue that there is some form of deficiency in the franchise system that led to the franchisee's eventual failure or refusal to pay (e.g., lack of adequate support), which should be considered a prior breach of contract by the franchisor. Courts, however, have been clear that franchisees have two options in the face of an alleged prior breach of contract by the franchisor:

> When one party to a contract materially breaches his duties under the contract, the other party may proceed in one of two ways. He can either consider the contract terminated and sue for total breach, or he can continue his performance and sue for partial breach. As Defendants have ceased paying the amounts due under the franchise and lease agreements, they seem to have chosen the first option of considering [Plaintiff's] alleged breach a total breach. Thus,

[118] 547 U.S. 388 (2005).

> Defendants themselves appear to have terminated their contractual relationship with [Plaintiff]. Although Defendants may prevail on their breach of contract claims, thus excusing them from paying the amounts currently due and perhaps entitling them to further damages, the Court cannot see how this separate cause of action entitles them to continued rights under the franchise agreement. In order to have preserved their right to recover for the alleged breaches and to continue to use the [Plaintiff's] trademark, Defendants should have continued to pay royalties, advertising expenses and rent.[119]

As case law makes clear, under no circumstances may the franchisee continue to operate the franchise and refuse to pay for such rights, as is often the case in non-payment cases.

Franchisees may also assert as a defense (or as an outright fraud-based counterclaim) that the franchisor's FDD misrepresented certain earnings claims, to the extent included in the FDD, which provided the franchisee false assurances of expected earnings. These financial performance representation ("FPR") claims are often presented by way of an argument that some agent of the franchisor provided the franchisee with certain financial information that is not reflected in the franchisor's FDD. An interesting scenario arises when a franchisee, despite having expressly disclaimed (usually multiple times in the franchise agreement by way of non-reliance clauses[120]) receiving or relying upon any pre-sale financial performance representations, claims that it, nevertheless, received and relied upon such representations that ultimately proved to be false. This is an uphill argument for a franchisee given the ample case law providing that non-reliance clauses are generally enforceable. This is especially true in that "[t]he enforcement of non-reliance clauses recognizes that parties with free will

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[119] *S & R Corp. v. Jiffy Lube Int'l, Inc.,* 968 F.2d 371, 376 (3d Cir. 1992) (quoting *Burger King v. Austin,* Bus. Fran. Guide (CCH) ¶ 9788 at 22,069 (S.D. Fla. Dec. 26, 1990)).

[120] Franchise agreements are sometimes are signed by parties without careful thought as to the ramifications of certain provisions (this is, of course, despite provisions requiring acknowledgment that a party thoroughly read the agreement and understood its terms, which, ironically, are also often overlooked). Nevertheless, parties are expected to understand the import of each of the provisions in the agreement and the effect it may have on their business and business relationship. *See, e.g., Madden v. Kaiser Found. Hosps.,* 17 Cal. 3d 699, 710 (Cal. 1979) ("[O]ne who assents to a contract is bound by its provisions and cannot complain of unfamiliarity with the language of the instrument.") (en banc).

should say no rather than lie in a contract."[121] By falsely indicating that it was never provided with any pre-sale financial performance representations not reflected in the FDD, the franchisee effectively forecloses the franchisor's ability to cure any unauthorized financial performance representations by "setting the record straight," explaining to the franchisee that the information it received was incorrect and pointing it in the right direction (either by way of excluding the franchisee from consideration for a franchise or through addendums to the franchise agreement that may contain a release acknowledging what occurred).

Despite the overwhelming case law on non-reliance clauses, franchisors are most certainly cautioned not to consider this a "get out of jail free card" to provide all manner of pre-sale financial performance representations not contained in the FDD. There surely is some set of facts – based on fairness or equity – that a court or arbitrator could consider that may find the non-reliance clause to be unenforceable in certain circumstances.

Notwithstanding the relative ease with which a franchisor may be able to establish a breach of contract for non-payment, a franchisor must still make sure that it complies will all notice and cure requirements set forth in the parties' franchise agreement and applicable state law. Any default and/or termination notice must adhere to the requirements of the franchise agreement and any applicable state laws in its method of delivery, the statement of the basis for default and/or termination, any ability to cure, and the fallouts should a franchisee fail to cure, to name a few.

B. "Obey All Laws" Provisions

Franchisors spend considerable amounts of time, resources, and energy promoting the brand in an effort to develop goodwill and brand recognition. Because the public often identifies a specific franchisee with the larger franchise system, it is essential that the franchisee maintains a positive public image, as a representative of

[121] *See Abry Partners V, L.P. v. F & W Acquisition LLC,* 891 A.2d 1032, 1058 (Del. Ch. 2006) ("To fail to enforce non-reliance clauses is not to promote a public policy against lying. Rather, it is to excuse a lie made by one contracting party in writing—the lie that it was relying only on contractual representations and that no other representations had been made—to enable it to prove that another party lied orally or in a writing outside the contract's four corners. For the plaintiff in such a situation to prove its fraudulent inducement claim, it proves itself not only a liar, but a liar in the most inexcusable of commercial circumstances: in a freely negotiated written contract. Put colloquially, this is necessarily a 'Double Liar' scenario. To allow the buyer to prevail on its claim is to sanction its own fraudulent conduct.").

the brand.[122] What happens, then, when a franchisee engages in an act or acts that has the potential to injure the sterling reputation of a franchise system?

Franchise agreements, by and large, contain provisions requiring franchisees to comply with and obey all federal, state, and local laws. These types of provisions are used by franchisors to ensure the sanctity of the franchise relationship as well as to protect the overall brand image. To be sure, the franchise relationship is built upon a foundation of trust. If a franchisee is unwilling to obey the law by engaging in, among other things, acts of dishonesty, then the franchisor loses confidence in the franchisee's willingness and ability to comply with the terms of the franchise agreement. Additionally, as often occurs, a franchisee's violations of the law becomes public and has the potential to negatively impact the franchise system as a whole. As a result, franchisors often reserve the right in the franchise agreement to terminate the franchisee if there is proof that the franchisee has failed to "obey all laws."[123]

Franchisees typically attempt to defend these types of cases by alleging that (1) the franchisee has not been *convicted* of any crime, (2) there has been no harm to the franchisor by way of the franchisee's conduct, and/or (3) the franchisor was improperly motivated to oust the franchisee and was looking for any means to do so. These defenses, however, do not fair too well. For example, in *Amerada Hess Corp. v. Quinn*,[124] the franchisee was found to have been overcharging customers for purchases of gasoline in violation of the Economic Stabilization Act of 1970. The franchise agreement at issue stated that it would be a violation of the franchise agreement for the franchisee to engage in such conduct, in violation of the law. The franchisee attempted

[122] *See, e.g., Dunkin' Donuts Inc. v. Gav-Stra Donuts, Inc.,* 139 F. Supp. 2d 147, 155, 2001 WL 396342 (D. Mass. 2001) ("This case is more complicated than [*Dunkin' Donuts Inc. v.*] *Panagakos* because here one co-franchisee made his best efforts to cure the dishonesty of another co-franchisee. However, the genie had been let out of the bottle before defendants had a chance to stop it. Despite these good faith efforts, there was media coverage referring to Gavriel as a Dunkin' Donuts franchisee."). In light of the potential for negative impact on the brand, oftentimes, "obey all laws" cases can be coupled with breaches of a "goodwill" provision, if provided for in a franchise agreement.

[123] Important for drafting considerations of "obey all laws" provisions is the fact that such provisions should not make it a requirement that the franchisee admit or otherwise be convicted of a violation of the law; rather it will be enough if there is "proof" that the franchisee failed to comply with the law. That way, the franchisor only need to prove by a preponderance of the evidence that a violation occurred as opposed to beyond a reasonable doubt as would otherwise be required for a criminal conviction. *See Dunkin' Donuts Franchised Rest. LLC v. Strategic Venture Group, Inc.,* 2010 WL 4687838 (D.N.J. 2010). Additionally, as with many termination provisions in a franchise agreement, the franchisor is often required to provide an opportunity to cure any alleged failure to "obey all laws." Franchisors should consult the applicable language of the franchise agreement and any state laws regarding termination of franchise agreements.

[124] 143 N.J. Super 237 (Law Div. 1976).

to argue that the violation of the franchise agreement “might escape attention or cause only slight upset and, therefore, is insubstantial in the actual or potential impact of the franchisee’s derelictions upon the franchisor’s trade name, trademark, good will and image.”[125] In response, the court rejected the franchisee’s argument, stating:

> Reason and common sense require rejection of this contention. A franchisor, such as Hess here, has interest in a particular franchisee’s performance broader than the mere protection and enhancement of its trade name, trademark and the good will attached thereto, though these are, of course, important. The franchisor also has an interest in the marketing of its products, here gasoline and motor oil, through the franchise, and a franchisee’s breach of his reasonable obligations thereunder, proved to have adversely impacted the volume of the franchisor’s goods sold through the franchisee, would substantially impair that interest so as to justify termination. But more basic than this, it is the opinion of the court that a franchisee who has willfully violated the statutes and regulations governing the operation of his business Contra [sic] the terms of the franchise agreement, has failed to substantially perform his franchise obligations within the intendment of the Franchise Practices Act

Id. at 252. The Court went on to conclude “[t]hat Hess must constantly police its franchise structure in order to protect its good will and image for the benefit of all is made plain from the evidence. Defendant’s overcharge might be but an isolated instance. However, the welfare of the franchise structure requires that Hess take such action, the minor effect of which is to terminate [the defendant franchisee], but the major effect of which is to protect and preserve the good will and image shared by itself and all of its franchisees.”

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[125] *Id.* at 251-52.

Similarly, claims of improper motive are almost reflexively made by terminated franchisees and just as uniformly rejected by the courts.[126] For example, in *Dunkin' Donuts Inc. v. Martinez*,[127] Dunkin' terminated a franchisee based on his commission of tax evasion (though the franchisee never admitted to any violation nor was the franchisee convicted of tax evasion at the time of termination). Dunkin's franchise agreement contained an "obey all laws" provision stating: "Franchisee agrees to comply promptly with all applicable laws, rules, regulations, ordinances, and orders of public authorities including, but not limited to, health departments, Board of Fire Underwriters and other similar organizations."[128] The franchisee argued that Dunkin' had an ulterior motive in terminating the franchise agreement because the franchisee was unwilling to convert his Blimpie's franchise to Dunkin's competing Togo's franchise. The Court,

[126] *See Dunkin' Donuts, Inc. v. Chyi Liu,* No. CIV.A. 00-3666, 2002 WL 1471421, at *8 (E.D. Pa. June 25, 2002), *aff'd sub nom. Dunkin' Donuts Inc. v. Liu,* 79 F. App'x 543 (3d Cir. 2003) (rejecting "ulterior motive" defense where Dunkin' terminated a franchise agreement because the franchisees failed to pay franchise fees and advertising fund contributions and where before and after litigation ensued, Dunkin' offered franchisees opportunity to sell franchises); *Dunkin' Donuts Inc. v. Patel,* 174 F. Supp. 2d 202, 212 (D.N.J. 2001) ("Dunkin's motives in conducting its inspections have no bearing on whether Defendants breached their Franchise Agreement with Plaintiff by failing to properly maintain the three shops."); *Dunkin' Donuts Inc. v. Donuts, Inc.,* No. 99-CV-1141, 2000 WL 1808517, at *8 (N.D. Ill. Dec. 6, 2000) (in rejecting a similar pretext argument, the court held that "assuming, arguendo, that Dunkin' in fact terminated the Franchise Agreements because, for example, it did not care for [the franchisee's] activism on behalf of franchisees, [the franchisee's] material breaches were sufficient to justify termination." (quoting *Robertson* and *Great American Cookie*)); *Major Oldsmobile, Inc. v. Gen. Motors Corp.,* No. 93 CIV. 2189 (SWK), 1995 WL 326475, at *8 (S.D.N.Y. May 31, 1995), *aff'd*, 101 F.3d 684 (2d Cir. 1996) ("[S]ince defendant had the right to terminate the Agreement upon plaintiff's breach, it is legally irrelevant whether defendant was also motivated by reasons which would not themselves constitute valid grounds for termination of the contract."); *Refinemet Int'l Co. v. Eastbourne N.V.,* 815 F. Supp. 738, 742 (S.D.N.Y. 1993), *aff'd on other grounds*, 25 F.3d 105 (2d Cir. 1994); *Dayan v. McDonald's Corp.,* 466 N.E.2d 958, 993 (Ill. Ct. App. 1984). All of these cases reflect the well-established rule that a "party has an absolute, unqualified right to terminate a contract on notice pursuant to an unconditional termination clause without court inquiry into whether the termination was activated by an ulterior motive." *Big Apple Car, Inc. v. City of N.Y.,* 611 N.Y.S.2d 533, 534 (N.Y. App. Div. 1994).

[127] 2003 WL 685875 (S.D. Fla. Feb. 21, 2003), *aff'd sub nom. Philomar, Inc. v. Dunkin' Donuts, Inc.,* No. 03-11569, 2003 WL 22994236 (11th Cir. Dec. 12, 2003).

[128] *Dunkin' Donuts Inc.,* 2003 WL 685875 at 4.

citing to *McDonald's Corp. v. Robertson*,[129] found that even if there was some ulterior motive on the part of Dunkin' to terminate the franchise agreements, such motives were irrelevant in light of the franchisee's material breaches of the franchise agreements.[130]

A franchisee's engagement in criminal conduct is often found to be an incurable default, warranting termination. Franchisees cannot turn a blind eye toward "obey all laws" provisions, even when the wrongful acts are being carried out by a co-franchisee.[131]

Changes in political climate can often highlight a difficulty with the "obey all laws" provisions. For example, a convenience store franchise, like 7-Eleven, Inc., must ensure compliance with the laws governing age restricted products, like cigarettes and alcohol. Recently, there has been an increase in the number of enforcement actions brought by the Center for Tobacco Products in which it seeks fines as low as $250.00, and other escalating penalties, such as loss of the right to sell tobacco products. This concept could apply in a variety of franchise industries, especially in regulated fields, and could place the franchisor in an interesting conundrum: is any singular violation a terminable offense or is there a sliding scale?

C. Non-Compliance With System Standards

Compliance with "system standards" is the primary measure used by franchisors to ensure that the brand as a whole offers a consistent customer experience (i.e. brand uniformity). Where a threat to the operation and reputation of the brand is perceived, enforcement of system standards can be an effective means to "save the day."

As part of joining a franchise system, a franchisee agrees to adhere to the franchise system's rules and standards. Traditionally, there were two options available

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[129] 147 F.3d 1301, 1309 (11th Cir. 1998) ("[F]ailure to comply with McDonald's QSC and food safety standards constituted a material breach of the franchise agreement sufficient to justify termination, and thus, it does not matter whether McDonald's also possessed an ulterior, or improper motive for terminating the [franchisee's] franchise agreement.").

[130] *Dunkin' Donuts Inc.,* 2003 WL 685875 at *12; *see also Original Great American Chocolate Cookie Co., Inc. v. River Valley Cookies, Ltd.,* 970 F.2d 273, 279 (7th Cir. 1992), where the court held that "[t]he fact that the [franchisor] may, as the [franchisees] argue, have treated the other franchisees more leniently is no more a defense to a breach of contract than laxity in enforcing the speed limit is a defense to a speeding ticket."

[131] *See Dunkin' Donuts Inc. v. Gav-Stra Donuts, Inc.,* 139 F. Supp. 2d 147, 154 (D. Mass. 2001) (quoting Restatement (Second) of Contracts, § 288(2) (1979)) ("Unless a contrary intention is manifested, a promise by two or more promisors is a promise that the same performance shall be given."); *id.* § 289(1) ("where two or more parties to a contract promise the same performance to the same promisee, each is bound for the whole performance thereof")).

to a franchisor for enforcing system standards – (1) coach and counsel the franchisee into compliance, perhaps sending default letter or other legal notices, and (2) terminate the franchisee. While each may have its varying degree of effectiveness, there are other avenues available to the franchisor to ensure a consistent brand experience.

An often overlooked but equally effective way to enforce system standards is to file an action seeking injunctive relief requiring a franchisee to comply with system standards. In this type of action, the franchisor is not seeking to terminate the franchisee, but merely require its immediate compliance with the system standards. To bring such an action, the franchisor will issue a notice to cure, wait the required amount of time for any allowed opportunity to cure, and, assuming continued non-compliance, thereafter file a complaint and motion for preliminary injunctive relief.[132] Typically, the motion for preliminary injunctive relief can be heard within a few days or weeks of having been filed, thus, providing a franchisor an efficient means in ensuring compliance. Enforcement of system standards by way of a preliminary injunction is perceived to be more forceful than a run-of-the-mill deficiency letter, but not as drastic as a full-blown termination.[133]

Inconsistent enforcement of system standards violations is often cited by franchisees as a defense to system standards claims in both the termination and injunctive context. Franchisees will argue that the franchisor has not enforced system standards in the past and waived the right to do so, or has inconsistently enforced its standards, so the franchisee feels as if they are being singled out arbitrarily for compliance. This type of argument contradicts the franchisor's assertion of irreparable harm where a franchisor seeks to compel compliance with its standards through injunctive relief. Put plainly, if the franchisor does not require all franchisees to comply with a particular standard, how is it being harmed? These are often fact specific inquiries and have the potential to put the entire system on display.[134]

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[132] The four traditional factors for injunctive relief are: (1) a substantial likelihood of success on the merits (or actual success on the merits for a permanent injunction); (2) a likely threat of irreparable injury absent an injunction; (3) the balance of harms favors granting an injunction; and (4) the injunction is in the public interest. *See eBay Inc. v. MercExchange, L.L.C.,* 547 U.S. 388 (2006); *Winter v. Natural Res. Def. Council, Inc.,* 555 U.S. 7 (2008).

[133] A very critical component of any injunctive relief action is the payment of the franchisor's attorneys' fees and costs by the franchisee, assuming the franchise agreement allows for the recovery of attorneys' fees and costs. The prospect of having to pay significant legal expenses for non-compliance sends a clear message to the franchisee and the franchise system as a whole that the franchisor is serious about maintaining a consistent brand experience.

[134] *Peterbrooke Franchising of Am., LLC v. Miami Chocolates, LLC*, 16-20417-CIV, 2018 WL 1083552, at *1 (S.D. Fla. Feb. 28, 2018)(rejecting franchisee's claim that failure to install a required point of sale system was immaterial and did not justify termination of the franchise agreement).

In the context of a termination, depending on the system standard at issue, a franchisee may argue that the inconsistent enforcement of a particular standard indicates that it is not too important and therefore does not warrant punitive action (termination) by the franchisor. Standards that affect consumers or the public health, such as sanitation requirements,[135] and standards that affect the administration of the system, are generally considered material.

There are system-wide consequences when a franchisee can successfully defeat the attempted application of a franchisor's system standards. Thus, a franchisor should constantly be policing its system to ensure compliance with its system standards (without trudging too far into the joint employer fray), among other things. In so doing, a franchisor should be cognizant of the need to develop a "record" of system standards violations by a franchisee. Franchisors will be on a better footing in the eyes of a court if they are able to present multiple, concrete examples of affirmative violations of its system standards (oftentimes, pictures are worth a thousand words).

D. Non-Competition Claims

As part of entering the franchise system, franchisees are handed the "keys to the kingdom," where the franchisor provides all manner of confidential and proprietary information to the franchisee in order to operate the franchise. As a means to protect the dissemination and use of such information and "know how" by a franchisee in competition with the franchisor, franchise agreements almost universally contain non-compete agreements.

Typically, franchise agreements contain two types of non-compete agreements: (1) in-term non-competes, restricting a franchisee's ability to own or be engaged in a "competing business" while continuing to be a franchisee within the franchise system; and (2) post-term non-competes, restricting a franchisee's ability to own or be engaged in a "competing business" following the non-renewal or termination of a franchise agreement. Competing businesses are usually defined as those business that operate in the same business segment as the franchisor, offering the same or similar types of good or services.

The enforceability of covenants not to compete, whether in-term or post-term, is generally a matter of state law. Thus, it is important for franchisors and franchisees alike to understand what law applies in terms of the enforcement of non-compete agreements. For example, even where a franchise agreement selects the law of Colorado, if a franchisee is located in California, it is likely that California's general

[135] *See Dunkin' Donuts Inc. v. Priya Enterprises, Inc.,* 89 F. Supp. 2d 319, 323 (E.D.N.Y. 2000) (where franchisor sued franchisee to enforce the franchise agreement's sanitation requirements and the sanitation requirements were found to be enforceable).

prohibition on post-termination non-competes will restrict enforcement of the clause as against a California franchisee.[136]

As a general rule, courts will enforce covenants not to compete so long as they are reasonable in time and geographical scope and necessary to protect a franchisor's legitimate business interests. Legitimate business interests can include the protection of trade secrets, confidential information and customer relationships.[137] Additionally, enforcement of non-compete agreements has the added effect of potentially deterring "copy cats" within the franchise system.[138] Moreover, as one court observed:

> Non-competition agreements between a franchisor and a franchisee are designed not only to protect the interests of the immediate parties but also to protect other franchisees against competitive activities. Thus, to the extent that such non-competition agreements are exacted from all franchisees, each franchisee is thereby protected from competition from other franchisees.[139]

Typically, post-termination non-competes are generally subjected to more scrutiny as they are viewed as significant restraints on trade. Post-termination covenants not to compete are usually limited to one or two years and within a 25-mile radius of the franchisee's former franchised business. Where post-termination non-competes are deemed to be overbroad, some courts will "blue pencil" the covenant so as to make it reasonable.[140]

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[136] *See* Cal. Bus. Code. Prof. § 16600 ("Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.")

[137] *See Jackson Hewitt Inc. v. Childress*, No. 06-909, 2008 WL 199539, *7 (D.N.J. Jan. 22, 2008).

[138] *Athlete's Foot Mktg. Assocs., Inc. v. Zell Inv., Inc.,* 2000 WL 426186, at *7 (W.D. Pa. Feb. 17, 2000) (*"*Other . . . franchisees . . . may be watching to see if [the defendant] is permitted to breach its non-compete covenant, which would establish a potentially catastrophic precedent and a 'domino' effect whereby a series of franchisees leave the fold to establish competing business at or near the location of their [franchise] store(s).").

[139] *Casey's Gen. Stores v. Campbell Oil Co.,* 441 N.W.2d 758, 761 (Iowa 1989).

[140] *See, e.g.,* Fla. Stat. § 542.335(1)(c).

In-term non-competes are generally less scrutinized by courts, even in California,[141] as they are of limited duration (i.e. during the time the franchisee remains in the system), they ensure a franchisee's loyalty to the franchise system's good and services,[142] and generally do not prohibit a franchisee's ability to make a living.[143]

E. Trademark Infringement Claims

A franchisor's trademark is one of the most valuable components of a franchise system. Indeed, the licensing of a trademark is one of only three required elements in the definition of a franchise under the FTC Rule on Franchising.[144] Thus, it is not surprising that a number of franchise disputes, particularly following termination or expiration of a franchise agreement, involve trademark claims.

Franchise agreements regularly have provisions requiring that upon termination or non-renewal of the franchise agreement, the franchisee is required, as part of its de-branding process, to cease using the franchisor's trademarks. Notwithstanding its post-termination contractual obligations, a franchisee may ignore them and continue to operate its business using and displaying the franchisor's trademarks and trade dress.

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[141] *See Comedy Club, Inc. v. Improv W. Associates,* 553 F.3d 1277, 1286–88 (9th Cir. 2009) (enforcing in-term covenant consistent with Fed. R. Civ. P. 65); *Dayton Time Lock Service, Inc. v. Silent Watchman Corp.,* 52 Cal.App.3d. 1, 124 Cal.Rptr. 678 (1975) (upholding enforcement of an in-term covenant not to compete under California law); *Keating v. Baskin-Robbins,* 2001 WL 407017 (Mar. 27, 2011 E.D.N.C.) (same, applying California law); *see also Shaklee U.S. v. Giddens,* 934 F.2d 324 (Table), 1991 WL 90003 (9th Cir. 1991), cert. denied, 502 U.S. 1033 (1992) ("California cases clearly establish that contractual prohibitions against current employees' competing with their employers do not violate 16600.").

[142] *See Dunkin' Donuts Franchising LLC v. C3WAIN Inc.,* 677 F. App'x 779, 784 (3d Cir. 2017) (franchisor "had an interest in ensuring its franchisees were loyal to its products and it was harmed by granting a franchise to an entity whose loyalties were divided."). Quarles & Brady LLP is counsel for Dunkin' Donuts in this case.

[143] Even where a covenant not to compete may foreclose a franchisee's ability to "make a living," courts have consistently held that where a franchisee's own actions have resulted in the enforcement of a restrictive covenant, they cannot complain of the resulting harm. *See Our Town v. Rousseau,* No. 3:16-CV-2484, 2017 WL 34698, at *8 (M.D. Pa. Jan. 3, 2017) ("However, where, as here, the harm Defendants complain of is entirely of their own making Courts recognize that '[t]he self-inflicted nature of any harm suffered by the wrongdoer ... weighs heavily in favor of granting preliminary injunctive relief.'") (quoting *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Napolitano,* 85 F. Supp. 2d 491, 498 (E.D. Penn. 2000) (citing *Pappan Enters., Inc. v. Hardee's Food Sys., Inc.,* 143 F.3d 800, 806 (3d Cir. 1998)).

[144] 16 C.F.R. Parts 436 & 437 (the "FTC Rule").

Franchisors typically bring trademark infringement actions as part of a motion for preliminary and permanent injunctive relief, requiring that the former franchisee honor its post-termination obligations, and often under the Lanham Act. The main focus of the Lanham Act is whether the franchisee's use of the franchisor's trademarks are likely to cause customer confusion or mistake or otherwise have the effect of exhibiting false continuing affiliation with the franchisor.[145] Indeed, the basic idea of trademark infringement is that the use of a distinctive source identifying trademark in connection with similar goods or services is likely to confuse consumers into believing that both products and services emanate from the trademark owner. By creating the misimpression that a relationship exists between the trademark owner and the infringer's products, not only are consumers deceived, but the trademark owner loses its ability to convey that it is the sole source of the product or service being offered and to ensure the quality of the products or services being offered under its marks. As a result, the trademark owner loses control over the consumer's experience with its marks and the goodwill associated therewith.[146] Where a former franchisee is continues to use and display a franchisor's trademarks after termination or non-renewal of a franchise agreement, courts do not hesitate to find likelihood of confusion for purposes of trademark infringement.[147]

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[145] 15 U.S.C. §1114(1)(a); 15 U.S.C. §1125(a).

[146] *See El Greco Leather Prods., Co. v. Shoe World, Inc.,* 806 F.2d 392, 395 (2d Cir. 1986) ("One of the most valuable and important protections afforded by the Lanham Act is the right to control the quality of the goods manufactured under the holder's trademark."); *Quantum Fitness Corp. v. Quantum Lifestyle Ctrs.* L.L.C., 83 F. Supp. 2d 810, 831 (S.D. Tex. 1999) (""When a likelihood of confusion exists, the plaintiff's lack of control over the quality of the defendant's goods or services constitutes an immediate and irreparable injury, regardless of the actual quality of those goods or services.").

[147] *See, e.g., Century 21 Real Estate LLC v. All Prof'l Realty, Inc.,* 889 F. Supp. 2d 1198, 1234 (E.D. Cal. 2012), *aff'd,* 600 F. App'x 502 (9th Cir. 2015) ("There are no such extenuating circumstances in this case. All Professional's infringement was willful and it refused to de-mark until the court issued an order enjoining its use of the marks."); *Emerald City Mgmt., L.L.C. v. Kahn,* No. 4:14-CV-358, 2014 WL 3809660, at *1 (E.D. Tex. Aug. 1, 2014), *aff'd,* 624 F. App'x 223, 2015 WL 8592500 (5th Cir. 2015) ("Since the parties are using the identical mark, Downtown Fever, in Texas, a likelihood of confusion in Texas is presumed."); *Bad Ass Coffee Co. of Hawaii v. JH Nterprises, LLC,* 636 F. Supp. 2d 1237, 1249 (D. Utah 2009) ("Defendants' overnight switch to Java Cove may send the message to potential customers that [the franchisor] endorses Java Cove, or that the Defendants no longer stand by [the franchisor]. Such messages are likely to erode [the franchisor's] goodwill in the marketplace."); *Dunkin' Donuts Inc. v. Northern Queens Bakery, Inc.,* 216 F. Supp. 2d 31, 44 (E.D.N.Y. 2001) ("Here, defendants are using the exact same mark as they used when they were properly franchised, which will generate confusion among Dunkin' Donuts customers as to the source of defendants' goods and services.").

VII. COMMON FRANCHISEE CLAIMS, REMEDIES AND FRANCHISOR DEFENSES

A. When is a franchise, a franchise?

Franchising is a somewhat exclusive club, meaning that not all business relationships are franchises. Some franchise litigation begins with the question: is this relationship a franchise.

There is no standard definition of a franchise. The FTC Rule contains a basic description. Various states have registration, disclosure[148] and relationship statutes with their own definitions of a franchise.[149] Some state statutes expressly prohibit a business from marketing itself for sale as a "franchise" without advance acceptance of a disclosure statement from a state agency.

Despite the lack of a uniform definition, there are three common attributes of franchises. Per the FTC Rule, a commercial business arrangement is a franchise where the franchisor (1) provides a trademark or other commercial symbol for use in the operation of the business; (2) exercises control or provides significant assistance to the business operator; and (3) is paid a minimum payment or required fee.

Irrespective of whether a business self-identifies as a "franchise,"[150] it may be considered a franchise, subject to franchise regulation and liable for violations

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[148] The states that have enacted registration and disclosure statutes are: Arkansas (Ark. Code Ann. §§ 4-72-201 to -210 (2001); California (Cal. Corp. Code §§ 31100-31516 (2001)); Delaware (Del. Code Ann. tit. 6, §§ 2551-2556 (2000)); Hawaii (Haw. Rev. Stat. §§ 482E-1 to -12 (2000); Illinois (815 Ill. Comp. Stat. Ann. 705/1 to /44 (2001)); Indiana (Ind. Code Ann. §§ 23-2-2.5-1 to -51 (2000)); Iowa (Iowa Code §§ 523B.1 to .3 (2001)); Maryland (Md. Code Ann. [Bus. Reg.] §§ 14-201 to -233 (2001); Minnesota (Minn. Stat. §§ 80C.01 to - 30 (2000)); New York (N.Y. Gen. Bus. Law §§ 680-695 (2001)); New Jersey (N.J. Stat. §§ 56:10-1 to -29 (2001)); North Dakota (N.D. Cent. Code §§ 51-19-01 to -17 (2000)); Oregon (Ore. Rev. Stat. §§ 650.005 to 650.085 (1999)); Rhode Island (R.I. Gen. Laws §§ 19-28.1-1 to -34 (2001)); South Dakota (S.D. Codified Laws §§ 37-25A-1 to -87 (2001)); Virginia (Va. Code Ann. §§ 13.1-557 to -574 (2001)); Washington (Wash. Rev. Code §§ 19.100.010 to .940 (2001)); and Wisconsin (Wis. Stat. §§ 553.01 to .78 (2000)). See also Fla. Stat. § 559.802(1) (2000), which "exempts franchises from filing as long as the franchisor files notice with the proper authority that the franchisor is in substantial compliance with the FTC Rule and pays the required fee." Michigan and Ohio require pre-sale disclosure but not registration. *See* Mich. Comp. Laws § 19.854(8) (2000); and Ohio Rev. Code Ann. § 1334.02 (Anderson 2001).

[149] *See, e.g.,* Florida Franchise Act, Fla. Stat. § 817.416.

[150] The FTC Rule contains certain exemptions. For example, the FTC Rule does not apply to "large franchisees" and petroleum marketers and resellers. Additionally, certain other industries enjoy industry specific regulation. For example, automobile manufacturers and distributors and beer distributors.

thereof.[151] To determine whether a business relationship is a franchise, courts nationwide walk through these general elements as codified or adopted by the common law in the jurisdiction of their respective states.

The first element of a franchise is easily met. For example, a trademark license satisfies the first element of the FTC Rule. A franchise relationship is not established unless the licensor also exerts control (or provides assistance) to the licensee and collects a fee.

Significant control exists where a licensor specifies the overall method of operation of the business. This factor turns on a fact specific inquiry about how the business operates. A court may find the requisite level of control to establish a franchise relationship when a franchisor restricts the business location or sales territory, specifies design, appearance or training requirements, prescribes operating hours, accounting practices or personnel policies, establishes production methods or standards (such as recipes), or restricts products a franchisee may sell. Significant assistance exists where the franchisor furnishes a detailed operations manual, assists in selecting the business location, provides marketing, management or personnel advice, among others things.

In twelve states, the legal definition of a franchise includes a “marketing plan.”[152] Other state franchise statutes instead analyze whether there is a "community of interest" between the franchisor and franchisee.[153] Some states have a unique definition of a franchise.[154]

Finally, in order to qualify as a franchise, the business relationship must include a direct or indirect payment or franchise fee paid to the licensor for the right to operate the business. This element may be satisfied through payment of a traditional initial fee, rent,

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[151] *Charts v. Nationwide Mut. Ins. Co.*, 397 F. Supp. 2d 357, 368–69 (D. Conn. 2005), *rev'd sub nom. Chartschlaa v. Nationwide Mut. Ins. Co.*, 538 F.3d 116 (2d Cir. 2008)(reversing, on other grounds, $2 million jury verdict holding that an insurance agency was found to be a franchise); *H.C. Duke & Son, LLC v. Prism Mktg. Corp.*, 411CV04006SLDJAG, 2013 WL 5460209, at *8 (C.D. Ill. Sept. 30, 2013)(denying franchisor’s motion to dismiss on the basis that the franchisee could not establish payment of a franchise fee); *To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc.,* 152 F.3d 658, 662 (7th Cir.1998) (finding a franchise where $500 payment was required over the life of the agreement), *but see Bly & Sons, Inc. v. Ethan Allen Interiors, Inc.*, CIV. 05-668-GPM, 2006 WL 2547202, at *2 (S.D. Ill. Sept. 1, 2006)(summary judgment in favor of franchisor where franchisee could not establish the payment of a franchise fee).

[152] California, Illinois, Indiana, Iowa, Maryland, Michigan, North Dakota, Oregon, Rhode Island, Virginia, Washington, and Wisconsin.

[153] Hawaii, Minnesota, Mississippi, Nebraska, and South Dakota.

[154] Arkansas, Delaware and Florida.

security deposits, escrow deposits, equipment rental fees, consulting fees, training fees site assistance fees and ongoing royalty payments.

Within the last few years the question of whether a franchise is a franchise has taken on a new meaning. Franchisees have challenged whether the franchisor is "just" a franchisor or whether the "significant control" element discussed above crosses a line, and converts the franchisor into the franchisees' employer and subjects it to state and federal labor laws.[155] This type of claim appears to be the unintended consequence of the developments in joint employer jurisprudence. An analysis of the licensor's amount of control will answer the question of whether a licensor is a franchisor and whether the franchisor is an employer; however, the answer may be different to both of these questions. As noted in the *Haitayan, et al. v. 7-Eleven, Inc.* decision, a franchisor may exert control but the level of control does not necessary establish an employer-employee relationship.

B. Disclosure Violations: When Things Go Wrong in the Formation of the Relationship

As noted above, franchise relationships are governed by state and federal law. One type of claim that franchisee attorneys see as the proverbial low hanging fruit are claims that arise before the franchise relationship even begins. When a franchisor does not follow the procedure outlined by the FTC or by state law, the franchisor invites a potential lawsuit.

The FTC Rule establishes the base line process for how a franchisor can sell franchises. It identifies required pre-sale disclosures, prohibited sales practices and mandates a "waiting period" before a franchise agreement may be signed and a franchise relationship consummated.

A franchisor must provide the FDD to a prospective franchisee at least two weeks (14 calendar days) before the franchisee signs the agreement and money exchanges hands. Some states have modified waiting periods. The franchisor's FDD must disclose specified information[156] such as information regarding the franchisor's background, current and recent litigation and bankruptcy involving the franchisor (or its officers), the costs involved in starting or operating a franchise, marks that the franchisor will license to the franchisee (and whether or not the franchisor has been issued a federally protected trademark), and financial statements about the franchisor.

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[155] *Naik v. 7-Eleven, Inc.*, CIV. 13-4578 RMB/JS, 2014 WL 3844792, at *4 (D.N.J. Aug. 5, 2014)(finding that a complaint established sufficient allegations of employee status under the Fair Labor Standards Act ("FLSA")); *but see Haitayan, et al. v. 7-Eleven, Inc.*, Case No. CV 17-7454-JFW, 2018 WL 1626248 (C.D. Cal. Mar. 14, 2018)(granting franchisor's motion for judgment on the pleadings and dismissing franchisees' claims under FLSA and the California Labor Code).

[156] *See* Section II, *supra*.

It must also contain copies of all of the proposed agreements that will govern the franchise relationship and discuss key provisions governing the relationship.

Some of these requirements, like advance delivery, appear to be relatively simple to meet especially in the technology era. Standardized franchise sale and record keeping processes are oftentimes the franchisor's best guard against both this simple type of disclosure violation and more complicated ones that challenge the content of disclosures.

Invariably, during the franchise sales process, a franchisee will inquire: how much money am I going to make? While the question may appear benign, it is the answer where the danger (or potential liability) arises.

The FTC Rule declares:

> [i]t is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any franchise seller covered by part 436 to:
>
> . . .
>
> (c) [d]isseminate any financial performance representations to prospective franchisees unless the franchisor has a reasonable basis and written substantiation for the representation at the time the representation is made, and the representation is included in Item 19 (§ 436.5(s)) of the franchisor's disclosure document.

16 C.F.R. § 436.9.

Disclosure about financial performance is optional. If a franchisor elects to make a financial performance representation ("FPR"), it must follow specific reasonableness and written substantiation requirements in so doing. Put another way, if a franchisor wants to be in a position to answer a franchisees' well-intentioned questions about the historical performance of the brand or outlets and the future profitability of the business venture, it must make an Item 19 disclosure.

If a franchisor elects to make an Item 19 disclosure, it must include the following language:

> The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information

> about possible performance at a particular location or under particular circumstances.

Even where a franchisor elects not to make any financial performance representations, the FTC Rule requires that the franchisor make specific disclaimers:

> We do not make any representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies.

The decision of whether or not to include an Item 19 disclosure is not one that should be taken lightly. Whether or not a franchisor (or its sales agents) intends to mislead a prospective franchisee with FPRs, any franchisor making FPRs that is not contained in or different from the disclosure contained in an Item 19 disclosure risks violating the FTC Rule.

Notwithstanding the fact that FPRs are permitted under specific guidelines and only where there is a reasonable basis, franchisors and their sales staff sometimes have difficulty with the prohibition on discussion of financial performance. This is understandable as the definition of an FRP is quite broad. Nearly any statement (oral or written) made to a prospective franchisee (even in a general advertisement) that expressly or by implicitly contains a specific level or range of actual or potential sales, income, gross profits, or net profits is an FRP.

While off the cuff statements are generally not actionable, franchisor's sales representatives who work with franchisees to develop pro formas or who provide written materials to the franchisee may find themselves on the wrong side of the disclosure rules.[157] FPRs, sometimes referred to as "earnings claims" may be included in sales brochures, advertising materials, on a website or in presentations made by the sales team.

A franchisee cannot simply sue a franchisor for violation of the FTC Rule because there is no private right of action. The Federal Trade Commission has enforcement authority to seek cease and desist orders and other remedies, but a franchisee cannot alone access such remedies. Some states have their own statutory franchise disclosure rules as noted above and these statues often authorize private lawsuits. For other states, unfair trade practices statutes or "Little FTC Acts" may

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[157] *See, e.g., Coraud LLC v. Kidville Franchise Co., LLC,* 109 F. Supp. 3d 615, 619 (S.D.N.Y. 2015).

provide a cause of action.[158] Unlike common law claims, claims under these acts do not generally contain a scienter requirement and liability may be found irrespective of intent to deceive or proof of reliance. The type of disclosure violations that give rise to statutory claims depend on the jurisdiction.[159] Actionable FPRs may also provide a legal basis for common law fraud and negligent misrepresentation or for claims seeking rescission, a legal claim that permits a party to cancel a contract.

In these circumstances, franchisors often defend against FPR claims by relying on integration and merger language contained in the franchise agreement.[160] Some franchisors have also included franchise questionnaires specifically inquiring whether FPRs were made during the sale and disclosure process. The usefulness of such provisions or questionnaires depends on the language and the forum. Some state disclosure statues have anti-waiver provisions which prohibit franchisors from relying upon the protections of contractual provisions. [161]

C. Operations Claims

Franchising presents an interesting business opportunity in which the franchisee benefits from the franchisor's trademark and "system" requirements and the franchisor

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

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

[160] *Steak n Shake Enterprises, Inc. v. Globex Co., LLC*, 110 F. Supp. 3d 1057 (D. Colo. 2015), *aff'd,* 659 Fed. Appx. 506 (10th Cir. 2016) (integration clause barred franchisee's claim for fraudulent inducement); but see *EV Scarsdale Corp. v. Engel & Voelkers N. E. LLC*, 48 Misc. 3d 1019, 1022, 13 N.Y.S.3d 805, 808 (N.Y. Sup. Ct. 2015) (disclaimer and integration clauses not permitted under New York and Rhode Island law).

[161] *See, e.g., Emfore Corp. v. Blimpie Assocs*., Ltd., 51 A.D.3d 434, 435, 860 N.Y.S.2d 12, 14 (N.Y. 2008) (where the court held that a "franchise disclosure questionnaire" completed at the time of the franchise sale, in which the franchisee did not identify any earnings information that the franchisor provided outside of the FDD, could not be used to bar the franchisee from pursuing claims under the anti-fraud provisions of the New York Franchise Sales Act); Cousin Subs Sys. Inc. v. Better Subs Dev. Inc., No. 09-C-0336, 2011 WL 4585541, at *8 (E.D. Wis. Sept. 30, 2011) (where the court held that a "no reliance" clause in the franchise agreement could not be used to bar claims under the anti-fraud provisions of the Wisconsin Franchise Investment Law and the Indiana Franchise Disclosure Act); Randall v. Lady of Am. Franchise Corp., 532 F. Supp. 2d 1071, 1089 (D. Minn. 2007) (holding that "[f]ranchisors cannot use contractual provisions to protect themselves from being sued for misrepresentation under the Minnesota Franchise Act").

benefits from the franchisee's investment in the brand and the expansion of the brand in the franchise's local community. As noted above, a franchisor may assert claims against a franchisee for failing to comply with system standards. Franchisees also have a variety of claims against a franchisor for the franchisor's conduct in the operation of the franchise.

1. Disputes Over Territory

Often the subject of dispute between franchisee and franchisor are territorial rights where a franchisor wishes to expand into a profitable area close to a high performing franchisee. These claims are sometimes referred to as encroachment claims and can arise when a franchisor wants to develop a corporate store or a new franchise location. While the franchisor may want to increase its footprint, a franchisee may see the new unit (be it corporate or franchisee owned) as unwanted competition.[162] In short, although franchisees have an interest in the franchisor's growth, which in turn expands brand recognition, a franchisee understandably wants to protect its franchised business in its geographic area against loss of revenue from other franchisees (or the franchisor) competing in the same area. Generally, franchisees welcome the franchisor's expansion, so long as it is not too nearby.[163]

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

Scheck v. Burger King Corp.,[164] the seminal case on good faith and fair dealing in the encroachment context, has been both widely criticized and adopted in the

[162] More rarely, franchisees complain when a franchisor is not expanding the brand.

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

[164] 756 F. Supp. 543 (S.D. Fla. 1991), *reconsid. denied*, 798 F. Supp. 692 (S.D. Fla. 1992).

encroachment context and elsewhere.[165] In *In re Vylene Enterprises*, the Ninth Circuit, relying on *Scheck*, held that the franchisor acted in bad faith when the franchisor built a competing restaurant that not only had the potential to hurt the franchisee but also reduced the franchisor's royalties from the franchisee's operations. *In re Vylene Enters.*, 90 F.3d 1472 (9th Cir. 1996).

Territorial encroachment continues to be a hot topic. *Michael D. Bryman and Janice P Handlers Bryman v. El Pollo Loco, Inc.*, Case No. MC026045, is currently pending in the Superior Court of California, County of Los Angeles – North District (). In the *Bryman* case,[166] the franchisees owned and operated the sole El Pollo Loco restaurant in the Lancaster, California area since the late 1990s. In 2014, the franchisor opened two corporate stores in close proximity to the existing franchisee owned store, relying on a "reservation of rights clause" contained in the franchise documents. Prior to the trial, the Court determined that the reservation of rights clause was unconscionable and prohibited the franchisor from relying on it as a defense at trial. The jury found in the franchisees favor on the issue of liability and future proceedings are to be held to determine the amount of damages.

2. Failure to Provide Training and Support

It is not uncommon for a franchisee to acquire a business in an industry where he or she may have little exposure or experience rather than to invest in and develop an entirely unique business opportunity. To that end, franchisees expect to be provided with training and support that will permit them to operate their franchise successfully.

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[165] *See Chang v. McDonald's Corp.*, 105 F.3d 664 (9th Cir. 1996); *Payne v. McDonald's Corp.*, 957 F. Supp. 749 (D. Md. 1997) (the *Payne* court also noted that other judges in the Southern District of Florida had chosen not to follow *Scheck*); *Nibeel v. McDonald's Corp.*, Case No. 97 C 7203, 1998 WL 547286, (N.D. Ill. Aug. 27, 1998); *Perez v. McDonald's Corp.*, 60 F. Supp. 2d 1030 (E.D. Cal. 1998); *Zuckerman v. McDonald's Corp.*, 35 F. Supp. 2d 135 (D. Mass. 1999); *Interim Health Care of N. Illinois, Inc. v. Interim Health Care, Inc.*, 225 F.3d 876 (7th Cir. 2000) (holding that the franchisor did not breach the implied covenant of good faith and fair dealing by servicing patients in the franchisee's territory which was permissible per the terms of the contract). Some courts applying New York and Michigan law similarly held that the implied covenant of good faith and fair dealing "does not create independent substantive rights or create rights inconsistent with those explicitly set out in the contract." *Carlock v. Pillsbury Co.*, 719 F. Supp. 791 (D. Minn. 1989); *Cook v. Little Caesar Enters., Inc.*, 972 F. Supp. 400 (E.D. Mich. 2000) (finding that *Scheck* is contrary to Michigan law). Other courts have declined to apply *Scheck* by distinguishing *Scheck* on the grounds that *Scheck* did not involve an express reservation by a franchisor to enter the territory of a franchisee. *Clark v. America's Favorite Chicken Co.*, 916 F. Supp. 586 (E.D. La. 1996). The Eleventh Circuit in *Burger King Corp. v. Weaver*, 169 F.3d 1310, 1317 (11th Cir. 1999) repudiated *Scheck* as "unconvincing logic."

[166] Franchisees in the Bryman litigation are represented by Zarco Einhorn Salkowski & Brito, P.A.

Generally, a franchisor's FDD will describe, in general and specific terms, the type of training and on-going support that a franchisee should expect to receive through the course of the franchise relationship. Disconnects between the franchisor's promises and the services provided to the franchisee can lead to lawsuits.

Franchisees may claim that the franchisor neglected to provide training (or support), failed to provide adequate or effective training (or support) or provided training and support that was in some way negative to the business. Any of these issues may lead to a claim for breach of contract.

Franchisors often defend against support and training claims by relying in specific contract provisions that enumerate and limit what they are contractually obligated to provide.

3. Advertising Claims

It is not uncommon for a franchisor to require all franchisees to contribute to a marketing or advertising fund controlled by the franchisor. These funds, which are intentioned to be used for the common good of the franchisees (and the system), can often be the source of abuse, misuse and general controversy. Many franchisors reserve sole discretionary authority to the manner in which the fund is maintained and used, so long as it is used for advertising related costs. Claims against a franchisor's misuse of funds arise when there is little transparency as to the use of those funds and franchisees can see no meaningful evidence of a marketing expenditure. Franchises may also bring claims where they suspect that the franchisor is diverting funds otherwise earmarked for the fund.[167]

4. The Obligation of Good Faith: How Much Discretion Does a Franchisor Have?

Claims that a franchisor breached its implied contractual duty to act in good faith are among the most prevalent claims operational claims. The contours of the doctrine, like the relationship statutes, vary from state to state. In basic terms, all contracting parties are expected to behave honestly, fairly and with good faith intentions in connection with their contractual rights and obligations. The purpose of the contract and the parties' reasonable expectations are among a court's chief evidence of whether a duty has been breached.[168] To that end, this doctrine is not used to expand or

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[167] *Moghaddam v. Dunkin; Donuts, Inc.* 322 F. Supp. 2d 44 (D. Ma. 2004) (entering summary judgment in favor of franchisor on franchisees claim of diverting funds from advertising fund).

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

contradict the express contractual terms and will not operate to add obligations where there would otherwise not be any. Instead, it operates as a gap filler or a counterbalance, where the contract expressly affords one party discretion.

This type of claim arises in a variety of factual contexts.[169] A franchisee will present evidence that the franchisor was acting in bad faith, contrary to the established course of performance between the parties or is somehow otherwise acting unreasonably in a way that is affecting the franchisee's business. A franchisor will generally defend relying on its business judgment and to show that a particular franchisee cannot establish that the franchisor acted with deliberate bad faith as to that particular franchisee or location.

5. Pricing Claims

Over the last twenty (20) years, there has been a change in the way pricing matters have been handled in franchising. Before the Supreme Court's decision in *State Oil Co. v. Khan, et al*.[170] franchisors refrained from controlling the prices at which franchisees could sell products, thereby allowing franchisees freedom to set, raise and lower their own prices. From an administrative perspective, a wide disparity in retail price between outlets could render advertising misleading and limit the franchisor's ability to conduct promotions.

The *State Oil* decision provided that a rule of reason analysis would apply to vertical maximum price decisions. This opened the door and franchisors began to reserve to themselves the right to establish maximum prices for products sold pursuant to the franchise agreement. Ten years later, in the decision of *Leegin Creative Leather Products, Inc. v. PSKS, Inc*.,[171] the Supreme Court held that vertical minimum price fixing should not be per se illegal but should also be reviewed under a rule of reason analysis. The *Leegin* decision opened the door even further to the franchisors' ability to establish prices.

Despite the change in the law, it is the franchise agreement that may ultimately determine who has the right to set prices (separate from whether the prices established otherwise violate anti-trust law). Franchisors that elect to establish prices must be

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

[170] 522 U.S. 3 (1997).

[171] 551 U.S. 877 (2007).

cognizant of the terms of their agreements when attempting to set prices.[172] Unsurprisingly, contract review is generally the first step in evaluating franchisee claims.

6. Statutory Claims

The FTC Rule discussed above applies only to claims that arise before the relationship is formed. There is no federal standard that applies to the operational relationship between franchisee and franchisor. In 2015, two bills were introduced in Congress aimed at bringing "fairness" to the franchise relationship.[173]

The Fair Franchise Act specifically defined certain conduct that is commonly the source of many franchise complaints as an unfair trade and business practice.[174] The Fair Franchise Act also acknowledges that franchise agreements impose duties of good faith and due care on franchisors and would give franchisees a statutory cause of action against franchisors that violate those duties. Many state relationship statutes already proscribe this conduct. Neither bill has been passed, but these bills signify at least a Congressional acknowledgment of the need for a uniform law for nationwide business operations.

In the absence of federal law, franchisees must turn to the state relationship statutes to provide a legal basis for challenges to business practices during the course of the relationship. These statutes vary from state to state and franchisors should be cognizant of the requirements as they expand their footprint and approve franchisees

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[172] *Compare Stuller, Inc. v. Steak N Shake Enterprises, Inc.*, 695 F.3d 676, 677 (7th Cir. 2012) (affirming entry of preliminary injunction prohibiting termination for franchisees' failure to comply with pricing policy) with *Steak n Shake Enterprises, Inc. v. Globex Co., LLC,* No. 13-CV-01751-RM-CBS, 2015 WL 3883590 (D. Colo. June 23, 2015) (franchisor had right to set maximum menu prices under franchise agreement and to terminate franchisee for failure to comply).

[173] The Small Business Administration Franchise Loan Transparency Act (H.R. 3195) and the Fair Franchise Act (H.R. 3196). The full text of each bill is available through the Library of Congress at http://thomas.loc.gov. In addition to operational concerns, both bills, in some way, addressed advance disclosures discussed in Section B above.

[174] H.R. 3196, § 3(b);(5)(b), barring, as "unfair," franchisors from: prohibiting, or penalizing franchisees for forming or participating in, franchise associations; discriminating against franchisees by imposing conditions on some franchisees but not others; imposing unreasonable and excessive renewal fees; enforcing mandatory arbitration clauses or prohibiting class or mass actions; terminating, cancelling, or refusing to renew franchise agreements based on franchisees' failure to participate in promotional campaigns, sell services and products at a specific price, or meet sales quotas; collecting liquidated damages in excess of average monthly royalties for the previous calendar year multiplied by six months or the number of months remaining in the franchise agreement, whichever is less; and refusing to provide, free of charge, physical copies of all records and accountings of marketing, rewards programs, advertising funds, and fees paid by franchisees for suppliers.

domiciled in states who have such a statute. Despite the fact that it is common practice for most franchisors to include a choice of law provision in their franchise agreements, some state relationship statues render unenforceable contractual provisions that are contrary to statutory protections.

Statutory relationship claims arise on a variety of subjects, such as territorial encroachment,[175] free association,[176] good faith and commercially reasonable system modifications or requirements[177] and others.[178]

D. Claims Regarding Termination, Transfer and Renewal

Franchisees may have a variety of statutory and contractual claims regarding the manner in which the relationship ends.

1. Wrongful Termination

Franchise agreements contain a finite term for the operation of the relationship. Often, a franchisee may also be given the right or opportunity to renew the relationship for a number of years. Termination occurs when the relationship stops before the natural term of the contract.

Certain state statutes outline specific guidelines for termination of the relationship. For example, some states require minimum notice periods, a specified method for the delivery of the notice or the opportunity to cure. Relationship statutes may also limit termination to circumstances defined as "good cause." Like the statutes themselves, the definition of what amount to "good cause" varies from state to state. Examples include monetary default, under reporting, bankruptcy, unauthorized use of the trademark etc. A franchisor may have greater exposure for damages resulting from a finding of improper termination pursuant to a state statute, where the statute specifically authorizes additional recovery.

Barring the application of such statutes, the contract itself governs. Franchises agreements may be terminated for cause, upon notice, in certain circumstances, or without cause, and without notice, in others. While certain occurrences, like a franchise filing for bankruptcy, will generally result in an automatic termination of the franchise

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175 Regulated in Hawaii, Indiana, Iowa, Minnesota and Washington.

176 State relationship statutes in Arkansas, California, Hawaii, Illinois, Iowa, Michigan, Minnesota Nebraska, New Jersey, Rhode Island and Washington prohibit franchisors from restricting membership in a franchise association.

177 Arkansas Hawaii, Iowa, Minnesota, Nebraska, New Jersey and Washington require an element of commercial reasonableness in the franchise relationship.

178 *See* Section VII.D. *infra*, discussing state relationship statues in the context of termination and renewal claims.

relationship, there is no uniform guideline that applies.[179] A franchisor may reserve the right to automatically termination the agreement if the franchisee repeatedly violates the agreement or acts in a way that has a negative impact on the system.

A franchisee may challenge the basis for termination as well as the procedure by which the termination is affected. To this end, a terminating franchisor must pay heed to the notice periods required in advance of termination and the manner in which a notice is delivered to the franchisee. If it fails to follow the letter of the contract, it may be liable for breach of contract.

2. Failure to Renew

There is no uniform standard for renewal. Often, this is a matter of what the franchise agreement or specific state statutes, where applicable, provide. The franchise agreement will identify whether the franchisee has the right to review, and if so, what conditions, if any, apply.

Certain state statutes limit a franchisor's ability to deny a renewal.[180] In some states, non-renewal is treated similarly to termination. While other states impose a notice requirement on the franchisor.

3. Denial of the Right to Transfer

Franchisees rarely enjoy the unfettered right to transfer their franchise business or the assets of the franchise business. The franchisor usually reserves the right to consent to a transfer. Some agreements state that a franchisor cannot unreasonably withhold consent. Other franchise agreements enumerate specific considerations for transfer, such as approval of the incoming franchisee or the purchase price. The extent of a franchisor's discretion is subject to the implied covenant of good faith and fair dealing.

The reasons why a franchisee may want to or need to sell their business are varied. It is possible that the franchisee wishes to retire or relocate or simply no longer wishes to continue in the business but does wish to monetize the value of its years of service to the brand.

Like with many of the claims discussed in this paper, a franchisor must specifically consider its contractual obligations and the applicable statutory law. Failure to do so will result in lawsuits by franchisees unhappy with the franchisor's decision to interfere with a transfer.

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[179] The Fair Franchising Act referenced above included a series of guidelines for renewal, transfer and termination, including a good cause requirement for termination.

[180] Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Washington and Wisconsin.

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

Franchisees have a panoply of available remedies depending on the type of claim. A few types mentioned above include damages, injunctive relief and rescission. Franchisees may also be entitled to restitution, declaratory relief and specific performance. As noted above, after litigation commences, litigants sometimes look for an exit strategy. Litigation is expensive and a franchisee who has already made a significant investment in the brand wants to consider the upside of a fight with the franchisor, which may ultimately end their relationship. A brief look at what a franchisee stands to gain is illustrative.

From the franchisee's perspective, contractual and statutory damages may permit the franchisee to recover its investment, if unlawfully duped into the relationship, or to recover lost profits damages based on the franchisor's wrongful termination of the franchise agreement. The test for lost profits damages is very fact-specific and ultimately turns upon the franchisee's historic performance with the brand. However, outlets that did not open or that have a limited track record of actual performance to look to may be able to prove lost damages through the yardstick method by looking at the performance or other (like) franchisees in the same system and market.

Sometimes, a franchisee simply wants to turn the clock back and make it as if they never entered into the franchise system to begin with. Fourteen states permit rescission and restitutionary relief.[181] Often, rescission is permitted when the franchisor has failed to provide the required disclosure document or if the information contained in the disclosure document is false or misleading. The particular relief available to a franchisee may depend on whether there is a choice of law provision contained in the franchise agreement and whether such a provision will be deemed enforceable as noted in Section B.

A franchisee may also raise a claim for common law rescission where a contract was induced by fraud or duress or when the franchisor commits a material breach. Franchisees should not sit on their rights when they believe they have a reason to seek redress. A common defense to an action for rescission is a waiver or laches defense, if which may apply if the franchisee waits to long to assert such a claim.

Cost of litigation, and whether you can shift the cost to the opposing party, is generally a factor to consider at all stages of litigation. While franchise agreements may provide for recovery of attorneys' fees and costs, not all agreements permit such recovery. Franchise agreement that contain one-sided fee provisions that expressly permit recovery by only one party, generally the franchisor, are often interpreted to be reciprocal.

Franchisees may be able to collect attorneys' fees under a state statute, where they are deemed a prevailing party. In consideration of such claims, franchisees must

[181] *See, e.g.*, Cal. Corp. Code § 31300 (2004); Fla Stat 817.416 (3).

be cognizant that franchisors may also be able to recover attorneys' fees if they successfully defend claims.[182]

VIII. CONCLUSION

At least one federal judge acknowledged that the nature of franchising often favors and means victory for the franchisor.[183] Notwithstanding, franchising as a business practice continues to thrive and, despite the symbiotic nature of franchising, disputes arise in the context of the relationship that require legal intervention. Unlike many other types of business litigation (and more like consumer litigation), disputes between franchisees and franchisors can have vast, system wide implications. A judicial ruling on the validity of a standard form contract can affect all franchisees. A jury verdict in favor of one franchisee, regardless of the monetary figure, may spread like wild fire through the franchise community and result future suits, causing economic strain and stress on the franchisor's resources. The trend toward arbitration may render some disputes too expensive for franchisees and, in the opinion of franchisee attorneys, give another advantage to the franchisor.

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[182] *HRCC, LTD., v. Hard Rock Café International (USA), Inc. et al,* 614CV2004ORL40KRS, 2018 WL 1863778, at *1 (M.D. Fla. Mar. 26, 2018) (awarding attorneys' fees and costs under Florida's Deceptive and Unfair Trade Practices Act).

[183] *Tim Hortons USA, Inc. v. Singh*, 16-23041-CIV, 2017 WL 4837552, at *2 (S.D. Fla. Oct. 25, 2017) (quoting Rupert M. Barkoff et al., Fundamentals of Franchising 333 (4th ed. 2015)).