Franchise Law Journal

2023–2024 Editorial Board

Editor-in-Chief
John M. Doroghazi (2024)
Wiggin and Dana LLP
jdoroghazi@wiggin.com

Associate Editors

Maisa Jean Frank (2025)
Lathrop GPM LLP
maisa.frank@lathropgpm.com

Matthew Gruenberg (2026)
DLA Piper LLP (US)
matthew.gruenberg@dlapiper.com

David A. Harford (2024)
Bryan Cave Leighton Paisner LLP
david.harford@bclplaw.com

Aaron-Michael Sapp (2026)
Cheng Cohen LLC
asapp@chengcohen.com

Andrew M. Malzahn (2024)
Dady & Gardner, P.A.
amalzahn@dadygardner.com

Topic & Article Editors

Jess A. Dance (2024)
Polsinelli PC
jdance@polsinelli.com

Matthew S. DeAntonio (2024)
Bradley Arant Boult Cummings LLP
mdeantonio@bradley.com

Melanie C. Kalmanson (2024)
Quarles & Brady LLP
Melanie.kalmanson@quarles.com

Lauren W. Linderman (2024)
Faegre Drinker Biddle & Reath LLP
Lauren.linderman@faegredrinker.com

Sawan S. Patel (2024)
Larkin, Hoffman, Daly & Lindgren, Ltd.
spatel@larkinhoffman.com

Briar Siljander (2024)
Trio Law PLC
briar@triolawplc.com

Matthew J. Soroky (2024)
Lewitt Hackmann Shapiro Marshall & Harlan
msoroky@lewitthackman.com

Managing Editor
Julie Roberts Furgerson
ABA Publishing
American Bar Association
julie.furgerson@americanbar.org

STATEMENT OF IDENTIFICATION

Franchise Law Journal (ISSN: 8756-7962 (print); 2163-2154 (online)) is published quarterly, by season, by the American Bar Association Forum on Franchising, 321 North Clark Street, Chicago, Illinois 60654-7598. *Franchise Law Journal* seeks to inform and educate members of the bar by publishing articles, columns, and reviews concerning legal developments relevant to franchising as a method of distributing products and services. *Franchise Law Journal* is indexed in the *Current Law Index* under the citation Franchising.

Requests for permission to reproduce or republish any material from the *Franchise Law Journal* should be sent to copyright@americanbar.org. Address corrections should be sent to coa@americanbar.org. The opinions expressed in the articles presented in *Franchise Law Journal* are those of the authors and shall not be construed to represent the policies of the American Bar Association or the Forum on Franchising. Copyright © 2024 American Bar Association. Produced by ABA Publishing.

// FRANCHISE LAW JOURNAL

VOLUME 43, NUMBER 2

TABLE OF CONTENTS

From the Editor-in-Chief — v
John M. Doroghazi

Franchising Heats Up — vii
Earsa R. Jackson & Erin C. Johnsen

ARTICLES

Understanding the Grantor's Burden: Good Cause Under the Wisconsin Fair Dealership Law — 105
James B. Egle, Jeffrey A. Mandell & Isaac S. Brodkey

Franchise Agreement Provisions That Can Make or Break a Court Case — 131
Thomas A. Telesca, Rachel A. Morgenstern & Briana A. Enck-Smith

Attorney Fees in Franchise Disputes: Atypical Mechanisms for Obtaining a Fee Award — 153
Tyler Hartney & Silas Petersen

Trends in Punitive Damages: From Nightmare to Restraint, Reprehensibility, and Proportionality — 167
David S. Catuogno, Caitlin C. Conklin & Aidan Nowak

FEATURE

LADR Case Notes (December 2023–February 2024) and FLJ Currents (Fall 2023) — 179
Andrew M. Malzahn, Matthew J. Soroky & Matthew S. DeAntonio

From the Editor-in-Chief

John M. Doroghazi*

Mr. Doroghazi

This issue opens with an announcement from Earsa Jackson and Erin Conway Johnsen about attending the Annual Forum on Franchising. Recent experiences in litigation have reminded me of why the attending the Forum each year and building relationships within the franchise bar is so valuable to a practicing franchise attorney.

Specifically, I recently successfully resolved an arbitration for a franchisor client that centered on whether the franchisor was responsible for the closure of a franchise owned by a multi-unit operator and if the franchisor subsequently should have allowed a third-party franchisee to open a new location near the now closed franchise. Opposing counsel is an experienced member of the franchise bar whom I know well. In our experience, opposing counsel is the kind of person that "you can do business with," meaning this person is practical and you can trust them not to burn you when having candid conversations about the case. Our respective clients benefitted greatly from this relationship throughout the litigation, which resolved about two months before the arbitration hearing. Instead of motion practice over the scope of discovery, we were able to resolve disputes over the scope of discovery in one phone call. We were able to dispense with much of the Kabuki theater that often accompanies settlement negotiations and get to reasonable number ranges much quicker.[1] We were also able to do what many lawyers would consider unorthodox: having a clearing of the air in a direct meeting between the clients, which let both sides back off of their more extreme settlement positions. With less

1. I have worked with numerous successful entrepreneurs and business executives who are flabbergasted by the usual lawyer method of negotiation: an unreasonably high opening demand, which is met with an equally unreasonable opening counter and then multiple grounding rounds of moves to get to a final number. They are used to simply pricing an asset and then offering what it is worth and, if the price is not accepted, moving on.

**John M. Doroghazi (jdoroghazi@wiggin) is a partner in the New Haven office of Wiggin and Dana LLP, where he focuses on franchise, class action, and complex commercial and business litigation. Feel free to reach out to John directly for comments on this editorial or any other matters related to the* Franchise Law Journal.

FranchiseLaw_Vol43_No2_Spring24.indd 5 6/6/24 9:43 AM

sophisticated counsel and clients, such a meeting would almost certainly have backfired. To be sure, both sides still aggressively advocated their positions, but we were able to do so without a lot of the lawyer nonsense that makes litigation annoying and costly. And that would not have been possible without a relationship that is based, in part, on years of seeing each other at the Forum. So come to the Forum. Someday, it will let you fast-forward over the most annoying parts of being a litigator.

Now to the articles. First up is an article from Jeffrey Mandell, Isaac Brodkey, and James Egle entitled *Understanding the Grantor's Burden: Good Cause Under the Wisconsin Fair Dealership Law*. This is the second of a planned trilogy of articles by the authors about the Wisconsin Fair Dealership Law to commemorate its fiftieth anniversary. As the title suggests, the article exhaustively covers what does and does not constitute good cause for termination under the act.

Second, Thomas Telesca, Rachel Morgenstern, and Briana A. Enck-Smith have catalogued common contractual provisions that have outsized effects in franchise disputes and provide advice on best practices for these provisions in *Contract Provisions That Can Make or Break Your Case*.

Third, new authors Tyler Hartney and Silar Petersen provide readers with some uncommon strategies for recovering attorneys' fees in franchise disputes in the aptly titled article *Attorney Fees in Franchise Disputes: Atypical Mechanisms for Obtaining a Fee Award*

Finally, we end with a discussion of every defendant's greatest fear: punitive damages. David Catuogno, Caitlin Conklin, and Aidan Nowak explain the trends in punitive damages and offer hope that punitive damages will not be a runaway train in *Trends in Punitive Damages: From Nightmare to Restraint, Reprehensibility, and Proportionality*.

Finally, we close out our issue with *LADR Case Notes from December 2023 to February 2024 and Franchising & Distribution Currents* by Andrew Malzahn, Matthew Soroky, and Matthew DeAntonio.

Franchising Heats Up

*Earsa R. Jackson & Erin C. Johnsen**

Ms. Jackson

Ms. Johnsen

The ABA Forum on Franchising Annual Meeting is headed to the desert! We invite you to join us October 16–18, 2024, at the JW Marriott Phoenix Desert Ridge Resort & Spa.

Come start your experience early with us on Wednesday with our three intensive programs. For attorneys new to franchise practice, we will be including our annual *Fundamentals of Franchising* program, where experienced franchise practitioners offer a full-day introduction to franchise law and practice. Our second intensive program will provide practical tips for navigating domestic and international data privacy laws, to help both franchisors and franchisees to understand their obligations to protect the personal data collected by franchise systems. Our third intensive program will focus on franchise advisory councils (FACs) and franchisee associations from the perspectives of franchisee counsel, franchisor outside counsel, and in-house franchisor counsel—from the nuts and bolts of formation and functioning, to practical tips for how franchisors can optimize their relationships with FACs and associations.

Our main meeting programming will, as always, include two high-quality plenary sessions. Thursday morning will kick off with the *Annual Franchise and Distribution Law Developments* plenary, thanks to the hard work of co-presenters Eleanor Vaida Gerhards and Joseph S. Goode. Our Friday morning plenary will examine issues regarding the timely topic of artificial intelligence and its use in franchise legal practice. Our programming will continue with twenty-four workshops offering the best in franchise education and will cover a variety of litigation, transactional, international, and regulatory issues. Just a few of the outstanding workshop topics include: practical considerations to effectuate rescission, practitioner tips for maximizing the effectiveness of mandatory pre-litigation mediation, good faith in international franchising, implementing systemwide changes to maximize

**Earsa Jackson (ejackson@clarkhill.com) is a member of Clark Hill based in Dallas, Texas. Erin Conway Johnsen (ecjohnsen@yourfranchiselawyer.com) is a partner at Garner, Ginsburg & Johnsen, P.A. located in Minneapolis, Minnesota.*

compliance and minimize conflict, effective resale and refranchising programs, and common ethical dilemmas in franchise practice.

As always, the annual meeting will also include many opportunities to network and reconnect with colleagues and friends. Highlights of our social events include our popular welcome reception on Wednesday night at the resort, where we will enjoy the sunset with the mountains in the distance. For newcomers to the Forum—please consider attending our Wednesday night Newcomers/YLD Networking Event after the welcome reception, where you can meet and connect with other new attendees over food, drinks, fire pits, and lawn games. On Thursday night, we will immerse ourselves in the musical traditions and instruments of the world at the Musical Instrument Museum, featuring interactive exhibits and a collection of more than 7,500 instruments from more than 200 countries and territories (everything from a 6,000-year-old drum to Prince's purple grand piano). For those staying over on Friday, you will have an opportunity to experience Frank Lloyd Wright's winter home and studio, Taliesin West. And, as always, our Divisions and Caucuses are busy planning their networking breakfast and lunch events.

We can't wait to see you in Phoenix for the 47th Forum on Franchising Annual Meeting October 16–18, 2024, where *Franchising Heats Up*!

FranchiseLaw_Vol43_No2_Spring24.indd 8 6/6/24 9:43 AM

Understanding the Grantor's Burden: Good Cause Under the Wisconsin Fair Dealership Law

*James B. Egle, Jeffrey A. Mandell & Isaac S. Brodkey**

Mr. Egle

Mr. Mandell

Mr. Brodkey

Good cause has been called the "heart and soul"[1] of the Wisconsin Fair Dealership Law[2] (WFDL), ensuring that successful and committed dealers can sleep easy at night knowing that their dealership cannot be arbitrarily terminated.[3] In *Talking Past Each Other: The Divergent Approaches to*

1. *See* Brian Butler & Jeffrey A. Mandell, The Wisconsin Fair Dealership Law § 6.1 (5th ed. 2022).

2. Wis. Stat. § 135.01 *et seq*.

3. While this article focuses solely on what constitutes "good cause" under the Wisconsin Fair Dealership Law, for more on good cause generally see, for example, Adi Ayal & Uri Benoliel, *Good-Cause Statutes Revisited: An Empirical Assessment*, 90 Ind. L.J. 1177 (2015); Uri Benoliel, *The Expectation of Continuity Effect and Franchise Termination Laws: A Behavioral Perspective*, 46 Am. Bus. L.J. 139 (2009); Boyd Allan Byers, *Making a Case for Federal Regulation of Franchise Terminations—A Return-of-Equity Approach*, 19 J. Corp. L. 607 (1994); Robert W. Emerson, *Franchise Terminations: "Good Cause" Decoded*, 51 Wake Forest L. Rev. 103 (2016); Rose Marie Reynolds, *Good Cause for Franchise Termination: An Irreconcilable Difference Between Franchisee Fault and Franchisor Market Withdrawal?*, 1992 BYU L. Rev. 785 (1992); Craig R. Tractenberg, Robert B. Calihan & Ann-Marie Luciano, *Legal Considerations in Franchise Renewals*, 23 Franchise L.J. 198, 19–200 (2004); Tracey A. Nicastro, Note, *How the Cookie Crumbles: The Good Cause Requirement for Terminating a Franchise Agreement*, 28 Val. U. L. Rev. 785 (1994).

**James B. Egle (jegle@staffordlaw.com) is a partner in Stafford Rosenbaum LLP's Madison Office and a co-leader of its Dealership and Franchise practice group. He focuses his practice on complex commercial transactions, including franchise and distribution law. Jeffrey A. Mandell (jmandell@staffordlaw.com) is a partner in Stafford Rosenbaum LLP's Madison office, where he co-leads the Dealership and Franchise practice group, as well as the Election and Political Law practice group. Isaac S. Brodkey (ibrodkey@staffordlaw.com) is a senior associate in Stafford Rosenbaum LLP's Madison office. His practice focuses on commercial and franchise litigation.*

FranchiseLaw_Vol43_No2_Spring24.indd 105 6/6/24 9:43 AM

the Community of Interest Standard in Wisconsin's State and Federal Courts, the authors discussed the divergent issues that putative dealers must navigate in asserting protection under the statute in state and federal courts.[4] Proving the existence of a community of interest is the dealer's primary responsibility in any WFDL case.[5] But, once proven, the burden flips back to the grantor to prove the existence of good cause.[6] Read together, the community-of-interest inquiry is directed toward answering "who gets protection?" while good cause turns to "for how long?"

Despite fifty years of litigation under the WFDL, what constitutes good cause still is not always clear. As with the community-of-interest standard, case law has revealed that whether good cause exists is a fact-intensive inquiry ill-suited for summary judgment.[7] This article endeavors to provide greater clarity on the good-cause question as borne out in the WFDL's history, examining and offering detailed explanations for each of the three categories of good cause: definitional, per se, and judicially recognized.

To start, the article will discuss definitional good cause, which arises when a dealer fails to substantially comply with the grantor's essential, reasonable, and nondiscriminatory requirements, or engages in bad-faith conduct. Next, the article will discuss per se good cause, which relates to specific instances of financial irresponsibility. Last, the article will discuss a subset of judicially created instances of good cause and the recognition by state and federal courts alike that a grantor may have good cause for its action based on its own economic circumstances, regardless of a dealer's performance. For purposes of the discussion below, the authors assume that the parties are in a dealership relationship protected by the WFDL; the only focus here is on good cause, though the issues in any WFDL dispute are likely to be more numerous and complex.

---

4. Jeffrey A. Mandell, Isaac S. Brodkey & James B. Egle, *Talking Past Each Other: Divergent Approaches to the Community-of-Interest Standard in Wisconsin's State and Federal Courts*, 43 Franchise L.J. 23 (2024).

5. *Id.* at 25–29. Once a community of interest is proven, a dealer must also demonstrate that the grantor took an adverse action—i.e., termination, cancellation, non-renewal, or substantially changed the dealer's competitive circumstances—against the dealer. The adverse-action inquiry can be collapsed to the following question: Is the grantor attempting to end or substantially change the nature of the relationship? If the answer is yes, then the WFDL's good cause requirement is triggered. If the answer is no, then the WFDL is not implicated and the dealer's claim fails. *See* Butler & Mandell, *supra* note 1, § 7. As discussed within, courts, at times, have conflated the adverse-action inquiry with the good-cause inquiry. *See infra* Part III.A.iii. If a purported dealer derives at least five percent of its sales from intoxicating liquor produced by its purported grantor, then the dealer does not need to demonstrate a community of interest. *See* Wis. Stat. §§ 135.02(3)(b), 135.066.

6. Wis. Stat. § 135.03.

7. *See* Frieburg Farm Equip., Inc. v. Van Dale, Inc., 978 F.2d 395, 401 (7th Cir. 1992) ("[W]hether a grantor had good cause is a question of fact for a jury," to be taken away only in circumstances where "a reasonable person could arrive at only one conclusion.").

I. Definitional Good Cause

The WFDL defines "good cause" to terminate, cancel, fail to renew, or substantially change the competitive conditions of a dealership in two ways.[8] First, good cause may exist where a dealer fails to "comply substantially with essential and reasonable requirements imposed upon the dealer by the grantor, which requirements are not discriminatory as compared with requirements imposed on other similarly situated dealers either by their terms or in the manner of their enforcement."[9] Second, good cause may exist when the dealer acts in "bad faith . . . in carrying out the terms of the dealership."[10]

The first definition is commonly used in franchise and dealership statutes across the country.[11] It requires that the grantor issue ninety days' written notice detailing the grounds for the adverse action and provide a sixty-day opportunity to cure.[12] The second definition is less commonly featured in other statutes,[13] and, if a grantor seeks to take an adverse action upon the dealer's bad faith, the grantor's notice obligations may be obviated entirely. This section offers a framework to understand definitional good cause and explain what may constitute bad-faith conduct justifying termination.

A. *Failure to Substantially Comply with What?*

On first read, the primary definition of good cause is perplexing. Thankfully, the definition can be broken out into six component parts. For good cause to exist, the grantor must prove that (1) the dealer failed to comply (2) substantially with (3) essential, (4) reasonable, and (5) nondiscriminatory requirements (6) imposed or sought to be imposed.[14] Some courts have expressed disfavor with viewing good cause as an elemental test and have taken a "gestalt" approach to the inquiry.[15] Whether good cause exists is

8. Wis. Stat. § 135.02(4).
9. *Id.*
10. *Id.*
11. Ayal & Benoliel, *supra* note 3, at 334 ("To date, only seventeen of the fifty states have adopted statutes requiring 'good cause' as a condition for the termination of a franchise contract by a franchisor. Under these statutes, good cause is commonly defined as a franchisee's failure to adequately comply with the requirements of the franchise agreement."); *see also* 2 W. Michael Garner, Franchise & Distribution Law & Practice § 10:22.
12. Wis. Stat. § 135.04.
13. As explained later, many state statutes identify specific instances of conduct justifying immediate termination or lessened notice and cure requirements, but the WFDL is unique in its generalized "bad faith" articulation. *See* Garner, *supra* note 11, § 10:25.
14. The authors build from the framework identified in Butler & Mandell, *supra* note 1, § 6.3.
15. For a detailed analysis of this point, see Kaeser Compressors, Inc. v. Compressor & Pump Repair Servs., Inc., 781 F. Supp. 2d 819 (E.D. Wis. 2011). There, Judge Griesbach writes:

> [The putative dealer's] argument is premised on the belief that there are two distinct "prongs" of the WFDL's good cause definition, both of which must be met before a dealer may terminate for good cause. Although the statute requires new requirements imposed by a grantor to be both essential and reasonable, courts have noted that these terms "are closely related and were clearly intended to be read together."

undoubtedly an inquiry that requires the factfinder to consider the totality of the parties' dealings; that truism, however, provides no reason to read any particular requirement out of the statute.[16] If a grantor can demonstrate each of these six elements, then definitional good cause exists, irrespective of whether good cause exists on another basis.[17]

i. Dealer's Fault

Definitional good cause contemplates a deficiency or failure of a dealer to perform to a certain level. In essence, the focus on the dealer's shortcomings is the fundamental protection provided by good-cause statutes: where a dealer performs, good cause does not exist to terminate; where a dealer fails to perform, good cause may exist, and the statute will not foreclose the grantor changing or ending the relationship. As a corollary, this approach to good cause generally means that a dealer cannot be terminated due to matters outside of its control.[18]

The Seventh Circuit's decision in *Frieburg Farm Equipment, Inc. v. Van Dale, Inc.*[19] demonstrates how a dealer may be protected by the WFDL even as it is significantly underperforming. There, the Seventh Circuit was tasked, *inter alia*, with assessing two important questions: (1) whether a protected dealership existed, and (2) whether the district court erred in declining to decide whether good cause existed as a matter of law.[20] After finding that a protected dealership existed,[21] the court turned to whether the grantor had good cause to terminate the parties' relationship. To start, the court found that whether good cause exists is a question of fact for a jury—not

> *Deutchland Enterprises, Ltd. v. Burger King Corp.*, 957 F.2d 449, 452 (7th Cir. 1992). In other words, a court need not determine whether each requirement imposed by a grantor is both "essential" and "reasonable;" [sic] it must instead analyze good cause as a whole. One reason for this *gestalt* approach, surely, is that very few proposed changes could be deemed "essential" to a grantor's business, that is, necessary to prevent imminent bankruptcy. For example, as [the dealer] notes, the mere fact that the parties had been doing business in a certain way for years would undercut the idea that the new language is actually essential to [the grantor's] business. The point of the statute, instead, is to allow grantors to make non-discriminatory changes in their dealership regime so long as those changes are reasonable and important to their overall business model. Accordingly, rather than determining whether the proposed new contract was actually "essential," I must determine whether it was a commercially reasonable requirement imposed by the grantor.

Id. at 822.

16. *See* Marotz v. Hallman, 734 N.W.2d 411, 418 (Wis. 2007) ("In interpreting a statute, courts give effect to every word so that no portion of the statute is rendered superfluous.").

17. *See infra* Parts II, III.

18. Ziegler Co. v. Rexnord, Inc., 433 N.W.2d 8, 15 (Wis. 1988) (Abrahamson, J., concurring) ("The majority's interpretation of the good cause requirement focuses on the grantor and therefore contravenes the plain language of sec. 135.02(4), Stats. which focuses entirely on the conduct of the dealer."). As explained later, Wisconsin courts have recognized that good cause may exist based on a grantor's own economic circumstances. *See infra* Part III.

19. Frieburg Farm Equip., Inc. v. Van Dale, Inc., 978 F.2d 395 (7th Cir. 1992).

20. *Id.* at 398–402.

21. For a discussion of the first question, see Mandell, Brodkey & Egle, *supra* note 4, at 40–41.

to be disturbed unless a "reasonable person could arrive at only one conclusion."[22] In this instance, the jury had found that there was no good cause. Van Dale argued that the jury verdict should be overturned for several reasons: (a) Frieburg failed to "meet established sales goals," (b) there was a "greater than forty percent decline in Frieburg's annual purchases of Van Dale products during the course of the dealership," and (c) Frieburg had increased its purchases from manufacturers competitive to Van Dale.[23] The court acknowledged that the grantor's arguments had "some merit," in that a dealer's deficient sales and purchasing performance *can* constitute good cause, but concluded that, in the circumstances at hand, the jury verdict was not unreasonable.[24]

Although the rationale is implicit, the *Frieburg* court seemingly relied primarily on the first part of the six-part definitional test—that any shortcomings of Frieburg were not the dealer's fault. Van Dale's claim regarding purchasing competitive products was deemed meritless because Frieburg adduced evidence demonstrating that Van Dale was unable to fill the dealer's orders.[25] As for the sales performance, the court found that Frieburg set forth evidence demonstrating that its sales of Van Dale products dropped steeply due to the grantor appointing three additional dealers in the two rural counties where Frieburg had operated exclusively.[26] It followed that Frieburg's ability to meet its sales and marketing obligations was not a matter entirely within its control, but suffered, in large part, due to its grantor's actions.[27]

ii. Substantial, Not Perfect

The WFDL does not require perfect compliance. Presumably borrowing from contract law,[28] the WFDL requires that a dealer substantially comply with its obligations under the dealership, meaning that a performance still can be considered complete if the essential purpose is accomplished, despite the dealer failing to precisely meet a particular requirement.[29] This doctrine

22. *Frieburg*, 978 F.2d at 401.
23. *Id.*
24. *Id.*
25. *Id.* at 401–02.
26. *Id.*
27. *But see*, *e.g.*, Aring Equip. Co. v. Link-Belt Constr. Equip. Co., Bus. Franchise Guide (CCH) ¶ 8906 (Wis. Cir. Ct. Cnty. 1987) (finding good cause for termination existed where dealer failed to meet sales goals).
28. Kreyer v. Driscoll, 159 N.W.2d 680, 682 (Wis. 1968) ("The doctrine of substantial performance is an equitable doctrine and constitutes an exception in building contracts to the general rule requiring complete performance of the contract. To recover on an uncompleted construction contract on a claim of having substantially, but not fully, performed it, the contractor must make a good faith effort to perform and substantially perform his agreement.").
29. *Cf.* Gen. Motors Corp. v. New A.C. Chevrolet, Inc., 91 F. Supp. 2d 733, 740 (D.N.J. 2000), *aff'd*, 263 F.3d 296 (3d Cir. 2001) ("'[S]ubstantial compliance' is surely something less than absolute adherence to every nuanced term of an agreement, but substantial compliance—at a minimum—requires that the franchisee refrain from acting in direct defiance of a term of the Agreement. This is especially true when, as here, the franchisee has received specific notice from the franchisor that its behavior is a violation of the agreement."); *see also Substantial-Performance*

ensures that the continuation of a dealership does not depend on a dealer's Levitical adherence to any particular terms and provides the dealer some slack in achieving its objectives. Naturally, whether a particular performance is sufficiently substantial is difficult to ascertain. On one end, a dealer missing its sale targets by a fraction of a decimal certainly seems to constitute substantial compliance, but instances like that are few and far between.[30]

A federal court's decision in *Brown Dog, Inc. v. Quizno's Franchise Co. LLC* demonstrates how substantial performance is an intricately fact-bound question.[31] There, Quizno's restaurants expanded throughout the country through the use of Area Directors.[32] An Area Director is a person (usually an existing franchisee) who purchases from the franchisor the right to develop franchises in a defined territory and agrees to open and maintain an "ever-increasing number of stores in [the] territory pursuant to a quarterly quota spelled out in the written contract."[33] In 2000, Brown Dog—a franchisee that already owned two restaurants—paid $75,000 for the right to be an Area Director in twenty-two counties in central and west-central Wisconsin.[34]

Like other Area Directors, under its Area Director Marketing Agreement (ADMA), Brown Dog was obligated to solicit franchisees for future Quizno's restaurants in the territory pursuant to a development quota.[35] The development quota increased on an annual basis, and during the parties' relationship the annual quota rose from one in the year 2000 to ten by the year 2004.[36] From 2000 through the first quarter of 2002, Brown Dog met or exceeded its quota, but began to struggle in subsequent quarters.[37] By the third quarter of 2002, despite Brown Dog only being one store behind on its quota, Quizno's sent Brown Dog notice requiring that Brown Dog cure its default within ninety days or Quizno's would terminate the ADMA.[38] Despite its efforts, Brown Dog failed to cure its default within that period, and, on September 23, 2003, Quizno's issued Brown Dog a termination notice, effective Christmas Eve of that year.[39]

Doctrine, Black's Law Dictionary (11th ed. 2019) ("The rule that if a good-faith attempt to perform does not precisely meet the terms of an agreement or statutory requirements, the performance will still be considered complete if the essential purpose is accomplished, subject to a claim for damages for the shortfall.").

30. *See* Edward R. Spalty & Todd C. Ditus, *Risky Business: Franchise Terminations for Failure to Meet Performance Quotas*, 6 Franchise L.J. 1, 20 (1987) ("For example, if a franchisee falls just slightly short of its performance quota, a court may find that such failure is nothing more than a technical violation of the franchise agreement. The franchise agreement may not be terminated for a mere technical violation due to the drastic effect of termination.").

31. Brown Dog, Inc. v. Quizno's Franchise Co. LLC, 2005 WL 3555425 (W.D. Wis. Dec. 27, 2005).

32. *Id.* at *1.

33. *Id.*

34. *Id.* at *6.

35. *Id.*

36. *Id.* at *10.

37. *Id.* at *7.

38. *Id.* at *8.

39. *Id.*

FranchiseLaw_Vol43_No2_Spring24.indd 110 6/6/24 9:43 AM

Having already decided at summary judgment that a protected dealership existed,[40] the court was tasked with determining whether Brown Dog substantially complied with its obligations under the ADMA and, if not, whether Quizno's discriminated against the franchisee by terminating the ADMA.[41] The court answered no to both questions. Importantly, the court found that Brown Dog failed to substantially comply with the development quota for nearly a year and a half and did not have only a bad quarter or two.[42] The court also took into account the "hyper-competitiveness of the fast food market" and "the criticality to Quizno's of constant, predictable growth" as well as Quizno's repeated efforts to bring Brown Dog into compliance in determining that Brown Dog's compliance fell below the substantial-compliance threshold.[43]

The upshot of the *Brown Dog* case is that substantial compliance turns heavily on the parties' actual interactions. Throughout the parties' relationship, the dealer either achieved its development quota or achieved eighty percent of its quota. Facially, this fact seems to be substantially complying with the dealership requirements. But when the importance of close compliance with the quota and the grantor's repeated demands for closer compliance are considered, it is apparent that the dealer's compliance was not aligned with the grantor's goals and expectations. Consequently, the court found that good cause existed to terminate.

iii. Essentiality

The WFDL requires that a grantor can take adverse action toward a dealer only if, *inter alia*, the dealer fails to meet its "essential" and "reasonable" requirements. Some courts have treated these conditions coextensively, noting that the terms "are closely related and were clearly intended to be read together."[44] This treatment fails to appreciate the difference between the two terms that are not always mutually inclusive. A requirement is "essential" if it is material to the continuation of a dealership, whereas a requirement is "reasonable" if it is fair and appropriate under the circumstances.

To illustrate, consider a heavy-farm-equipment dealer operating exclusively in Door County, Wisconsin. Pursuant to its agreement with its grantor, the dealer is obligated to have the highest sales of combine harvesters across the entire country. The obligation to sell the grantor's product is certainly essential, but requiring a small operation to lead the country in sales is certainly unreasonable under the circumstances. Or, consider if the same dealer were obligated to maintain ninety days' worth of inventory. Maintaining

40. *Id.* at *9.
41. *Id.*
42. *Id.* at *12.
43. *Id.*
44. *See*, *e.g.*, Deutschland Enters., Ltd. v. Burger King Corp., 957 F.2d 449, 452 (7th Cir.1992); Kaeser Compressors Inc. v. Compressor & Pump Repair Servs., Inc., 781 F. Supp. 2d, 819, 822 (E.D. Wis. 2011); C.L. Thompson Co. v. Festo Corp., 708 F. Supp. 221, 227–28 (E.D. Wis. 1989).

inventory *may* be—but is not necessarily—essential, and, under the circumstances, ninety days' worth of inventory seems reasonable enough.

Essentiality is closely related to materiality,[45] but what is essential is generally subject to two viewpoints. From a dealer's perspective, sale of a grantor's product is the *raison d'être* of a dealership arrangement and thus termination is inappropriate where a dealer continues to successfully sell a grantor's products.[46] Grantors tend to take a broader perspective and evaluate a dealer's performance not strictly based on sales but also in terms of whether the dealer is marketing the products in a manner consistent with the grantor's mission and vision.[47] Under this perspective, a wayward dealer cannot skate by simply on sales performance, no matter how good that performance may be; it must also conduct its business in alignment with the grantor's objectives.

Wisconsin courts have generally considered the totality of the parties' dealings when determining if a particular requirement was essential to the parties' relationship. Where there is nationwide distribution, courts generally have found that uniformity in both the form and execution of the parties' contract is essential in that "it can streamline and standardize relationships with dealers across the country."[48] Standardization of dealer conduct is of particular concern where a distribution network is made up of dozens of small dealers heavily dependent on the use of the grantor's trademarks.[49]

45. For a discussion of what constitutes a material obligation, see Leon F. Hirzel, *An Analysis of Franchise Agreement Terminations and Nonrenewals for Failure to Meet Minimum Performance Standards*, 37 Franchise L.J. 123, 128–29 (2017).

46. Or, as Judge Randa put it, "[The WFDL] was primarily designed to prevent the 'evil' of termination where a dealer had successfully operated and invested in a franchise or dealership." Open Pantry Food Marts of Wis., Inc. v. Garcia's Five, Inc., Bus. Fran. Guide (CCH) ¶ 8072, at 14195 (Wis. Cir. Ct. Milwaukee Cnty. 1983). This concept is a driving maxim across the WFDL's history and is well-rooted in the state and federal courts' assessment of a grantor's "objectively ascertainable" need to implement a systemic change. *See supra* Part III.A.i.

47. *Cf.* Power Test Petroleum Distribs., Inc. v. Calcu Gas, Inc., 754 F.2d 91, 97 (2d Cir. 1985) ("This creation and perpetuation of goodwill depends on customer recognition. The nature of goodwill is dictated by the consumer's desire to do business with the same seller. The buyer expects the same experience with each purchase—this is the *reason d'etre* [sic] for the sale."); *see also* David Gurnick, *Some Maxims of Franchise Law*, 42 Franchise L.J. 271, 276 (2023) (noting the importance of a trademark in a franchise system); Scott Makar, *In Defense of Franchisors: The Law and Economics of Franchise Quality Assurance Mechanisms*, 33 Vill. L. Rev. 721, 729–31 (1988) (discussing intangible assets of a franchisor and a free rider problem where a franchisee fails to meet franchisor expectations and ultimately harms the system).

48. *Kaeser Compressors*, 781 F. Supp. 2d at 823; *see, e.g.*, McDonald's v. Werve, 392 N.W.2d 130 (Wis. Ct. App. 1986) (unpublished) (upholding jury's finding that the requirement for McDonald's franchise to exercise option before third year reasonable and essential); Moodie v. School Book Fairs, Inc., 889 F.2d 739, 745–46 (7th Cir. 1989) ("[W]e believe failure to sign the agreement constituted a failure to comply substantially with reasonable requirements. A company is entitled to maintain uniform contract terms with its many dealers."); Wis. Music Network, Inc. v. Muzak Ltd. P'ship, 5 F.3d 218, 224 (7th Cir. 1993) ("It is not unreasonable for Muzak to rewrite its license agreements in an orderly fashion, incorporating new terms as the agreements require renewal."); Re/Max N. Cent., Inc. v. Cook, 272 F.3d 424, 432 (7th Cir. 2001) ("Re/Max is entitled to maintain uniform contract terms with its dealers.").

49. *See* James B. Egle & Isaac S. Brodkey, *Encroachment in the Era of Digital Delivery Platforms: Impact of Delivery Apps on Brick and Mortar Exclusive Territories*, 41 Franchise L.J. 195, 209 (2021) ("When a franchisor fails to adequately police its trademark, it runs the risk of abandonment

That said, whether to enforce compliance with a particular provision places grantors in a difficult spot, weighing the importance of standard measures against the litigation and reputational risk that would follow from a termination.[50] This is a delicate balance.[51]

As for inessential requirements, not every term in a lengthy dealership or franchise agreement can be considered essential to the success and continuation of a dealership. For example, most dealership agreements provide sections detailing how each party must provide notice to the other. While important in some instances, it would be farfetched to believe that a dealer's failure to provide notice in the precise form outlined in a particular agreement would warrant terminating the parties' relationship under the WFDL.

iv. Reasonableness

Whether a requirement is reasonable depends on the expectations of a dealer in the circumstances. Most often, the question of reasonableness arises in the context of sales targets.[52] The requirements imposed by the grantor in *Chili Implement Co. v. CNH America, LLC*[53] proved to be a textbook example of unreasonable requirements. There, Chili Implement was a dealer of CNH's agricultural equipment.[54] In March 2010, CNH sent Chili Implement notice that it failed to achieve a satisfactory market share in selling CNH's products and failed to stock a sufficient level of inventory.[55] To avoid termination, CNH required that Chili Implement "meet or exceed 90% of the Wisconsin state market share" and "stock sufficient inventory conducive to achieving that market share."[56] Chili Implement failed to meet these goals, and CNH

of the mark. Naked licensing occurs when a licensor grants permission to use a mark without sufficient control over the licensee's goods or services. The Lanham Act requires that trademark holders, including franchisors, adequately maintain certain quality standards."); Stephanie Russ & Laura Kupish, *It's My Franchise Agreement, I'll Enforce It However I Want to—Maybe You Will, Maybe You Won't*, 37 Franchise L.J. 589, 589 (2018) ("A hallmark feature of any franchise system is uniformity, which begins with the franchise agreement and is supported by a system's operations manual. The franchise agreement sets forth the contractual rights and obligations of both the franchisee and the franchisor, and one of the franchisee's contractual obligations is to comply with the franchisor's standards, as described in the franchisor's operations manual. The existence of, and compliance with, the standards drives the uniformity that franchisors and franchisees seek."); *see also* Joseph Schumacher, Edward Wood Dunham & G. Adam Schweickert III, *Retaining and Improving Brand Equity by Enforcing System Standards*, 24 Franchise L.J. 10 (2004); Craig Tractenberg, Jean-Philippe Turgeon & Stéphanie Destrempes, *The Franchisor's Duty to Police the Franchise System*, 36 Franchise L.J. 87 (2016).

50. *See* Spalty & Ditus, *supra* note 30, at 1.

51. Mark J. Burzych & Emily L. Matthews, *Selective Enforcement of Franchise Agreement Terms and System Standards*, 23 Franchise L.J. 110 (2003) (discussing concerns regarding the selective enforcement of certain requirements); *see infra* Part I.A.iv.

52. *See* Hirzel, *supra* note 45.

53. Chili Implement Co. v. CNH Am., LLC, 2015 WI App 43, 362 Wis. 2d 540, 865 N.W.2d 885 (2015) (unpublished, per curiam).

54. *Id.* ¶ 4. The issue of whether a dealership existed was a matter decided by a jury and was not appealed. *Id.* ¶ 4, n. 1.

55. *Id.* ¶ 5.

56. *Id.*

terminated.[57] Six months after termination, Chili Implement sued CNH, alleging that it had been terminated in contravention of the WFDL.[58]

At trial, Chili Implement was able to prove both that a dealership existed and that CNH lacked good cause to terminate.[59] Relevant to this article,[60] on appeal, CNH did not contest that a dealership existed and focused on the good-cause finding. Despite Chili Implement's potentially poor performance, the appellate court concluded that good cause did not exist because the requirements imposed were unreasonable on account of Chili Implement's size as a dealer and ultimately discriminatory actions against the dealer.[61]

The reasonableness of a particular requirement is a fact-bound inquiry. It seems wholly unreasonable to require a small dealer in a small territory to lead the country in overall sales. At the same time, if that dealer possesses the best market for the grantor's products, perhaps it is not entirely unreasonable to expect a higher level of performance than other dealers within the grantor's distribution network.

v. Non-Discriminatory

Nondiscriminatory treatment is a critical aspect of good-cause protection, which is designed to protect dealers from arbitrary treatment.[62] The statute plainly provides that the requirements imposed or sought to be imposed by a grantor must be nondiscriminatory by their terms or in the manner of their enforcement as compared to the requirements imposed on other "similarly situated dealers."[63] Although there is much to unpack, commentators have distilled the rule down to the following:

> If a grantor wishes to terminate a dealer protected by [the WFDL] on the basis of default in a given area, the grantor must be prepared to show either that all other dealers in its organization whose performances in that area are as bad as or worse than that of the candidate for termination have themselves been threatened with termination or that the grantor has a good reason for treating differently any who have not been.[64]

At a high level, this prohibition is plain: a grantor cannot treat its dealer in La Crosse substantially differently from its dealer in Janesville (or from a dealer outside of Wisconsin). But identifying a similarly situated dealer is not always an easy exercise, as it is a rarity for two dealers to operate under

57. *Id.* ¶ 6.
58. *Id.*
59. *Id.* ¶ 8.
60. Much of the court's opinion is dedicated to assessing a statute of limitations question. *Id.* ¶¶ 9–21.
61. *Id.* ¶¶ 26–28.
62. Emerson, *supra* note 3, at 589 ("'Good cause' requirements in franchising have developed to compel franchisors to treat their franchisees equally and fairly.").
63. Wis. Stat. § 135.02(4).
64. Butler & Mandell, *supra* note 1, § 6.44.

identical market conditions and circumstances.[65] Nonetheless, as a federal judge noted when assessing whether evidence regarding the grantor's treatment of purportedly similarly situated dealers could be admitted at trial, "precise equivalence is not required; the parties must be comparable, not clones."[66]

Generally, the greater the number of dealers in a distribution network, the easier it is to identify an appropriate foil for a particular dealer.[67] The reverse is true as well; where there are only a handful of authorized dealers in the country, it is generally more difficult to compare their circumstances against one another.[68] That said, in *Deutchland Enterprises, Ltd. v. Burger King Corp.*,[69] the Seventh Circuit found a Burger King franchisee was not discriminated against when the franchisor terminated the relationship due to the franchisee taking on competing franchises, despite the franchisor permitting the other franchisees to do the same.[70] There, the purported dealer was not "similarly situated" to the other franchisees that were, unlike the dealer, publicly traded corporations and confronted the issue ten years before the dealer's lawsuit.[71]

Where a grantor acts consistently in its treatment of its dealership network, it is less likely to be found to act discriminatorily. For example, in *L-O Distributors, Inc. v. Speed Queen Co.*,[72] the U.S. District Court for the District of Minnesota found the grantor's decision to terminate due to poor sales performance was not discriminatory under the WFDL because, in part, the grantor has a "clear policy of terminating distributorships that fail to increase their market share."[73] A similar finding was made with respect to a grantor terminating a dealer for refusing to operate its store twenty-four hours a day as required for all of the grantor's stores.[74] In *Brown Dog*, a federal magistrate judge found that Quizno's termination of the dealership was not discriminatory because Quizno's made an "across-the-board decision to enforce more

65. *Id.* ("Rarely, if ever, will two dealers be operating under identical circumstances. Typically, they will be selling in different areas, each of which has different market characteristics. They will have different levels of experience with the grantor's products. They may be facing different levels of competition.").

66. Am. Dairy Queen Corp. v. Universal Inv. Corp., No. 16-CV-323-WMC, 2017 WL 4083595, at *2 (W.D. Wis. Sept. 15, 2017) (quoting Andy Mohr Truck Ctr., Inc. v. Volvo Trucks N. Am., 869 F.3d 598, 604 (7th Cir. 2017) (assessing claims under Indiana Franchise Disclosure Act and Indiana Deceptive Franchise Practices Act)).

67. For example, a national fast-food franchisor is likely to have enough franchisees in its network to appropriately assess an individual dealer.

68. For example, if a grantor has just five dealers covering the entirety of the United States, there is a significantly greater chance that the dealers are dissimilar.

69. Deutchland Enters., Ltd. v. Burger King Corp., 957 F.2d 449 (7th Cir. 1992).

70. *Id.* at 453.

71. *Id.*

72. L-O Distribs., Inc. v. Speed Queen Co., 611 F. Supp. 1569, 1581 (D. Minn. 1985).

73. *Id.*

74. Tiesling v. White Hen Pantry, 121 Wis. 2d 701, 361 N.W.2d 311 (Wis. Ct. App. 1984) (unpublished).

FranchiseLaw_Vol43_No2_Spring24.indd 115 6/6/24 9:43 AM

diligently the terms of the contracts that its [dealers] already had signed."[75] By contrast, in *Advanced Agri-Systems, Ltd. v. Southwestern Porcelain, Inc.*, the U.S. District Court for the Western District of Wisconsin found that the grantor's failure to terminate other dealers whose performance was worse than the dealer's demonstrated that the grantor discriminated against the dealer when it attempted to terminate the dealer for failing to meet its sales quotas.[76] All told, the nondiscrimination requirement necessitates consistency, but not necessarily homogeneity.[77]

vi. Imposed

The WFDL requires that the grantor can terminate on the dealer's failure to substantially comply with only those requirements that it has actually imposed or intends to impose on a dealer. The grantor cannot manufacture good cause on the assumption that a dealer will not be able to comply with a particular provision, nor can a grantor terminate a dealer because it "failed to do something that it did not know it was supposed to do."[78] The WFDL requires that the grantor bring the requirements "home" to the dealer in order for good cause to exist.[79]

This issue most commonly arises where a grantor asks its dealer to sign a new agreement that varies from the parties' previous dealings. As alluded to above, in many instances, a grantor has a legitimate interest in maintaining uniform contracts with its dealership network. Friction often arises when a grantor seeks to bring its dealership network into uniformity, particularly when the grantor seeks to formalize a long-standing handshake agreement or update the contracts of dealers with older contracts at renewal.

The case law on when a grantor can impose new uniform terms on a dealer is closely related to the systemic-change exception to good cause. In *Wisconsin Music Network v. Muzak*,[80] the Seventh Circuit found that a grantor requiring its dealers to participate in a new marketing program was justified as the dealer failed to demonstrate that it would suffer customer loss or decreased profits on behalf of the new program, whereas the grantor was able to demonstrate the economic necessity of its decision.[81] At summary judgment in the *Kaeser Compressor, Inc. v. Compressor & Pump Repair Services*,

75. Advanced Agri-Systems, Ltd. v. Sw. Porcelain, Inc., 2005 WL 3555425, at *14 (W.D. Wis. Dec. 27, 2005).

76. Advanced Agri-Systems, Ltd. v. Sw. Porcelain, Inc., No. 81-C-352 (W.D. Wis. Mar. 30, 1982) (unpublished).

77. Open Pantry Food Marts of Wis., Inc. v. Garcia's Five, Inc., Bus. Fran. Guide (CCH) ¶ 8072, at 14194–95 (Wis. Cir. Ct. Milwaukee Cnty. 1983) (holding a franchisor's toleration of some financial irresponsibility among its network did not preclude it from terminating an insolvent dealer); *see also* Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 279 (7th Cir. 1992) ("The fact that the Cookie Company may, as the Sigels argue, have treated 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.").

78. Butler & Mandell, *supra* note 1, § 6.39.

79. *Id.*

80. Wis. Music Network v. Muzak, 5 F.3d 218, 224 (7th Cir. 1993).

81. *Id.* at 224.

FranchiseLaw_Vol43_No2_Spring24.indd 116 6/6/24 9:43 AM

Inc. case, a federal judge determined that whether good cause existed for a grantor to require a dealer to commit to a new agreement already agreed upon by every other dealer in the network was a jury question due to the grantor failing to demonstrate the economic necessity and proportionality of the need for the dealer to undertake the proposed changes.[82] The grantor's attempt to impose the new agreement was assessed by the court through the systemic-change exception rather than the definitional good-cause test.[83]

This issue also arises in instances where grantors rely on the implicit imposition of a requirement. A course of dealing between the parties may reveal certain obligations and functions that differ or are not fully addressed even in the most detailed dealership agreements. Where no dealership agreement exists, it is markedly more difficult for grantors to "impose" a requirement on a dealer, and it is commonly more strenuous for parties to identify what is expected from the dealer.[84] As a result, grantors should be cautious when taking adverse action against a dealer for failing to comply with an implicit requirement.[85]

B. *Bad Faith*

Bad faith is an issue rarely litigated under the WFDL, but nevertheless serves an integral protection for grantors. Although not defined by the statute, bad faith can be understood as intentional actions undertaken by a dealer subversive to carrying out the dealership. Unlike many other state franchise relationship statutes,[86] the WFDL does not explicitly allow a grantor

82. Kaeser Compressors, Inc. v. Compressor & Pump Repair Servs., Inc., 781 F. Supp. 2d 819, 827 (E.D. Wis. 2011). Judge Griesbach explains that determining whether good cause exists is not always a comfortable exercise for judges:

> This is not to say that the above exercise is a comfortable one. The Fair Dealership law was designed to give a particular class of citizens—dealers—a leg-up in their relationships with mostly out-of-state manufacturers, who were viewed to have outsized bargaining power and an ability to exploit local distributors. But though the law may have been well-intentioned, it has sometimes required judges and juries to sit as economic commissars intermediating disputes between business entities or opining on the wisdom of various corporate structures (or even Girl Scout councils). Judges and juries, of course, have little training in assessing whether business activities are "reasonable" or "essential," and the costs and time involved in reaching a final decision are a product of the law's inherent uncertainties, many of which are on display in this case. Despite these concerns, I conclude that a trial will be required to determine the questions posed here.

Id.

83. *See infra* Part III.

84. *See supra* Part I.A.iii. (discussing essentiality).

85. Butler & Mandell, *supra* note 1, § 6.42.

86. Jason J. Stover, *No Cure, No Problem: State Franchise Laws and Termination for Incurable Defaults*, 23 Franchise L.J. 217 (2004) (observing that one commentator has noted, "most state franchise relationship statutes . . . provide that the franchisor may terminate the franchisee immediately or on very short notice if the franchisee has committed a severe or incurable breach. While every state defines a severe breach differently, common examples mirror those spelled out in most franchise agreements and include abandonment, conviction of a serious crime, declaration of bankruptcy, fraud, multiple breaches over a fixed period of time, or a violation that threatens public health or safety.") (collecting statutes); *see also* Chad J. Doellinger,

FranchiseLaw_Vol43_No2_Spring24.indd 117 6/6/24 9:43 AM

to immediately terminate a relationship if the dealer acts in bad faith, but, when a dealer frustrates the fundamental purposes of the dealership, case law from Wisconsin and elsewhere teaches that the relationship is irreparably vitiated, and thus immediate termination may be justified.

The U.S. District Court for the Eastern District of Wisconsin's decision in *Harnischfeger Corp. v. Superior Crane Corp.*[87] is the seminal WFDL case on bad faith. There, Superior Crane was a distributor for Harnischfeger—a designer and manufacturer of material handling equipment and parts.[88] During the course of the relationship, Superior Crane began to manufacture and sell pirated Harnischfeger parts without Harnischfeger's knowledge, authority, or approval.[89] The products were sold in a manner that would leave end consumers believing that they were purchasing genuine Harnischfeger products.[90] In addition to producing and selling counterfeit products, Superior Crane also misappropriated Harnischfeger's drawings and furnished such materials to third parties.[91] Harnischfeger sued, alleging a series of violations of the RICO Act, the Lanham Act, and Harnischfeger's common law and statutory trade secret rights, among other claims.[92] Superior Crane countersued under the WFDL alleging that Harnischfeger violated the statute by failing to provide Superior an opportunity to cure.[93]

The court viewed the main issue in this case as whether a dealer "who commits acts so egregious and so destructive of the dealership . . . waives his right to remedy the act or whether the acts create a harm which is incapable of being cured."[94] The court found that the "type of bad faith conduct displayed by Superior Crane and admitted by Superior Crane cannot be protected by the Wisconsin Fair Dealership Law," and thus Harnischfeger had the "right to terminate" the parties' relationship without an opportunity to cure."[95]

More recently, in *Rustic Retreats v. Pioneer Log Homes of British Columbia*,[96] a federal magistrate judge reaffirmed that "direct and incontrovertible evidence of serious bad-faith conduct at the time a grantor terminates a dealership may negate the notice requirement" under the WFDL.[97] But, at the preliminary-injunction stage, Pioneer Log Homes, unlike Harnischfeger, did

Incurable Breaches: A Fresh Look at an Old Problem, 32 Franchise L.J. 119 (2013) (discussing, *inter alia*, when criminal conduct, dishonesty and self-dealing, and failure to use best efforts may be deemed incurable).

87. Harnischfeger Corp. v. Superior Crane Corp., No. 94-c-1244, 1995 Bus. Franchise Guide (CCH) ¶ 10,618, at 26,468 (E.D. Wis. Feb. 13, 1995).

88. *Id.* at 26,469.

89. *Id.*

90. *Id.*

91. *Id.* at 26,470.

92. *Id.* at 26,470.

93. *Id.*

94. *Id.* at 26,471.

95. *Id.*

96. Rustic Retreats v. Pioneer Log Homes of British Columbia, 2020 WL 3415645, at *7 (E.D. Wis. June 22, 2020).

97. *Id.* at *7 (citing Wis. Stat. § 135.04).

FranchiseLaw_Vol43_No2_Spring24.indd 118 6/6/24 9:43 AM

not demonstrate that the dealer's use of its proprietary designs was bad faith as opposed to a "good-faith misunderstanding of or disagreement about the terms of the Agreement."[98]

The common thread across these cases and others[99] is that, once torn, the trust between the dealer and grantor cannot be patched up by the dealer merely expressing willingness to work with the grantor to rectify its actions. Some conduct is, by definition, legally incurable. While affording substantial protections for performing dealers, it seems inconsistent with the statute's purpose to force a grantor, like Harnishfeger, to continue working with a dealer that has used its position to undermine the grantor's ability to sell its products. It follows that, when conduct is so egregious to significantly harm a grantor's operations and goodwill, then bad faith likely exists and immediate termination is justified. That said, to date, there is no published state-court opinion on whether bad faith allows for immediate termination of a dealer.

II. Per Se Good Cause

The WFDL, like many franchise and dealership statutes,[100] recognizes that good cause may exist on account of the specific instances of a dealer's financial (ir)responsibility. First, good cause may exist when a dealer fails to pay sums owed under the parties' relationship; second, good cause may exist

98. *Id.*

99. *See*, *e.g.*, H&R Block, Inc. v. Otto, No. 80-cv-7409 (Wis. Cir. Ct. Dane Cty. May 5, 1980) (holding termination without notice was justified where a dealer undermined the foundation of grantor's business and reputation); Olin v. Cent. Indus., Inc., 576 F.2d 642, 648 (5th Cir. 1978) (termination without notice appropriate where a distributor misappropriated the grantor's products).

100. Garner, *supra* note 11, §§ 10:29-31 ("Under most states' relationship statutes, the franchisee's institution of insolvency or bankruptcy proceedings, or the assignment of the franchisee's assets for the benefit of creditors, is grounds for immediate termination of the franchise agreement. In those states where it is not a ground for immediate termination, it will certainly be upheld as ground for termination for cause, since insolvency or bankruptcy means that the franchisee cannot operate the business."). In addition to financial irresponsibility, many state statutes list other instances of per se good cause. *See* Robert W. Emerson, *Franchise Terminations: Legal Rights and Practical Effects When Franchisees Claim the Franchisor Discriminates*, 35 Am. Bus. L.J. 559, 582–84 (1998) ("(1) failure to pay when due all or some of the royalties or fees owed to the franchisor; (2) giving false reports to the franchisor; (3) abandoning or otherwise ceasing to do business at the specified location; (4) failure to correct defects in products or services; (5) failure to meet franchise standards and specifications, or repeated violations of any contractual conditions; (6) impairment of the franchisor's trademark; (7) conviction for a crime; (8) a court finding of bankruptcy, or otherwise having bankruptcy proceedings instituted against the franchisee; (9) general assignment of business assets to creditors; (10) having a receiver or designee take over franchise operations; (11) failure to adhere to the terms of any lease, mortgage, promissory note, installment loan, security agreement, or other financial instrument the franchisor holds over either the franchise itself or the business premises; (12) loss of the right to occupy the premises of the franchised business; (13) government seizure of or a creditor's foreclosure on the franchised premises; (14) operating the franchise in a manner imminently endangering public health and safety; (15) repeatedly failing to comply with lawful franchise agreement provisions; and (16) making a material misrepresentation to the franchisor."); *see also* Stover, *supra* note 86, at 217 n.2 (collecting statutes identifying when per se good cause exists).

where the dealer becomes insolvent, declares bankruptcy, or is otherwise assigned for the benefit of creditors. The notice and cure requirements for adverse actions undertaken pursuant to these changes is shorter than they are for actions taken pursuant to definitional good cause.

A. *Failure to Pay*

Under most dealership arrangements, a dealer will make payments toward a grantor for the right to sell or distribute its goods or services, or to use the grantor's trade symbols,[101] and such payments under such agreements are material to the continuation of the relationship.[102] Reflecting the importance of such payments, the WFDL has little sympathy for the failure of a dealer to pay sums owed and abbreviates the grantor's cure requirements. In *White Hen Pantry v. Buttke*,[103] the Wisconsin Supreme Court held that a grantor may terminate a dealership on ninety days' notice, but need provide only ten days, rather than the ordinary sixty days, to cure the default in the case of a monetary default.[104] But where the parties contract for more protection for the dealer than afforded under the WFDL—e.g., thirty days, instead of ten days, to cure a failure to pay—courts may follow the contract's protection.[105]

B. *Insolvency, Bankruptcy, and Assignment for the Benefit of Creditors*

The WFDL's notice and cure provisions do not apply when a grantor seeks to terminate, cancel, or fail to renew due a dealer's "insolvency, occurrence of an assignment for the benefits of creditors or bankruptcy."[106] Colloquially, the

---

101. Not every dealership arrangement requires payment from a dealer to a grantor. Indeed, the statute only requires: "A contract or agreement, either expressed or implied, whether oral or written, between two or more persons, by which a person is granted the right to sell or distribute goods or services, or use a trade name, trademark, service mark, logotype, advertising or other commercial symbol, in which there is a community of interest in the business of offering, selling or distributing goods or services at wholesale, retail, by lease, agreement or otherwise." Wis. Stat. § 135.02(3)(a). In *Benson v. City of Madison*, the Wisconsin Supreme Court made plain that a protected dealership existed despite the golf professionals not making any payment to the municipality. 2017 WI 65, ¶53, 376 Wis. 2d 35, 897 N.W.2d 16 (2017); *see also* Girl Scouts of Manitou Council, Inc. v. Girl Scouts of U.S. of Am., Inc., 549 F.3d 1079 (7th Cir. 2008); JusticePoint v. City of Milwaukee, Case No. 2023CV5026 (Wis. Cir. Ct. Milwaukee Cnty.) (temporary restraining order granted in similar circumstances; denial of temporary injunction currently on appeal).

102. *See* Taizhou Yuanda Inv. Grp. Co. v. Z Outdoor Living, LLC, 522 F. Supp. 3d 476, 490 (W.D. Wis. 2021) ("The primary purpose of the Cooperation Agreement was to sell furniture, so Z Outdoor's failure to pay for substantial amounts of that furniture qualifies as a material breach."); *see also* Prof'l Serv. Network, Inc. v. Am. All. Holding Co., 238 F.3d 897, 901 (7th Cir. 2001) (incomplete payment constituted material breach); *see also* Emerson, *supra* note 3, at 111 (identifying failure to pay as been among the principal reasons that courts have accepted good cause for the termination of franchise agreements).

103. White Hen Pantry v. Buttke, 301 N.W.2d 216, 220 (Wis. 1981).

104. *Id.* at 219–20.

105. *See* Badgerland Truck Repair, Inc. v. R&S Truck Body Co., Inc., Case No. 99-C-1275 (E.D. Wis. Dec. 8, 2000) (unpublished) ("Of course, if parties to a contract so desire, they may agree to provide each other with more protection than is mandated by law. That is exactly what happened . . ." where dealer was afforded thirty days' notice under the parties' agreement to cure payment defaults.).

106. Wis. Stat. § 135.04.

FranchiseLaw_Vol43_No2_Spring24.indd 120 6/6/24 9:43 AM

authors consider insolvency, bankruptcy, and the assignment for the benefit of creditors to be the proverbial "all roads lead to Rome:" the company is going down. Legally, each of these terms carries a different connotation.

In Wisconsin, unlike in other jurisdictions, insolvency "does not mean the inability of the concern or person giving the alleged preference to meet current obligations as they become due in the regular course of business," nor "does it mean that the company or person is presently operating its business at a loss."[107] Rather, insolvency "simply means that the assets of the alleged insolvent are insufficient, at a fair valuation, to pay his debts."[108] The case law on insolvency is limited, but that which exists supports the "fair valuation" approach to whether a dealer is insolvent.[109]

Unlike insolvency, both bankruptcy and the assignment for the benefit of creditors refer to legal status. A dealer is bankrupt when it is able to file for bankruptcy under the Bankruptcy Code or be forced into bankruptcy by creditors.[110] What the grantor can and cannot do during the bankruptcy proceeding is a tricky question best handled by a specialist in the area.[111] Outside of federal bankruptcy, Wisconsin, like many states,[112] has allowed its courts to supervise proceedings where a party is assigned for the benefit of creditors under what is now known as a Chapter 128 receivership.[113] As with bankruptcy, a Chapter 128 receivership provides a mechanism for a party to liquidate its assets in an ordinary fashion. In the case of insolvency, bankruptcy, or the assignment for the benefit of creditors, the WFDL allows the grantor to terminate immediately.[114]

107. Schmitz v. Wis. Soap Mfg. Co., 235 N.W. 409, 411 (Wis. 1931).

108. *Id.*; *accord* Beloit Liquidating Tr. v. Grade, 2004 WI 39, ¶39 n.16, 270 Wis. 2d 356, 677 N.W.2d 298 (2004). Wisconsin is an outlier in adopting such a limited definition of insolvency. Generally, insolvency has two commonly accepted definitions: (1) "insolvency refers to the inability of a debtor to pay its debts as they mature" and (2) where a company's debts exceed its assets. *See* 15A Fletcher Cyc. Corp. § 7360.

109. Open Pantry Food Marts of Wis., Inc. v. Garcia's Five, Inc., Bus. Fran. Guide (CCH) ¶ 8072 at 14194–95 (Wis. Cir. Ct. Milwaukee Cnty. 1983) (finding good cause where dealer had a negative net worth of $45,031.74 and its assets could not cover its debts).

110. 11 U.S.C.A. § 109.

111. *See* Garner, *supra* note 11, § 10:29, Institution of insolvency or bankruptcy proceedings. For more discussion on bankruptcy in the franchise and dealership space, see, for example, Alan M. Anderson & Renee L. Jackson, *The Dischargeability of Claims for Injunctive Relief after Bankruptcy*, 21 Franchise L.J. 134 (2002); William J. Barrett, *Counterpoint: Bankruptcy and Assignment of Franchise Agreements over Franchisor's Objection*, 32 Franchise L.J. 247 (2013); Matthew J. Burne, *The Effect of Franchisor Bankruptcy on Executory Supply Contracts: Does the Franchisee Have A Remedy?*, 18 Barry L. Rev. 191 (2012); Craig R. Tractenberg, *What the Franchise Lawyer Needs to Know About Bankruptcy*, 20 Franchise L.J. 3 (2000).

112. Robert Richards & Nancy Ross, *Practical Issues in Assignments for the Benefit of Creditors*, 17 Am. Bankr. Inst. L. Rev. 5, 6 (2009) (discussing assignment for the benefit of creditor statutes and noting that in recent years, such statutes "have been used frequently in some states, such as California, Florida, Illinois, Massachusetts and Wisconsin."); Sharyn B. Zuch, *Alternatives to Franchisee Bankruptcy: Workouts, Compositions of Creditors, Assignments for the Benefit of Creditors, and Receiverships*, 33 Franchise L.J. 359, 368–71 (2014) (discussing assignment for the benefit of creditor statutes).

113. Kristin K. Beilke et al., Collections and Bankruptcy in Wisconsin, § 2.16 (3d ed. 2022); Wis. Stat. § 128.001 *et seq.*

114. *Id.*

III. Judicially Created Good Cause

While definitional good cause and good cause per se exhaust the grounds in the statutory text that justify otherwise-restricted conduct on the part of a grantor, courts interpreting the WDFL have found another kind of good cause. To do so, they have looked outside the statute's plain language and recognized that a grantor may have good cause to undertake an adverse action due to its own economic circumstances. There are two forms of judicially recognized good cause: (1) where a grantor acts pursuant to a nondiscriminatory systemic change, and (2) where a grantor withdraws from a market entirely.[115] Although commonly conflated, market withdrawals and systemic changes are different forms of good cause, with the critical difference being that a systemic change affects the operations of the existing distribution system, while a market withdrawal contemplates a grantor leaving a position within the marketplace. To illustrate, a grantor requiring a dealer to pay an increased royalty on widgets sold by the dealer is a systemic change, whereas a grantor stopping to sell completely widgets in the dealer's territory is withdrawing from the market. Together, these two exceptions ensure that a grantor be able to respond to and accommodate for its own economic problems, while ensuring that its dealers are not hung out to dry.

A. *Systemic Change*

The authors' previous article discussed at length the *Ziegler Co. v. Rexnord Inc.*[116] decision in which the Wisconsin Supreme Court set forth the judicial framework for determining when a community of interest exists.[117] There, the court reversed the grant of summary judgment and remanded the proceeding for a jury trial on the community-of-interest question, entitling Ziegler to protection under the statute.[118] Within a year of that decision, the dispute between the parties was again before the Wisconsin Supreme Court, and, this time, the court was tasked with determining whether good cause existed.[119]

In *Ziegler II*, the parties disagreed as to whether the grantor's decision to discontinue or modify the relationship from a dealership to a "tight agency" was an "attempt to increase its profitability" or to "stem ruinous losses."[120]

115. When a market withdrawal constitutes good cause to terminate a dealership or franchise is a matter that has been a hotly contested. *See, e.g.*, Michael Dady, *The Olds Market Withdrawal: Is What's Past, Prologue?*, 21 Franchise L.J. 65 (2001); Edward Wood Dunham, *Two Sides to Every Story*, 22 Franchise L.J. 3 (2002); Leonid Feller, *The Case for Federal Preemption of State Dealer Franchise Laws: Lessons Learned from General Motors' Oldsmobile Litigation and Other Market Withdrawals*, 11 U. Pa. J. Bus. L. 909 (2009); Garner, *supra* note 11, § 10.24; Michael J. Lockerby, *Revisionist History? Kicking the Tires of J. Michael Dady's Market Withdrawal Cases*, 21 Franchise L.J. 177 (2002); Michael J. Lockerby, *Market Withdrawal: Judges and Juries Aren't Buying What Terminated Dealers Are Selling*, 22 Franchise L.J. 151 (2003).

116. Ziegler Co. v. Rexnord Inc., 407 N.W.2d 873 (Wis. 1987).

117. Mandell, Brodkey & Egle, *supra* note 4, at 33–37.

118. Ziegler, 407 N.W.2d at 882.

119. Ziegler Co. v. Rexnord, Inc., 433 N.W.2d 8, 10 (Wis. 1988) (*Ziegler II*).

120. *Id.*

FranchiseLaw_Vol43_No2_Spring24.indd 122 6/6/24 9:43 AM

The court understood the "real issue" to be whether a grantor may "alter its method of doing business with its dealers . . . to accommodate its own economic problems" or whether the grantor "must subordinate those problems—regardless of how real, how legitimate, or how serious—in all respects and permanently if the dealer wishes to continue the dealership."[121]

Addressing that issue, the court found that a "grantor's economic circumstances may constitute good cause to alter its method of doing business with its dealers, but such changes must be essential, reasonable and nondiscriminatory" and "objectively ascertainable."[122] The court deemed the contrary position to be "unjust and unreasonable" and determined that the "Wisconsin legislature could not have intended to impose an eternal and unqualified duty of self-sacrifice upon every grantor that enters into a distributor-dealership agreement."[123] This holding was further supported by existing federal case law, which held that it was "common sense" to allow a grantor the ability to make certain changes to its distribution network in response to its own economic needs.[124]

The *Ziegler II* decision is ideologically aligned with a series of federal cases applying the WFDL to instances of systemic changes and market withdrawal. The driving rationale of these decisions is best exemplified in *Remus v. Amoco Oil Co.*,[125] where the Seventh Circuit questioned the extent of the statute to prohibit systemic changes where a grantor sought to implement a discount for a cash marketing program.[126] There, Judge Posner noted, in dicta:

> The statute may go somewhat further than we have suggested and protect dealers against new competition that has substantially adverse although not lethal effects. The statute is primarily designed to benefit existing dealers (it cannot benefit new dealers much, for they will have to compensate their franchisors for any favorable terms that the statute requires be included in the franchise). . . . We hesitate to conclude that the Wisconsin legislature meant to go further still . . . to prevent franchisors from instituting nondiscriminatory system-wide changes without the unanimous consent of the franchisees. Not only would such a law completely transform the relationship of franchisor and franchisee . . . but it would not serve the interests of the franchisees as a whole. Even if most of them would benefit from a proposed system-wide change, a handful of dissenters might be able to block it by suing under the Fair Dealership Law, especially if . . . they can use the class action device to increase the impact of the suit.[127]

In *Morley-Murphy Co. v. Zenith Electronics Corp.*,[128] the Seventh Circuit distilled the *Ziegler II* decision into a three-part test: a grantor may have good cause for a proposed change if there is "(1) an objectively ascertainable need

121. *Id.* at 11.
122. *Id.* at 11, 14.
123. *Id.* at 11.
124. *Id.* (citing Remus v. Amoco Oil Co., 794 F.2d 1238 (7th Cir.1986)).
125. *Remus*, 794 F.2d 1238.
126. *Id.* at 1238–40.
127. *Id.* at 1241 (cleaned up).
128. Morley-Murphy Co. v. Zenith Elecs. Corp., 142 F.3d 373 (7th Cir. 1998).

FranchiseLaw_Vol43_No2_Spring24.indd 123 6/6/24 9:43 AM

for change, (2) a proportionate response to that need, and (3) a nondiscriminatory action" to implement that response.[129] In that case, Zenith sought to overhaul its distribution network due to losing over $300 million in the five years immediately preceding the termination dispute and begin selling directly to retail outlets, which meant terminating Morley-Murphy, which had been one of its distributors.[130] Despite Zenith's significant losses, the Seventh Circuit still found that whether good cause existed was a jury question that could not be resolved as a matter of law.[131] The test, as clarified by *Morley-Murphy*, remains the standard for when a grantor may have good cause through a systematic change, yet each element is teeming with nuance.

i. Objectively Ascertainable Need for Change

For a change to be "objectively ascertainable," the grantor must demonstrate that its proposed change is well supported by its own economic circumstances. The U.S. District Court for the Eastern District of Wisconsin's decision in *Builder's World, Inc. v. Marvin Lumber & Cedar, Inc.*[132] exemplifies the grantor's burden. There, Marvin Lumber sought to change its dealership network by adopting a dealer-direct sales model within Builder's World's exclusive territory in eastern Wisconsin.[133] Builder's World sought to enjoin Marvin Lumber from undertaking such an action because the change posed would significantly hamper its ability to sell Marvin Lumber products in the territory.[134] In turn, Marvin Lumber argued that it had good cause to undertake this change due some of its competitors eliminating their two-step distribution systems and selling direct to dealer and due to several large dealers seeking to purchase directly from Marvin Lumber.[135]

The federal district court rejected Marvin Lumber's argument. According to the court, Marvin Lumber presented no evidence that its dealers would turn to competitors' products if Marvin Lumber did not make the change.[136] Additionally, Marvin Lumber presented no evidence that, but for the proposed change, it would suffer financially.[137] Instead, as the court notes, Marvin

129. *Id.* at 378.
130. *Id.* at 374–75.
131. *Id.* at 378. The *Morley-Murphy* decision is most commonly referenced regarding its purported prohibition on the recovery of extraterritorial damages under the WFDL. *See, e.g.*, Brava Salon Specialists, LLC v. Swedish Haircare, Inc., No. 22-cv-695, 2023 WL 1795512, at *3 (W.D. Wis. Feb. 7, 2023); Track, Inc. v. ASH N. Am., Inc., No. 21-cv-786, 2023 WL 2733679, at *5 (W.D. Wis. Mar. 31, 2023); Brio Corp. v. Meccano S.N., 690 F. Supp. 2d 731, 745 n.5 (E.D. Wis. 2010); Generac Corp. v. Caterpillar, Inc., 172 F.3d 971, 976 (7th Cir. 1999). But the U.S. Supreme Court's recent decision in *National Pork Producers Council v. Ross*, 143 S. Ct. 1142 (2023) triggers reconsideration of that premise. *See* Jeffrey A. Mandell & Isaac S. Brodkey, *Recent U.S. Supreme Court Decision Shows That the Dormant Commerce Clause Does Not Preclude Wisconsin Fair Dealership Law Damages for Sales Beyond State Borders*, 2023 Wis. L. Rev. Forward 1 (2023).
132. Builder's World, Inc. v. Marvin Lumber & Cedar, Inc., 482 F. Supp. 2d 1065, 1075 (E.D. Wis. Apr. 3, 2007).
133. *Id.* at 1069.
134. *Id.*
135. *Id.* at 1074–75.
136. *Id.* at 1075.
137. *Id.*

FranchiseLaw_Vol43_No2_Spring24.indd 124 6/6/24 9:43 AM

Lumber's financial condition had never been better prior to its proposed changes, experiencing "record sales and record profits" in Builder's World's territory.[138] It follows that Marvin Lumber was unable to demonstrate that it had an objectively ascertainable need to implement its changes.[139]

A critical aspect of the *Marvin Lumber* decision is the inability of the grantor to show that it would suffer economic harm if prohibited from undertaking its proposed changes.[140] The importance of demonstrating as much has been repeatedly found to be a persuasive factor in assessing the legitimacy of a proposed change.[141] That said, significant economic harm is by no means the only way for a grantor to demonstrate that it is acting in response to a legitimate need for change. Judge Griesbach explained that "a grantor need not show that the change is necessary for the grantor's very survival as a business[; it] is enough if [the grantor] proves that the proposed [change] was a nondiscriminatory and proportionate means of allowing the company to stay competitive in its market."[142]

ii. Proportional Response

Naturally, the proportionality inquiry is closely linked to the determination of whether the grantor has an objectively ascertainable need for change. The most detailed discussion of the proportionality inquiry is found in the Seventh Circuit's decision in *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America*.[143] There, the Girl Scouts of Manitou Council sued the Girl Scouts of the United States of America (GSUSA) under the WFDL due to the national organization's proposed reduction of the council's territory.[144] GSUSA argued that it had good cause to undertake such changes under the systemic-change exception, arguing that it needed to compress its council structure to address "unfavorable trends [in] membership, brand image and program effectiveness."[145] The Seventh Circuit rejected its argument for failing to demonstrate an objective need for the proposed reduction and proportionality in response to that need.[146]

---

138. *Id.*

139. *Id.*

140. *Id.* at 1074–75.

141. *See, e.g.*, Morley-Murphy Co. v. Zenith Elecs. Corp., 142 F.3d 373, 375 (7th Cir. 1998); Brava Salon Specialists, LLC v. REF N. Am., Inc., 2023 WL 7709310 (W.D. Wis. Nov. 15, 2023) ("Absent some meaningful showing of actual, material harm to its sales, profitability or long-term economic health, defendant has made little effort to show either 'an objectively ascertainable need for change' or 'a proportionate response to that need.'").

142. Kaeser Compressors, Inc. v. Compressor & Pump Repair Servs., Inc., 832 F. Supp. 2d 984, 996 (E.D. Wis. 2011). In the summary judgment decision, Judge Griesbach noted that "[p]resumably a grantor could also cite a pressing economic opportunity it wants to seize." *See* Kaeser Compressors, Inc. v. Compressor & Pump Repair Servs., Inc., 781 F. Supp. 2d 819, 827 n.3 (E.D. Wis. 2011).

143. Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of Am., 549 F.3d 1079 (7th Cir. 2008).

144. *Id.* at 1084–85.

145. *Id.* 1099.

146. *Id.* at 1098–1100.

Regarding proportionality, the court noted that GSUSA sought to form fewer councils, "each with a larger size," but that, in the present circumstance, reducing the territory from the Manitou council will not change the number of councils in Wisconsin.[147] Instead of fewer, larger councils, as applied, GSUSA would have the "same number of local councils, at least one of which [Manitou] will have a reduced capacity."[148] Therefore, according to the court, if GSUSA's reason were taken at face value, its response to that need is inconsistent.[149]

The GSUSA decision teaches that a grantor's response must be carefully tailored to the objective need and the mere existence of a need cannot justify any response. Stated differently, a need for change is not carte blanche for a grantor to undertake any action it so chooses. This concept is well-rooted in *Ziegler II*, where the grantor was suffering economic loss from the current arrangement and, rather than fully terminate the relationship, sought to change the relationship to a "tight agency"; whether this change was proportionate to Rexnord's needs was a matter left up to the factfinder after trial.[150]

Unlike the modifications to an existing dealership as found in *Girl Scouts* and *Ziegler II*, the *Morley-Murphy* court faced the question whether the complete termination of a dealership network was proportionate to the grantor's worsening financial condition. The court ultimately found that whether the response was proportionate was a matter for the jury to decide. At first blush, the complete termination of a dealership network seems not to be a tailored, proportionate response, but the holding is tenable considering the overwhelmingly severe harm suffered by Morley-Murphy prior to its attempted overhaul.

iii. Nondiscriminatory Action

Much like the nondiscrimination element of the definitional-good-cause test, for the systemic-change exception to apply, a grantor must demonstrate that its proposed change is not discriminatory. That said, a grantor is not required to show that all of its dealers or distribution partners would experience an equal effect due to that change. Rather, the grantor is required to show that none of its dealers or distribution partners was singled out by the grantor's decision—either preferentially or uniquely disadvantaged as compared to others in the network. To that end, much can be learned from a series of federal cases that provide that "non-discriminatory, system-wide changes" may not trigger WFDL protection.

Consider the Seventh Circuit's discussion of the nondiscrimination principle in its *East Bay Running Store, Inc. v. NIKE, Inc.* decision.[151] There,

147. *Id.* at 1099.
148. *Id.*
149. *Id.*
150. Ziegler Co. v. Rexnord, Inc., 433 N.W.2d 8, 14 (Wis. 1988).
151. E. Bay Running Store, Inc. v. NIKE, Inc., 890 F.2d 996 (7th Cir. 1989). After nearly forty years in business, East Bay closed its doors in 2022, but left a lasting legacy. *See, e.g.*, Joseph Pisani, *Sneakerheads Mourn Eastbay, Whose Catalog Was the Bible of Athletic Shoes*, Wall St. J.

Nike informed East Bay (and all of Nike's other dealers) that Nike would no longer offer Nike Air products for resale by mail, catalog, or electronic means in an effort to ensure that end-consumers "receive personal individualized attention."[152] At the time, East Bay was overwhelmingly dependent on its mail-order sales operations—sales of Nike Air products accounted for twenty-nine percent of East Bay's total sales.[153] East Bay sued, alleging that Nike's purported change was a substantial change to its competitive circumstances, contrary to the WFDL.[154]

The court rejected East Bay's argument, finding that the record demonstrated that Nike implemented the policy for "all of its retailers in the United States on an across-the-board, system-wide, non-discriminatory fashion."[155] East Bay was neither terminated as a Nike dealer nor deprived of its ability to sell Nike Air products: East Bay could simply no longer market the product in its mailings and catalogs.[156] The court found no malicious intent or "ploy by Nike to appropriate the good will established by East Bay in marketing the Nike Air products in [the] region."[157] Instead, Nike simply wanted to reconfigure how a particular product line was sold.[158] Consequently, "[b]ased on the non-discriminatory nature of [Nike's] 'no mail-order' policy," the court found that the WFDL was not violated in the first instance, and thus the grantor was not obligated to prove good cause.[159] In subsequent years, courts have made similar findings,[160] although the authors doubt whether *East Bay* is consistent with the Wisconsin Supreme Court's *Jungbluth v. Hometown Inc.* decision[161]—and therefore whether the outcome would have been the same were the case litigated in state, rather than federal, court.

(Dec. 31, 2022), https://www.wsj.com/articles/sneakerheads-mourn-eastbay-whose-catalog-was-the-bible-of-athletic-shoes-11672511699; Dan Woike, *Commentary: Eastbay Catalog Memories: It's Where a Generation Went to Look at Sneakers—and Dream*, L.A. Times, (Feb. 14, 2019), https://www.latimes.com/fashion/la-ig-sneakers-memories-of-eastbay-catalog-20190214-story.html.

152. *East Bay*, 890 F.2d at 998.

153. *Id.*

154. *Id.* at 998–99.

155. *Id.* at 1000.

156. *Id.*

157. *Id.* at 1001.

158. As explained later, this was not a product line termination because Nike Air products remained available for sale. *See infra* Part III.B.

159. *East Bay*, 890 F.2d at 1001.

160. *See, e.g.*, Queen v. Wineinger, 2022 WL 3027004 (W.D. Wis. Aug. 1, 2022); Conrad's Sentry, Inc. v. Supervalu, Inc., 357 F. Supp. 2d 1086, 1098 (W.D. Wis. 2005).

161. Jungbluth v. Hometown Inc., 548 N.W.2d 519 (Wis. 1996). There, the parties' contract provided that the grantor may replace the dealer's fuel tank and remodel its service station. *Id.* at 525. The change proved to have a dramatic effect on the dealer's business, and, although justified under the contract, the court found that it was a substantial change to is competitive conditions, triggering the grantor's obligations to provide proper notice. *Id*. at 524. Before the no-mail order rule, East Bay derived twenty-nine percent of its sales from Nike Air products, and, if implemented, East Bay would lose much of that percentage. In a vacuum, that is a "substantial change to the competitive conditions," even if Nike was justified for implementing the change. The *East Bay* court conflated the adverse-treatment inquiry with the good-cause inquiry. The result is a divergent series of cases that do not track how substantial changes are treated by Wisconsin courts. *See also* Astleford Equip. Co. v. Navistar Int'l Transp. Corp., 632 N.W.2d 182 (Minn. 2001). *But see* Builder's World, Inc. v. Marvin Lumber & Cedar, Inc., 482

While *East Bay* holds that the WFDL is not implicated because there was no substantial change in the competitive conditions of the dealer, the decision also sheds light on how the nondiscrimination principle functions with respect to nationwide changes. East Bay was affected more severely than other dealers in the network, but, nevertheless, Nike did not discriminate against the dealer when it applied its no-mail order rule to its entire network.

B. *Market Withdrawal*

Ziegler II's determination that a grantor's own economic circumstances could constitute good cause for a particular action was partially sourced from a series of federal court decisions dealing with market withdrawal.[162] Conceptually, market withdrawal can be broken into two categories: (1) withdrawal from a marketplace, and (2) product-line terminations. What constitutes good cause in either circumstance is not subject to a defined test, like the systemic-change exception, but is not void of form. In both instances, a grantor must demonstrate an abandonment of a market position.

To date, there is no published Wisconsin state-court opinion on whether a market-withdrawal defense is viable under the WFDL, but the defense is well-established in the Seventh Circuit and elsewhere. In *St. Joseph Equipment v. Massey-Ferguson, Inc.*,[163] the U.S. District Court for the Western District of Wisconsin was tasked with determining whether a grantor's decision to withdraw from the construction-machinery market in North America was a violation of the WFDL.[164] In answering this question, the court presented a series of rhetorical questions:

> Is a company with a poorly-selling product compelled to keep making and/or selling it, even at a loss, because s 135.03 won't permit it to drop the product? Must a company desirous of withdrawing from a particular geographic market—the entire North American continent, for example—continue operating in that market, even at a loss, because the effect of such a withdrawal on dealerships would be impermissible under the Act? Because the Act's prohibitions extend also to non-renewals, would a company in the above situations be compelled to renew dealerships in perpetuity or until its ultimate financial ruin? Should dealers such as the plaintiff be permitted to extract damage awards from corporate grantors simply because those grantors have become victims of a business downturn?[165]

According to the court, answering any of these questions affirmatively "would surely be to let the tail wag the dog" and "[m]ore seriously, it has the potential to precipitate some formidable constitutional questions."[166] The court further explained that it would be inconsistent with the statute's purposes for

F. Supp. 2d 1065, 1074–75 (E.D. Wis. 2007) (addressing whether a substantial change occurred separately from whether a grantor was justified in implementing a systemwide change).

162. For a detailed discussion of the pre-*Ziegler II* market-withdrawal cases, see Ann Hurwitz, *Franchisor Market Withdrawal: "Good Cause" for Termination?*, 7 Franchise L.J. 3 (1987).

163. St. Joseph Equip. v. Massey-Ferguson, Inc., 546 F. Supp. 1245 (W.D. Wis. 1982).

164. *Id.* at 1246.

165. *Id.* at 1247–48.

166. *Id.* at 1248.

"fair business relations" or the "'continuation of dealerships on a fair basis' to force a grantor to endure substantial financial loss to enable a dealer to continue selling certain products."[167] And, while the WFDL's underlying purposes govern where a grantor's motivations for termination are larger than a question of performance, the court concluded that "where . . . a grantor makes a nondiscriminatory product withdrawal over a large geographic area, that, without more, is not a violation of the WFDL."[168] Accordingly, while the court found that the grantor's decision to withdraw from the market was not a violation of the WFDL, notably, the court held the statute still required proper notice.[169]

The Seventh Circuit's *Kealey Pharmacy & Home Care Services, Inc. v. Walgreen Co.*[170] decision is sometimes cited for the premise that there is no market-withdrawal defense under the WFDL. While the *Kealey Pharmacy* court notes that the defense is not provided for in the statute, it is important to evaluate the court's holding in context. There, Walgreen was not withdrawing from the marketplace, but instead sought to "maintain and increase its own stores in the same marketing area in competition with plaintiffs who helped build up the Walgreen reputation and image" in the market.[171] The court found no basis in Wisconsin law that would allow for the "withdrawal from a geographic marketing area *such as undertaken by Walgreen*."[172] Later, in *Remus*, Judge Posner noted that "Walgreen . . . was trying to eliminate the dealers who had built its reputation in Wisconsin, so that it could open its own stores and appropriate the goodwill that the dealers had created," which is "just the sort of conduct that the Wisconsin legislature had wanted to prevent."[173] Thus, it seems reasonable to interpret the *Kealey Pharmacy* holding as the Seventh Circuit snuffing out a grantor attempting to supplant its dealership network with company-owned stores under a market-withdrawal argument, opposed to conclusively holding that there cannot be a market-withdrawal exception.

As for product lines, in *Lee Beverage Co. v. I.S.C. Wines of California, Inc.*,[174] a grantor's discontinuation of certain product lines was found to be good cause.[175] There, Lee Beverage distributed alcoholic beverages for United Vinters, Inc., which decided to sell certain product lines to I.S.C.[176] In turn, I.S.C. decided to bid the distribution rights for those products out to other distributors.[177] Lee Beverage sued, alleging that United Vinters unlawfully

167. *Id.*
168. *Id.*
169. *Id.* at 1250.
170. Kealey Pharmacy & Home Care Servs., Inc. v. Walgreen Co., 761 F.2d 345 (7th Cir. 1985).
171. *Id.* at 350.
172. *Id.*
173. Remus v. Amoco Oil Co., 794 F.2d 1238, 1241 (7th Cir.1986).
174. Lee Beverage Co. v. I.S.C. Wines of Cal., Inc., 623 F. Supp. 867 (E.D. Wis. 1985).
175. *Id.* at 871.
176. *Id.* at 868.
177. *Id.*

terminated the parties' agreement, and, in response, United Vinters claimed good cause.[178] The U.S. District Court for the Eastern District of Wisconsin sided with United Vinters, finding that good cause may exist "where the profitability of wide-scale sales of a product line has sunk to such a point that a sale or discontinuation of the product line is justified for the good of the corporation."[179] Despite being justified under the WFDL to drop the product line, the grantor still violated the WFDL by failing to provide proper notice.[180]

While both of these exceptions are underdeveloped, each reflects the fundamental principles underlying any grantor-based good cause: the WFDL cannot be interpreted to require that a grantor perpetually maintain its presence in a marketplace. Rather, the WFDL places requirements on grantors when they enter a marketplace and utilize dealers to distribute goods and services to consumers therein. Principal to these protections is preventing a grantor from terminating a dealer and appropriating the goodwill and market created by the dealer. But, where a grantor desires to completely leave a given market or cease selling a product altogether, no misappropriation has occurred, and thus the WFDL cannot be used as a trap to freeze a grantor into an unproductive relationship forever.

IV. Conclusion

The Wisconsin Fair Dealership Law was enacted to "promote the compelling public interest in fair business relations between dealers and grantors, and in the continuation of dealerships on a fair basis."[181] That is precisely the balance struck by the good-cause requirement, protecting dealers from unfair treatment while not handcuffing grantors to unsuccessful dealers.[182] Despite the abundant case law on the issue, whether good cause exists in a particular circumstance is rarely an easy determination and turns heavily on the facts of a particular action.

178. *Id.*
179. *Id.* at 869.
180. *Id.* at 871.
181. Wis. Stat. § 135.025(2)(a).
182. Jeffrey A. Mandell & Isaac S. Brodkey, *Wisconsin Fair Dealership Law Turns 50: Developments Lawyers Should Know*, 97 Wis. Law. 10, 16–18 (Mar. 2024).

Franchise Agreement Provisions That Can Make or Break a Court Case

*Thomas A. Telesca, Rachel A. Morgenstern & Briana A. Enck-Smith**

Mr. Telesca

Ms. Morgenstern

Ms. Enck-Smith

I. Introduction

The franchise agreement is ultimately at the core of every franchising dispute. Franchisees allege that the agreements are known for "highly technical and confusing language."[1] Meanwhile, courts have observed that even a seemingly "plain vanilla" franchise agreement may lead the parties down a "Rocky Road of federal litigation."[2] An ideal franchise agreement should balance the disclosures and mechanisms required to protect the franchisee, on the one hand, with the franchisor's need to protect its system and intellectual property from misuse, on the other.[3] Some courts have wrestled with interpreting and applying franchise agreements by contending that they "are not as likely to be scrutinized by less sophisticated people, whose judgment

1. Depianti v. Jan-Pro Franchising Int'l, Inc., 39 F. Supp. 3d 112, 140 (D. Mass. 2014), *aff'd*, 873 F.3d 21 (1st Cir. 2017).
2. Fowler v. Cold Stone Creamery, Inc., No. CA 13-662 S, 2013 WL 6181817, at *1 (D.R.I. Nov. 25, 2013).
3. Deanna Cook, *Preparation of the Franchise Disclosure Document*, *in* 2 Advising Small Businesses § 30:6 (2023).

**Thomas A. Telesca (ttelesca@rmfpc.com) is a partner and Rachel A. Morgenstern (rmorgenstern@rmfpc.com) and Briana A. Enck-Smith (benck-smith@rmfpc.com) are Associates at Ruskin Moscou Faltischek, P.C. in Uniondale, New York.* *The authors would like to acknowledge the assistance and contributions of Tyla Phillip and Jacqueline Fink, both of whom were Summer Associates at Ruskin Moscou Faltischek, P.C.*

may be compromised in the face of aggressive salesmanship."[4] When disputes arise, "accusations fly in both directions, with each side squawking that the other misrepresented key information."[5] When these disputes result in litigation,[6] certain franchise agreement provisions emerge to play a critical role in resolving the parties' differences.

This article surveys contract provisions that often play a central role in franchise litigation. To contextualize these provisions, the Part II briefly discusses the history of franchise law, including the interplay of federal and state law. Part III identifies provisions common to franchise disputes and analyzes how those provisions impact outcomes, including when they conflict with federal and state law.

II. The Interplay of State and Federal Franchising Law

The history of franchising in the United States dates back to the 1800s, with Isaac Singer's invention of the sewing machine.[7] Its expansion in the 1900s ultimately led the Federal Trade Commission (FTC) to regulate the disclosures made by franchisors to prospective franchisees.[8] In 1979, the FTC promulgated the "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures,"[9] more commonly known as the "Franchise Rule."[10]

In connection with any offer or sale of a franchise, franchisors must satisfy the Franchise Rule by providing the franchisee with a Franchise Disclosure Document (FDD),[11] which "is a document containing certain specified disclosures."[12] The Franchise Rule and its concomitant FDDs are designed "to prevent 'widespread deception in the sale of franchises and business opportunities through both material misrepresentations and nondisclosures of material facts [and] to ensure that prospective franchisees are not deceived

4. EV Scarsdale Corp. v. Engel & Voelkers N.E. LLC, 48 Misc. 3d 1019, 1037 (N.Y. Sup. Ct. 2015).

5. Cluck-U Chicken, Inc. v. Cluck-U Corp., 358 F. Supp. 3d 1295, 1305 (M.D. Fla. 2017).

6. For purposes of this article, the authors may use the word litigate but intend it also to capture arbitrate as many franchise agreements require disputes to be resolved through arbitration.

7. Jesse A. Berg, *The Growth of Franchising*, 3 Health L. Prac. Guide § 43:1 (2023).

8. *Id.*; Kenneth F. Darrow, *Registration of Franchises*, *in* Franchise L. & Prac. 11-1, 11-3 (1996).

9. Days Inn of Am. Franchising, Inc. v. Windham, 699 F. Supp. 1581, 1582–83 (N.D. Ga. 1988) (citing 16 C.F.R. §§ 436.1–436.11).

10. A Love of Food I, LLC v. Maoz Vegetarian USA, Inc., 70 F. Supp. 3d 376, 382 (D.D.C. 2014) (citing 62B Am. Jur. 2 *Private Franchise Contracts* § 26 (2d ed. 2014)).

11. Since July 1, 2007, franchisors could comply with the FTC's disclosure requirements by using any one of the following formats: (1) the original Franchise Rule; (2) the Uniform Franchise Offering Circular (UFOC); or (3) the amended Franchise Rule. "Once a franchisor selects a disclosure format, it must use that format and no other. As of July 1, 2008, however, all franchisors must use only the amended Franchise Rule." Fed. Trade Comm'n, *Introduction* to Franchise Rule Compliance Guide (2008), https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf.

12. Hanley v. Drs. Express Franchising, LLC, No. ELH-12-795, 2013 WL 690521, at *2 (D. Md. Feb. 25, 2013).

FranchiseLaw_Vol43_No2_Spring24.indd 132 6/6/24 9:43 AM

about the quality of the franchise relationship before they commit to buying a franchise.'"[13]

Generally, an FDD must contain "all material information necessary for [the franchisee] to make informed investment decisions."[14] It is "a prospectus that a franchisor is required by law to provide to potential franchisees"[15] containing "essential, reliable information,"[16] such as "the franchisor's corporate history and current financial condition, the track record of any other franchises, and the background of the franchisor's principal officers."[17] To that end, the Franchise Rule requires every FDD to disclose twenty-three items covering the following topics: the franchisor and any parents, predecessors or affiliates; business experience; litigation; bankruptcy; initial fees; other fees; estimated initial investment; restrictions on sources of products and services; franchisee's obligations; franchisor's assistance, advertising, computer systems and training; territory; trademark; patents, copyrights, and proprietary information; obligation to participate in the actual operation of the franchise business; restrictions on what the franchisee may sell; renewal, termination, transfer, and dispute resolution; public figures; financial performance representations; outlets and franchise information; financial statements; contracts; and receipts.[18] In other words, FDDs contain additional disclosures about certain franchise agreement provisions discussed later in this article.

The Franchise Rule serves as a floor for regulation, meaning that individual states and local governments can enact regulations "afford[ing] prospective franchisees equal or greater protection."[19] The Franchise Rule only preempts the franchise practices or laws of any state or local government to the extent that they are inconsistent with the Franchise Rule.[20] For example, the New York Franchise Sales Act's expansive framework to determine whether an entity is a franchisor has been described by commentators as a "left field" approach.[21] That Act defines a franchise by only two rather than the more traditional three elements: (i) a trademark *or* marketing plan described substantially by the franchisor and (ii) a franchise fee.[22]

State laws are of paramount importance because the franchisor's failure to comply with any of the requirements set forth by the Franchise Rule

13. Robinson v. Wingate Inns Int'l, Inc., No. 13-CV-2468 (CCC), 2013 WL 6860723, at *1 (D.N.J. Dec. 20, 2013) (quoting Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, 15445, 15448 (Mar. 30, 2007) (codified at 16 C.F.R. pts. 436, 437)).

14. David J. Kaufman, *An Overview of the Business and Law of Franchising*, Aspatore, 2013 WL 3773409, at *7 (June 2013).

15. Coraud LLC v. Kidville Franchise Co., LLC, 109 F. Supp. 3d 615, 618 (S.D.N.Y. 2015).

16. A Love of Food I, LLC v. Maoz Vegetarian USA, Inc., 70 F. Supp. 3d 376, 382 (D.D.C. 2014).

17. *Id.*

18. Fed. Trade Comm'n, *supra* note 11, at 29–119.

19. Patel v. 7-Eleven, Inc., 183 N.E.3d 398, 409 (Mass. 2022) (quoting 16 C.F.R. § 436.10(b)).

20. *Id.*

21. Rupert M. Barkoff, *New York Franchise Act: Out in Left Field*, N.Y.L.J. (May 1, 2012), https://www.law.com/newyorklawjournal/almID/1202550706155.

22. NY. Gen. Bus. Law § 681.

does not give rise to a private cause of action.[23] Moreover, many states have enacted laws that govern ongoing aspects of the franchise relationship. For example, under the New Jersey Franchise Practice Act, franchisors cannot terminate or refuse to renew the franchise agreement where the franchisee has substantially complied with the franchise agreement.[24] Courts have interpreted this law to entitle franchisees that qualify for its protection to an "infinite franchise" so long as they substantially comply with the terms of the agreement.[25] In this way, the interplay of franchise agreement provisions with federal and state franchise laws becomes key.

III. Critical Provisions of Typical Franchise Agreements That Impact Litigation

Below are a number of key provisions that often become the focus of litigation between franchisees and franchisors. By no means is this list exhaustive, but these are the provisions that parties often ignore at their peril. They appear in order of the typical life cycle of a franchise relationship.

A. *Disclaimers*

Disclaimers in a franchise agreement may negate reliance on alleged disclosures and representations made by a franchisor before execution of a franchise agreement. Disclaimers typically come in the form of an integration or merger clause, a "no oral representation" clause, or both.

Contractual disclaimers are important because "'the law necessarily presumes that parties to a contract have read and understood its contents' and that they have 'respect[ed] the gravity inherent in the contracting process and carefully review[ed] a contract to ensure that material representations are expressed in the instrument.'"[26] In *MTR Capital, LLC v. LaVida Massage Franchise Development, Inc.*, a Columbian engineer and his wife sought to invest in a LaVida franchise through their company MTR Capital, LLC (MTR) with the hope of simultaneously satisfying an investment requirement of an E-2 visa condition.[27] The franchisee's owners claimed that they did not read the franchise agreement carefully enough to understand it and did not hire an attorney in connection with its due diligence.[28] Less than two years after the franchise opened, MTR closed the location due to poor performance and sought to recover its entire investment, which amounted

23. W. Valley KB Venture, LLC v. ILKB LLC, No. 20-CV-3278 (JS) (AYS), 2021 WL 4171918, at *7 (E.D.N.Y. Sept. 13, 2021).
24. Dunkin' Donuts of Am., Inc. v. Middletown Donut Corp., 495 A.2d 66, 73 (N.J. 1985) (citing N.J. Stat. Ann. § 56:10-5).
25. *Id.* at 76.
26. MTR Cap., LLC v. LaVida Massage Franchise Dev., Inc., No. 17-CV-13552-TGB, 2020 WL 6536954, at *8 (E.D. Mich. Nov. 6, 2020) (quoting Billington v. Ginn-La Pine Island, Ltd., LLLP, 192 So. 3d 77, 84 (Fla. Dist. Ct. App. 2016)).
27. *Id.* at *4.
28. *Id.*

FranchiseLaw_Vol43_No2_Spring24.indd 134 6/6/24 9:43 AM

to $541,644.82 in start-up/build out costs, ongoing operating costs, and salaries.[29] MTR claimed that it relied on a financial performance spreadsheet provided to MTR before it signed the franchise agreement and on certain alleged misrepresentations in the FDD, among other things, to assert claims for fraudulent and negligent misrepresentations and violation of the Florida Deceptive and Unfair Trade Practices Act (FDUTPA).[30]

The U.S. District Court for Eastern District of Michigan, applying Florida law, presumed that the franchisee read the franchise agreement's disclaimer and that no "projections or representations regarding the amount of income" the franchisee could expect to earn had been given to the franchisee.[31] The court ruled, therefore, that the specific disclaimers contained in the franchise agreement negated any reliance on the alleged financial performance spreadsheet and related misrepresentations, which barred such claims.[32] But the franchise agreement disclaimer did not bar the franchisee's claims arising out of alleged deficiencies in the FDD. The court held that the franchisor failed to disclose the closing of five locations in a four-month span in the FDD, which constituted a violation under FDUPTA.[33]

Similarly, in *Coraud LLC v. Kidville Franchise Co., LLC*, the U.S. District Court for the Southern District of New York, relying on a New York state appellate court decision in *Emfore Corp. v. Blimpie Associates, Ltd.*, held that specific disclaimers in a franchise agreement barred common law fraud claims, but not claims under the New York Franchise Sales Act (NYFA).[34] However, a year before *Coraud*, another judge in the same court came to a different result in *Governara v. 7-Eleven, Inc.* and held that a disclaimer could bar claims under NYFA.[35]

Both *Coraud* and *Governara* focus on the anti-waiver language in section 687 of NYFA. Specifically, under section 687(4), "[a]ny condition, stipulation, or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law, . . . shall be void."[36] Section 687(5) provides that "[i]t is unlawful to require franchisee to assent to a release, assignment, novation, waiver or estoppel which would relieve a person from any duty or liability imposed by this article."[37]

29. *Id.* at *1.

30. *Id.*

31. *Id.* at *7.

32. *Id.* at *4.

33. *Id.* at *12. It is noteworthy that a claim under FDUPTA did not require the franchisee to prove reliance. *Id.* In addition, the court only awarded MTR $39,000 in damages, which was in effect a return of the franchise fee because that was the only expense incurred prior to signing the franchise agreement. *Id.*

34. Coraud LLC v. Kidville Franchise Co., LLC, 109 F. Supp. 3d 615, 620 (S.D.N.Y. 2015) (explaining that "potential volume, sales, income, or profits" was sufficiently specific to bar plaintiff's claim of reliance except under the NYFA which prohibits disclaimers (citing Emfore Corp. v. Blimpie Assocs., Ltd., 51 A.D. 3d 434 (N.Y. App. Div. 2008))).

35. Governara v. 7-Eleven, Inc., No. 13-CV-6094 (LAP), 2014 WL 4476534, at *5–6 (S.D.N.Y. June 12, 2015).

36. N.Y. Gen. Bus. Law § 687(4).

37. *Id.* § 687(5).

The court in *Governara* was not persuaded by the reasoning in *Emfore* interpreting section 687(5), which it criticized for relying on the waiver analysis of a third case interpreting an inapplicable landlord tenant statute.[38] The plaintiff in the landlord tenant matter had alleged that she was coerced into signing a lease and rider in which she disclaimed the use of her rent-stabilized apartment as a primary residence and, thus, the landlord could increase her rent.[39] The court in the landlord tenant matter held that, by signing the disclaimer, the plaintiff had waived an explicit benefit conferred upon her in the rent stabilization code.[40]

The court in *Governara* found that NYFA did "not give franchisees the statutory right to purchase a franchise *while relying on verbal representations outside of a written contract*, [and, thus,] the [franchise agreement's] non-reliance disclaimer is not proscribed per se by the [NYFA]."[41] The plaintiffs in *Governara*, according to the court, did not "allege that they were compelled or 'require[d] . . . to assent to a release, assignment, novation, waiver or estoppel."[42] The *Governara* court was concerned that *Emfore* would have a chilling effect on one of the goals of NYFA to "help franchisors 'root out dishonest sales personnel and avoid sales secured by fraud . . . .'"[43] In other words, franchisees would not have to carefully review the disclaimers if such disclaimers were not enforceable.

A year later in *Coraud*, the court declined to follow *Governara*.[44] The *Coraud* court focused on the language of section 687(4) rather than subsection (5), which it found clearly prohibits "waivers of 'compliance with any provision' of [NYFA]," which "makes it 'unlawful for a person, in connection with the offer, sale or purchase of a franchise,' to make a fraudulent statement."[45] According to the *Coraud* court, if *Governara* is followed, then section 687(4) would be eviscerated.[46]

The holding in *Coraud* is in line with a new policy statement by the North American Securities Administrators Association (NASAA), effective January 1, 2023, which prohibits the use of waivers or disclaimers of any rights under federal or state law.[47] While NASAA's policy statements are not binding, they usually are given considerable deference by states that regulate franchising.

38. *Governara*, 2014 WL 4476534, at *6 (citing Draper v. Georgia Props., Inc., 230 A.D. 2d 455, 455 (N.Y. App. Div. 1997).

39. *Id*.

40. *Id*. (citing *Draper*, 230 A.D. 2d at 458).

41. *Id*.

42. *Id*.

43. *Id*. at *7 (quoting Emfore Corp. v. Blimpie Assocs., Ltd., 51 A.D. 3d 434, 435 (N.Y. App. Div. 2008)).

44. Coraud LLC v. Kidville Franchise Co., LLC, 109 F. Supp. 3d 615, 621 (S.D.N.Y. 2015).

45. *Id*.

46. *Id*.

47. *See* N. Am. Sec. Adm'rs Ass'n, NASAA Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments, https://www.nasaa.org/wp-content/uploads/2022/09/NASAA-Franchise-Questionnaires-and-Acknowledgments-Statement-of-Policy-9-18-2022.pdf.

FranchiseLaw_Vol43_No2_Spring24.indd 136 6/6/24 9:43 AM

A franchisee's failure to conduct sufficient due diligence before entering into a franchise agreement may result in it losing a substantial part of its investment because of the enforceability of specific disclaimers in a franchise agreement. It bears emphasis that the disclaimers must be specific and not of a general nature to avoid a misrepresentation claim, and, even still, a well-drafted disclaimer may be ineffective against a claim bought under a state relationship law that invalidates disclaimers.

B. *Territorial Rights*

Territorial rights are a crucial element of any franchise agreement. "Encroachment" describes disputes where the franchisee alleges a significant decline in sales as a result of other franchisees or the franchisor operating in the same market area.[48] From a franchisor's perspective, opening a new location is within its rights, particularly if the franchise agreement does not grant the franchisee territorial exclusivity.[49] From a franchisee's perspective, encroachment limits the earning potential of the franchisee's already existing location.[50] So long as the franchise agreement does not grant any territorial exclusivity, courts acknowledge that the case law on encroachment is "friendlier" to franchisors than franchisees.[51]

For example, in *Barnes v. Burger King Corp.*, the U.S. District Court for the Southern District of Florida barred an encroachment claim under the covenant of good faith and fair dealing because the franchise agreement expressly allowed the franchisor to open another franchise in the vicinity of the franchisee.[52]

Similarly, in *Davis v. McDonald's Corp.*, the franchisee made a series of encroachment-related claims, including breach of contract, breach of the covenant of good faith and fair dealing, and fraud.[53] Although the franchisee conceded that the franchise agreement itself did not afford rights to any specific "customer base" or "market area," it argued that it had a "commercially reasonable expectation" that McDonald's would not act to substantially impact sales at its restaurants through the development of new stores and that one of McDonald's own policy documents prohibited this form of encroachment.[54] The U.S. District Court for the Northern District of Florida, applying Illinois law, disagreed and found that the relationship was governed by the express terms of the franchise agreement and that the policy document was not applicable because an integration clause within the

48. Davis v. McDonald's Corp., 44 F. Supp. 2d 1251, 1255 (N.D. Fla. 1998).
49. Michael H. Seid, *Encroachment – The Issues and Solutions*, MSA Worldwide (2011), https://www.msaworldwide.com/Encroachment-issues-point-counterpoint.pdf.
50. *Id*.
51. Kazi v. KFC US, LLC, No. 19-CV-03300 (RBJ), 2020 WL 6680361, at *8 (D. Colo. Nov. 12, 2020).
52. Barnes v. Burger King Corp., 932 F. Supp. 1420, 1438 (S.D. Fla. 1996).
53. *Davis*, 44 F. Supp. 2d at 1256.
54. *Id*.

franchise agreement made clear that the policy was not incorporated therein. Accordingly, the court granted summary judgment in McDonald's favor.[55]

The court cautioned, however, that if McDonald's had opened right next door it "might so completely frustrate the purpose of the franchise agreement" to warrant a contract claim.[56] The court also denied summary judgment as to claims of misrepresentations made after the franchise was formed. These "post-formation" misrepresentations, it held, could be actionable under state law, "as long as the franchisor possessed superior knowledge of the underlying facts."[57] The court reasoned that, even though the franchisee did not have any protection from encroachment under the franchise agreement, it "may nonetheless have reasonably relied on misrepresentations about future impact when deciding" to invest in its own restaurants.[58]

Indeed, the Ninth Circuit in *In re Vylene Enterprises, Inc.*, found that the franchisor who opened a restaurant within a mile and a half of the franchisee's location breached the covenant of good faith and fair dealing.[59] In doing so, it reasoned that the franchisee "*although not entitled to an exclusive territory*, was still entitled to expect that the franchisor would 'not act to destroy the right of the franchisee to enjoy the fruits of the contract."[60]

In a recent case, *Kazi v. KFC US, LLC*, the U.S. District Court for the District of Colorado dismissed the franchisee's contract-based encroachment claim because the new franchise granted by the franchisor was not within the franchisee's protected territory under the franchise agreement.[61] But the court denied the franchisor's motion to dismiss the franchisee's claim for a breach of the covenant of good faith and fair dealing.[62] The district court held that the franchisor when applying its own guidelines regarding expansion had to exercise its "discretion reasonably and not inconsistently with the parties' reasonable expectations."[63] After the district court similarly denied the franchisor's motion for summary judgment, the franchisee prevailed on its breach of good faith and fair dealing claim at trial. On appeal, the Tenth Circuit reasoned that "[t]he cases in other circuits involving similar franchise arrangements strongly support the proposition that if the franchise agreement addresses encroachment, the franchisee cannot invoke the good-faith covenant to expand its protection against encroachment beyond the contract terms."[64] The court distinguished *Vylene*, on which the franchisee's argument

55. *Id.* at 1256–59.
56. *Id.* at 1259.
57. *Id.* at 1261.
58. *Id.*
59. Vylene Enters., Inc. v. Naugles, Inc. (*In re* Vylene Enters., Inc.), 90 F.3d 1472, 1477 (9th Cir. 1996).
60. *Id.*
61. Kazi v. KFC US, LLC, No. 19-CV-03300 (RBJ), 2020 WL 6680361, at *8 (D. Colo. Nov. 12, 2020).
62. *Id.* at *6.
63. *Id.* at *8.
64. Kazi v. KFC US, LLC, 76 F.4th 993, 1004 (10th Cir. 2023).

FranchiseLaw_Vol43_No2_Spring24.indd 138 6/6/24 9:43 AM

heavily relied, as an outlier.[65] Because the franchisor had full discretion to franchise a new restaurant outside the franchisee's exclusive area and the duty of good faith and fair dealing did not confine that discretion, the Tenth Circuit reversed the jury's decision and remanded the matter to the district court to enter judgment in the franchisor's favor.[66]

In other instances, state statutes may protect against encroachment. For example, in *WMW, Inc. v. American Honda Motor Co., Inc.*, a dispute arose regarding the definition of the protected "relevant market area" for a corporate motor vehicle dealership.[67] The dealership WMW, Inc. brought an action against the franchisor and prospective franchised dealership, seeking injunctive relief on the grounds that the proposed dealership would overlap with WMW's "relevant market area" in violation of an anti-encroachment provision of the Georgia Motor Vehicle Franchise Practices Act.[68] The Supreme Court of Georgia held that, under the act, "a corporate dealership's 'relevant market area,'" defined as the area for which the dealer has standing to resist competition by a new or relocated dealership of the same franchisor, is the area located within an eight-mile radius of where a dealer qualified as such because it is "engaged in the business of selling . . . new motor vehicles" sells those vehicles, or where a dealer qualified as such because it "engages exclusively in the repair of motor vehicles."[69] Because the location that WMW asserted was the "relevant market area" was not where it sold new motor vehicles or engaged exclusively in the repair of motor vehicles, the court held that WMW had no standing to challenge the new proposed dealership.[70]

Without a clear understanding of the franchisee's territory, the franchisee's entire investment could be in jeopardy or the franchisor may be precluded from expanding. To avoid litigating this issue after the relationship is well underway, the parties to a franchise agreement should leave no ambiguity with respect to the territory being franchised.

C. *Required Suppliers*

Another familiar franchising dispute arises out of provisions that require the franchisee to use one or more franchisor-approved suppliers, including suppliers with whom the franchisor has a relationship. This type of restriction, often referred to as an "approved supplier program," is "almost universally recognized as a lawful way for a franchisor to organize its purchasing and supply function."[71] Indeed, to protect their brands and systems, many

65. *Id.*
66. *Id.*
67. WMW, Inc. v. Am. Honda Motor Co., Inc., 733 S.E.2d 269, 271 (Ga. 2012).
68. *Id.* (citing GA Code § 10-1-622(13.1)).
69. *Id.*
70. *Id.*
71. Philip F. Zeidman, *May the Franchisee Be Required to Purchase Products from the Franchisor?—May the Franchisee Be Required to Purchase Products from Approved Suppliers?*, *in* Legal Aspects of Selling & Buying § 9:68 (3d ed. 2021).

FranchiseLaw_Vol43_No2_Spring24.indd 139 6/6/24 9:43 AM

franchisors will employ strict purchasing provisions, for example, by designating a specific supplier or by appointing themselves as the sole suppliers.[72] The designated supplier, moreover, may be affiliated with the franchisor, creating additional revenue for owners of the franchise system. As long as this arrangement is disclosed to the franchisee, it is generally permissible, even where the franchisor's mandated vendors sell products at "supracompetitive prices."[73]

In *Window World of Baton Rouge, LLC v. Window World, Inc.*, for instance, a group of franchisees brought claims alleging that the franchisor unfairly restricted them to a single vendor, whose prices were not competitive, in exchange for rebates or kickbacks.[74] The concern regarding such rebates or kickbacks is that, where the franchisor's "secret profit" therefrom is not disclosed, franchisees may "unwittingly overpay for the franchise itself."[75] The franchisees' antitrust claim was based on their contention that they did not know the franchisor would lock them into using a sole supplier until after they signed the franchise agreement. In dismissing that claim, the court reasoned that the franchise agreement provided that franchisees would "only and exclusively" use vendors approved by Window World.[76] Even though the franchise agreement did not expressly contemplate restriction to a single vendor, the franchisees were "on notice" that restriction to a single vendor was possible.[77]

Similarly, in *Siemer v. Quizno's Franchise Co. LLC*, six franchisees entered into franchise agreements with Quizno's that required them to purchase products and materials essential to operating the franchise from either Quizno's or Quizno's-approved vendors.[78] But the franchisees alleged that the vendor prices were "deliberately inflated by kickbacks."[79] In dismissing franchisees' antitrust and common law fraud claims, the U.S. District Court for the Northern District of Illinois held that the franchise agreement explicitly warned plaintiffs that Quizno's might "receive payments from suppliers on account of such suppliers' dealings with Franchisee and other franchisees and may use all amounts so received without restriction and for any purpose [Quizno's] and its affiliates deem appropriate."[80]

By contrast, in *Burda v. Wendy's International, Inc.*, the franchisee relied on softer contractual language to avoid dismissal of its claim for an unlawful

72. *Id.*
73. Collins v. Int'l Dairy Queen, Inc., 980 F. Supp. 1252, 1258 (M.D. Ga. 1997).
74. Window World of Baton Rouge, LLC v. Window World, Inc., No. 15-CV-1, 2016 WL 6242945, at *2–3 (N.C. Super. Ct. Oct. 25, 2016).
75. Deborah A. DeMott, *Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions*, 19 Del. J. Corp. L. 65, 88 (1994).
76. *Window World of Baton Rouge, LLC*, 2016 WL 6242945, at *10.
77. *Id.*
78. Siemer v. Quizno's Franchise Co. LLC, No. 07 C 2170, 2008 WL 904874, at *1 (N.D. Ill. Mar. 31, 2008).
79. *Id.* at *7.
80. *Id.*

FranchiseLaw_Vol43_No2_Spring24.indd 140 6/6/24 9:43 AM

tying arrangement in violation of antitrust laws.[81] Although the franchise agreement required franchisees to purchase supplies solely from franchisor-approved suppliers, the court highlighted that the same supplier provision provided a mechanism for franchisees to obtain approval of different suppliers.[82] The court held that such language created a fact question as to whether it was reasonably foreseeable that the franchisor would later approve a single supplier and denied the franchisor's motion to dismiss on those grounds.[83]

Although these kinds of franchisor-approved or sole-supplier restrictions will generally be upheld, franchisors should not impose them lightly. One commentator has noted that "[b]y approving a product for use by franchisees, the franchisor may expose itself to tort liability if the product proves defective."[84] Additionally, those who seek to enforce such restrictions must do so consistently, or the right to do so may be forfeited.[85]

D. *Sale or Transfer Rights*

Many franchisees want to ultimately exit the franchise relationship by selling their franchised business to a buyer approved by the franchisor under the terms of the parties' franchise agreement. Of course, there is nothing "inherently evil" about franchisor's reserving the right to approve franchisee transfers.[86] In fact, it has repeatedly been held that such clauses serve legitimate business purposes, as long as that approval is not withheld arbitrarily[87] and does not cause "unreasonable restraints on trade."[88] This right makes sense given the franchisor's interest in protecting its brand from harm caused by an unworthy franchisee.

Sometimes courts will parse the precise contractual language to decide whether to apply an objective or subjective standard to the franchisor's denial of the transfer. For example, in *Richter v. Dairy Queen of Southern Arizona, Inc.*, the contract in dispute provided that the franchisor may not unreasonably withhold its consent to an assignment or transfer but also stated, in a separate provision, that the company had a right to "insist that any proposed assignee be a person, in [Dairy Queen]'s judgment, qualified to provide active supervision" over the store.[89] After the franchisee prevailed at trial, the appellate court noted that the approval provisions conflicted in that the former provision is consistent with an objective standard but the latter right

81. Burda v. Wendy's Int'l, Inc., 659 F. Supp. 2d 928, 935–36 (S.D. Ohio 2009).

82. *Id.*

83. *Id.*

84. Zeidman, *supra* note 71, § 9:68 (citing Wise v. Ky. Fried Chicken Corp., 555 F. Supp. 991 (D.N.H. 1983)).

85. *Id.* (citing Terry v. Int'l Dairy Queen, Inc., 554 F. Supp. 1088 (N.D. Ind. 1983)).

86. Walner v. Baskin-Robbins Ice Cream Co., 514 F. Supp. 1028, 1030 (N.D. Tex. 1981) ("Case law indicates there is nothing inherently evil in the franchisor retaining the right to approve a resale of the franchise." (citation omitted)).

87. Hickman v. Am. Honda Motor Co., 982 F. Supp. 881, 884 (N.D. Ga. 1997), *aff'd*, 138 F.3d 958 (11th Cir. 1998).

88. *Walner*, 514 F. Supp. at 1030.

89. Richter v. Dairy Queen of So. Ariz., Inc., 643 P.2d 508, 509 (Ariz. Ct. App. 1982).

to withhold consent in the franchisor's sole judgment required a subjective examination into whether the franchisor acted in good faith.[90] The court ultimately avoided deciding the issue because the franchisor only argued that its decision had been objectively reasonable at trial and therefore waived the subjective argument on appeal.[91] The appellate court then affirmed the trial court's decision that the franchisor unreasonably withheld its consent to the assignment because the evidence established that the prospective assignees were "reputable and experienced business persons with a record of meeting their obligations."[92]

In circumstances where state statutes govern resale, those statutes may impose their own standard of review. New Jersey law, for instance, provides that the franchisor cannot "unreasonably" withhold its consent to the transfer of a franchise and that the remedy of specific performance is available should it do so.[93] The New Jersey courts apply an objective test pursuant to which consent is reasonably withheld if the proposed franchisee is "materially deficient."[94] Specifically, they consider the "character, financial ability, [and] business experience" of the proposed franchisee.[95]

Written notice of any transfer may also be required by the franchisor. Certain states have notice requirements which may be waived for non-compliance. For instance, under the franchise laws of Arkansas, Nebraska, and New Jersey, a franchisee must provide notice of a transfer within sixty days and the franchisor must respond within that time period.[96] In Hawaii, the time period is thirty days.[97] A franchisor may also condition the transfer on the payment of a fee.[98]

Franchisors often reserve a right of first refusal in connection with any franchisee transfer request, but state-specific laws may render those provisions unenforceable. In *Bob Zimmerman Ford, Inc. v. Midwest Automotive I, L.L.C.*, for instance, the Iowa Supreme Court held that the right of first refusal as to any transfer, purportedly reserved by the franchisor in the franchise agreement, was contrary to a specific state statute and, therefore, unenforceable.[99] By contrast, the Ninth Circuit, in another matter in which California law applied and no similar statutory restriction existed, granted a preliminary injunction in the franchisor's favor on the grounds that the franchisor possessed a right of first refusal as to the transfer of the franchisee's

90. *Id.* at 510.
91. *Id.*
92. *Id.*
93. VW Credit, Inc. v. Coast Auto. Grp., Ltd., 787 A.2d 951, 953 (N.J. Super. Ct. App. Div. 2002).
94. *Id.* at 958.
95. *Id.* at 959.
96. Ark. Code. Ann. § 4-72-205(b)(1); Neb. Rev. Stat. § 87-405; N.J. Stat. Ann. § 56.10-6.
97. Haw. Rev. Stat. Ann. § 482E-6(2)(I)(iv).
98. *See, e.g.*, Iowa Code. Ann. § 523H.5(3)(a)(b).
99. Bob Zimmerman Ford, Inc. v. Midwest Auto. I, L.L.C., 679 N.W.2d 606, 611 (Iowa 2004) (citing Iowa Code Ann. § 322A.12).

FranchiseLaw_Vol43_No2_Spring24.indd 142 6/6/24 9:43 AM

shares, and the franchisor was likely to succeed on the merits of its action to enforce that right.[100]

In *Priority Auto Group, Inc. v. Ford Motor Co.*, a prospective buyer of a motor vehicle dealership brought an action against a franchisor, alleging that the franchisor violated a Virginia statute and tortiously interfered with contract and business expectancy when the franchisor exercised its right of first refusal under the franchise agreement, preventing the prospective buyer from making the purchase.[101] The court held that "[u]nder Virginia law, when a defendant is 'engaged in the lawful exercise of [its] statutory and contractual rights which incidentally may have interfered with the [plaintiff's] private negotiations [, such conduct] is not actionable and will not support recovery for tortious interference with contractual relations.'"[102]

Both the franchisee and franchisor should consider the terms of any exit strategy if the relationship sours. A balance must be struck between the franchisee's right to exit and recoup part or all of its investment and the franchisor's right to protect its brand and continue to operate in that area.

E. *Renewal*

Franchise agreements typically have specific renewal provisions, which must be adhered to, to avoid litigation over whether the agreement has renewed. The provisions often require franchisees to pay a fee and sign the then-current franchise agreement, which may have different terms than the original agreement with respect to, for example, royalty rates and marketing fees. These provisions may also require franchisees to update or remodel the franchised business and to sign a general release. Put another way, the franchise agreement's renewal provision may provide the franchisor an opportunity to reset the franchise relationship.

For example, in *Robinson v. Charter Practices International, LLC*, the franchisee purchased a veterinary hospital franchise from Charter Practices International, LLC, while at the same time the franchisee owned and operated independent clinics that were not part of the franchise system.[103] The franchise agreement contained a non-competition clause, which the franchisor did not enforce during the term of the agreement.[104] When the franchisee sought to renew, the franchisor notified the franchisee of "its intent to enforce the non-competition provision in the renewal agreement, meaning the then-current form of the franchise agreement."[105] The franchisee "did not disinvest from the independent clinics and the parties did not execute a renewal agreement."[106] The franchisee sued in federal district court, claiming

100. Prudential Real Est. Affiliates, Inc. v. PPR Realty, Inc., 204 F.3d 867, 874 (9th Cir. 2000).
101. Priority Auto Group, Inc. v. Ford Motor Co., 757 F.3d 137, 138 (4th Cir. 2014).
102. *Id.* at 144.
103. Robinson v. Charter Pracs. Int'l, LLC, 696 F. App'x 226, 227–28 (9th Cir. 2017).
104. *Id.*
105. *Id.*
106. *Id.*

FranchiseLaw_Vol43_No2_Spring24.indd 143 6/6/24 9:43 AM

the franchisor improperly refused to renew the agreement.[107] The Ninth Circuit affirmed dismissal of the franchisee's claims. The court found that the franchisor did not breach the franchise agreement's renewal provision because the plain language of that provision permitted the franchisor to condition renewal on compliance with the non-competition provision that would be in the renewal agreement.[108] The court also found that the franchisor's waiver of the non-competition provision in the original agreement did not extend to the corollary provision in the renewal agreement.[109]

In *Terrier*, *LLC v. HCAFranchise Corp.*, the plaintiffs argued that the defendant breached the franchise agreement "by including substantially and materially different terms in the renewal contract."[110] Defendant countered, pointing to the express language of the existing franchise, which stated that the franchisor may "at [its] sole and absolute discretion, include substantially different terms than those contained in [the original Agreement]."[111] The court, citing to a similar case in the U.S. District Court for the Central District of California, enforced the franchise agreement by its plain terms.[112] Relying on the same case, the court also rejected the plaintiffs' attempt to argue that the defendant's "take or leave" approach violated the covenant of good faith and fair dealing.[113]

When nearing the end of the term of their franchise agreement, franchisees should not assume that they can simply renew on the same terms and conditions.

F. *Termination*

Most franchise agreements require, for at least some types of violations, that the franchisor provide the franchisee with notice and have a good cause basis before terminating them. For other breaches, the agreement may allow for immediate termination upon written notice. These provisions may be enhanced by state-specific statutory protections. For example, New York, New Jersey, Virginia, and Michigan, to name but a few states, define "good cause" as grounds for termination.[114] Some states like Arkansas and Wash-

107. *Id.*
108. *Id.*
109. *Id.*
110. Terrier, LLC v. HCAFranchise Corp., Case No. 22-cv-01325-GMN-EJY, 2022 WL 4280251, at *5–6 (D. Nev. Sept. 15, 2022).
111. *Id.*
112. *Id.* at *6 (citing W. L.A. Pizza, Inc. v. Domino's Pizza, Inc., No. 08-cv-07484, 2008 WL 11424181 (C.D. Cal. Feb. 26, 2008)).
113. *Id.* at *7.
114. *See* N.J. Stat. Ann. § 56:10-5 ("[G]ood cause for terminating, canceling, or failing to renew a franchise shall be limited to failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise."); N.Y. Gen. Bus. Law § 199-c (Good cause includes, but should not be limited to: "(a) The dealer's failure to comply with a substantive requirement of a franchise agreement; (b) The dealer's failure to act in good faith in carrying out the terms of the franchise; [and] (c) The distributor's failure to renew his lease of the service station premises, provided the distributor does not supply the service station with motor fuels for a period of one year after the expiration of the lease."); Va. Code Ann. § 13.1-564 ("It shall

FranchiseLaw_Vol43_No2_Spring24.indd 144 6/6/24 9:43 AM

ington also take this protection a step further and require the franchisor to reimburse the franchisee in limited instances upon termination.[115]

Although franchisors fail to comply with these contractual and statutory requirements at their peril, courts may be more lenient toward a technical notice deficiency than a franchisor's failure to establish a good cause basis for termination. For example, in *Dunkin' Donuts Franchised Restaurants LLC v. Strategic Venture Group, Inc.*, the franchisee argued that the franchisor failed to provide proper notice by filing a lawsuit against the franchisee before the statutory sixty-day notice period expired.[116] The U.S. District Court for the District of New Jersey characterized the franchisee's motion to dismiss as an argument that the dispute was not yet ripe until the notice period expired and rejected that argument on two grounds. First, the court noted that nothing in the New Jersey statute prohibited the franchisor from filing a lawsuit during the sixty-day notice period.[117] Second, in any event, the sixty-day notice period had expired by the time the court issued its ruling.[118] Importantly, the notice for termination set forth the basis for termination including, among other things, the franchisee's alleged "under-reporting of sales, failure to pay contractually mandated fees on those sales and evasion of payroll taxes," which was deemed a valid basis for termination, if proved.[119]

Relatedly, in *7-Eleven, Inc. v. Sodhi*, the court ruled against a franchisee's claim that the franchisor had violated New Jersey's franchise statute by issuing a defective termination notice because, according to the court, a subsequent notice corrected the first notice's alleged deficiencies.[120] The court similarly found unpersuasive the argument that the filing of a complaint before the expiration of the notice period was improper.[121] The court ultimately held that franchisor had a good cause reason to terminate the agreement when the franchisee failed to pay or withhold taxes.[122]

Like the language in imprecisely drafted franchise agreements, some state statutes may not define what constitutes cause for termination under them.

be unlawful for a franchisor to cancel a franchise without reasonable cause or to use undue influence to induce a franchisee to surrender any right given to him by any provision contained in the franchise."); Mich. Comp. Laws § 445.1527(c) ("Good cause shall include the failure of the franchisee to comply with any lawful provision of the franchise agreement and to cure such failure after being given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure."); *see* also 7-Eleven, Inc. v. CJ-Grand, LLC, 517 F. Supp. 3d 688, 693–94 (E.D. Mich. 2021) (analyzing "good cause" requirement).

115. *See* Ark. Code Ann. § 4-72-209 (requiring franchisor to repurchase franchisee's inventory, supplies, and equipment if the franchise agreement is terminated without good cause); Wash. Rev. Code Ann. § 19.100.180 (requiring franchisor to purchase limited inventory and supplies from franchisee at fair market value at time of termination for good cause).

116. Dunkin' Donuts Franchised Rests. LLC v. Strategic Venture Group, Inc., No. 07-1923 (SRC), 2007 WL 2332190, at *2 (D.N.J. Aug. 13, 2007).

117. *Id.*

118. *Id.*

119. *Id.*

120. 7-Eleven, Inc. v. Sodhi, No. CV-13-3715 (MAS) (JS), 2017 WL 466514, at *3 (D.N.J. Jan. 31, 2017).

121. *Id.*

122. *Id.*

The Virginia Retail Franchising Act (VFRA) prohibits a franchisor from terminating a franchise without "reasonable cause."[123] In *G.M. Garrett Realty, Inc. v. Century 21 Real Estate Corp.*, a federal jury found that the franchisor had failed to comply with the statute's reasonable cause requirement when it terminated the franchisee for failing to pay past due amounts owed, and the jury awarded the franchisee damages.[124] On appeal, the franchisor argued that the jury's finding was incorrect as a matter of law because the jury also found, and the franchisee had admitted, that it did owe some past due amounts at the time the agreement was terminated.[125] After noting that neither the statute nor any case law interpreting it expanded on the statute's causal definition, the Fourth Circuit held that the jury's verdict was not incorrect as a matter of law because the statute required a "reasonable" cause, which is not the same as any cause.[126] The court asserted that the failure to pay disputed fees may represent a cause for termination, but termination on that basis may not be, as the jury concluded, reasonable.[127]

Parties to a franchise agreement should pay careful attention to the specifics of termination clauses and any state statute that may govern them.

G. *Covenants Not to Compete*

Franchise agreements often contain restrictive covenants, especially non-competition covenants. Non-competition agreements typically prohibit a franchisee from operating or having an interest in another business similar to the franchised business during the term of the franchise agreement and then for a period following its termination within a certain radius of the franchised location(s). Courts seek to balance a franchisor's legitimate business interest in protecting its proprietary system and goodwill against overreaching restraints on trade which may deprive a franchisee or its employees from earning a living.

As with business purchase agreements, courts are more likely to enforce non-competition provisions in franchise agreements because of the exchange of goodwill. For example, in *Jiffy Lube International, Inc. v. Weiss Bros.*, the U.S. District Court for the District of New Jersey provided that "[c]ovenants ancillary to the sale of a business are accorded far more latitude" and

> [o]ne can view a franchise agreement, in part, as a conveyance of the franchisor's good will to the franchisee for the length of the franchise. When the franchise terminates, the good will is, metaphysically, reconveyed to the franchisor. A restrictive covenant, reasonably crafted, is necessary to protect the good will after that reconveyance.[128]

---

123. Va. Code Ann. § 13.1-564.
124. G.M. Garrett Realty, Inc. v. Century 21 Real Est. Corp., 17 F. App'x 169, 171 (4th Cir. 2001).
125. *Id.*
126. *Id.* at 172.
127. *Id.*
128. Jiffy Lube Int'l, Inc. v. Weiss Bros., 834 F. Supp. 683, 691 (D.N.J. 1993) (internal quotations and citation omitted).

Notwithstanding the greater latitude that may be given to non-competition provisions in a franchise agreement, these provisions are still analyzed under a reasonableness standard. In general, courts consider three main factors: (1) the legitimacy of the business interest sought to be protected; (2) the economic or undue hardship imposed on the franchisee; and (3) whether the restriction would be inimical to the public interest.[129]

To determine whether a non-competition provision furthers legitimate business interests, courts analyze whether the restrictions are reasonably necessary for the protection of confidential information, trade secrets, or business goodwill, such as the franchisor's reputation and customer base for the franchisor and other franchisees.[130] Additionally, courts consider the scope of the covenant to assess whether it is overly broad or reasonably limited to activity that would compete with the franchise.[131] For example, if a restrictive covenant pertains to a pizza business, the restrictive covenant should bar no more than Italian food restaurants.[132] Likewise, courts will look to the geographic scope of the covenant to make sure it is narrowly tailored to protecting the franchise's "goodwill and customer bases."[133] This means that the franchisor should consider population density when selecting the geographic scope of the non-competition provision.[134] The covenant must also be reasonable as to time, but the length of time considered "reasonable" varies by state. For instance, under Ohio and Missouri law, durations between one and three years are regularly upheld.[135]

The extent to which the franchisee relied on established goodwill or developed its own goodwill may also affect the enforcement of a non-competition covenant.[136] The greater the extent to which the franchisee relied on and benefitted from, for instance, existing goodwill, training, assistance and a protected territory, the more likely the court is to deem a non-competition agreement enforceable.[137] Moreover, where non-competition covenants serve to prohibit the use of proprietary or unique elements of a business, courts may be more likely to enforce them by way of injunctive relief.[138]

129. *See, e.g., id.*; *see also* Merry Maids Ltd. P'ship v. Kamara, 33 F. Supp. 2d 443, 446 (D. Md. 1998) (holding that a one-year, seventy-five mile non-compete would likely be found reasonable under Tennessee law for a housekeeping service business).

130. ReBath LLC v. New England Bath Inc., No. CV-16-01700-PHX-DLR, 2016 WL 8670165, at *3 (D. Ariz. July 15, 2016).

131. *Id.* at *4.

132. Singas Famous Pizza Brands Corp. v. N.Y. Advert. LLC, 468 F. App'x 43, 47 (2d Cir. 2012).

133. *Id.*

134. Golden Krust Patties, Inc. v. Bullock, 957 F. Supp. 2d 186, 199 (E.D.N.Y. 2013).

135. *See, e.g.*, Dealer Specialties, Inc. v. Car Data 24/7, Inc., No. 1:15-cv-170, 2016 WL 5341797, at *6 (S.D. Ohio Sept. 23, 2016); Gold v. Holiday Rent-A-Car Int'l, Inc., 627 F. Supp. 280, 282 (W.D. Mo. 1985).

136. 3 David M. Epstein, Eckstrom's Licensing in Foreign & Domestic Operations § 18:3.50 (2023).

137. Maaco Franchising, LLC v. Boensch, No. 3:16-cv-155-GCM, 2016 WL 4746215, at *5–6 (W.D.N.C. Sept. 12, 2016).

138. E.B.N. Enters., Inc. v. C.L. Creative Images, Inc., No. 09-cv-6279, 2011 WL 1131313, at *3 (N.D. Ill. Mar. 28, 2011).

Sometimes franchisors will include language in the franchise agreement requiring the franchisee to agree that the covenant's parameters are reasonable and that violation of the covenant would cause irreparable injury to the franchisor. Franchisees should be aware that such language might "be viewed as an admission" that the franchisor will suffer irreparable harm (and thus be entitled to injunctive relief).[139]

For example, in *Singas Famous Pizza Brands Corp. v. New York Advert. LLC*, the Second Circuit held that a two-year restrictive covenant that prohibited a former pizza store franchisee from engaging in an Italian food service business within ten miles of the franchised location was "reasonably calculated towards furthering [the franchisor's] legitimate interests in protecting its knowledge and reputation as well as its customer good will."[140] As part of its analysis, the court considered the fact that the franchisee expressly agreed in the underlying franchise agreement that the ten-mile geographic limitation was "fair and reasonable," "necessary for the protection of the proprietary interest of [the franchisor]," and that a "violation of [the restriction] would cause substantial and irreparable injury to [the franchisor]."[141]

Even where zealous drafting results in overly broad language that is unenforceable on its face, all may not be lost for the franchisor. In some states, courts will "blue pencil" the covenant to limit its application concerning its geographical area, period of enforceability, or scope of activity.[142] For example, in *Jiffy Lube*, the U.S. District Court for the District of New Jersey blue-penciled a restrictive covenant with a term of three years and a radius of ten miles from the franchised location by reducing it to a radius of five miles. The court explained that the ten-mile radius was excessive because "[m]ost car owners will stay close to their homes or workplaces when deciding where to service their vehicles."[143]

In *Golden Krust Patties, Inc. v. Bullock*, the U.S. District Court for the Eastern District of New York reduced a two-year non-competition agreement within ten miles from the franchised location to four miles.[144] The court based its decision on the densely populated nature of the New York metropolitan area and the franchisor's admission during oral argument that most consumers in that region will not travel ten miles (or even five miles) to a fast-food establishment.[145]

In another example, in *Outdoor Lighting Perspectives Franchising, Inc. v. Home Amenities, Inc.*, the U.S. District Court for the Western District of North Carolina determined that a two-year covenant was reasonable, but the "100-mile buffer around the franchisee's territory is not necessary to

139. Ticor Title Ins. Co. v. Cohen, 173 F.3d 63, 69 (2d Cir. 1999).

140. Singas Famous Pizza Brands Corp. v. N.Y. Advert. LLC, 468 F. App'x 43, 47 (2d Cir. 2012).

141. *Id.* at 46.

142. Jiffy Lube Int'l, Inc. v. Weiss Bros., 834 F. Supp. 683, 691 (D.N.J. 1993).

143. *Id.* at 692.

144. Golden Krust Patties, Inc. v. Bullock, 957 F. Supp. 2d 186, 199 (E.D.N.Y. 2013).

145. *Id.*

FranchiseLaw_Vol43_No2_Spring24.indd 148 6/6/24 9:43 AM

protect [the franchisor's] legitimate business interests."[146] As such, the court blue-penciled and struck the words "100 miles of" in the relevant paragraph of the underlying franchise agreement.[147] The court further explained that, as revised, the non-competition agreement is reasonable because it protects the franchisor's legitimate business interests by restricting the franchisees' activities within their territory and the territories of other operating franchises.[148]

Although the use of non-competition clauses in franchise agreements has been widely accepted by courts to date, the FTC has proposed a new rule that bears attention. Specifically, in early January 2023, the FTC proposed a rule that would ban the use of new and existing post-termination non-competition covenants nationwide.[149] As initially proposed, the rule would exclude franchise agreements.[150] The FTC is scheduled to announce a decision on the proposed ban in April 2024.[151]

As a result, courts will likely be more skeptical of non-competition agreements in franchise agreements. Delaware courts, for instance, have been increasingly reluctant to enforce such covenants and have placed greater emphasis on restricting their enforcement to only activities germane to the business of the provision's target.[152] Accordingly, franchisors should ensure their clauses are reasonable and narrow, because those perceived as overly broad in substance, geographic scope, or duration may face additional scrutiny in court.[153]

H. *Choice-of-Law and Forum Selection Provisions*

Choice-of-law clauses allow the franchisor and franchisee to control which substantive law will govern their disputes. These provisions generally favor franchisors because they draft the franchise agreements and select their home state's law. But franchisors should use caution and precise drafting to avoid incidentally granting franchisees protections that they might not otherwise have been entitled to.

146. Outdoor Lighting Persps. Franchising, Inc. v. Home Amenities, Inc., No. 3:11-cv-0567, 2012 WL 137808, at *3 (W.D.N.C. Jan. 18, 2012).

147. *Id.*

148. *Id.*

149. Emilee Wentland, *Attorneys Weigh in as Action at FTC Turns to Franchising*, Franchise Times, Mar. 27, 2023, https://www.franchisetimes.com/franchise_resources/legal-eagles/attorneys-weigh-in-as-action-at-ftc-turns-to-franchising/article_5e11d440-c99a-11ed-abc8-b35ca15fd3a7.html.

150. *Id.*

151. Samuel Estreicher & Alexander Gelfond, *The FTC's Initial Policy Case for Banning All Non-Compete Clauses in Employment Agreements*, Justia (Oct. 24, 2023), https://verdict.justia.com/2023/10/24/the-ftcs-initial-policy-case-for-banning-all-non-compete-clauses-in-employment-agreements.

152. Eddy Moore, Jack Griffith & David Zylka, *Delaware Is Moving Away from Broadly Enforcing Non-Competition Restrictions*, Reuters (Mar. 13, 2023), https://www.reuters.com/legal/transactional/delaware-is-moving-away-broadly-enforcing-non-competition-restrictions-2023-03-13.

153. Dylan R. Newton & Michael S. Horn, *Shifts in the Enforceability of Franchise Non-Competes*, Franchising.com (Mar. 2, 2023), https://www.franchising.com/articles/shifts_in_the_enforceability_of_franchise_noncompetes.html.

For example, in *Red Lion Hotels Franchising, Inc. v. MAK, LLC*, a Washington-based hotel franchisor terminated a California-based franchisee and brought a breach of contract action.[154] The franchisee counterclaimed alleging that the franchisor violated provisions of the Washington Franchise Investment Protection Act (FIPA).[155] The franchisor objected on the grounds that FIPA only applied to franchisees located in the state.[156] The choice-of-law provision in the parties' franchise agreement stated that Washington law applies to disputes "without recourse to Washington (or any other) choice of law or conflict of law principles."[157] The Ninth Circuit construed that language to mean that it "should apply Washington law only insofar as that law, according to its own terms, would be applicable."[158] The court thoroughly reviewed the entirety of FIPA and determined that those provisions which included the language "in this state" limited their application to franchisees within the state.[159] But the "bill of rights" provision at issue did not contain the phrase "in this state" or any other territorial limitation.[160] The court concluded that the Washington choice-of-law provision entitled the franchisee to assert claims under FIPA's bill of rights provision because "if a state law does not have limitations on its geographical scope, courts will apply it to a contract governed by that state's law, even if parts of the contract are performed outside of the state."[161] Had the franchisor known that certain provisions of its own state's franchise law contained no geographical limitations and could protect out-of-state franchisees, it might have selected a different law to govern the franchise agreement or carved out the application of FIPA to any out-of-state franchisees.

According to one commentator, "almost half of the states have enacted statutes or rules restricting a franchisor's ability to include a choice-of-law clause on the franchise agreement."[162] But the application of statutory protections against out-of-state choice-of-law provisions can be nuanced and, as demonstrated in the next case, work against the party seeking to invoke the statute's protection. In *1-800-Got Junk? LLC v. Superior Court*, a California franchisee sought to enforce a Washington choice-of-law provision in a California franchise agreement in connection with its wrongful termination claims, while the Canadian franchisor sought to avoid it. The franchisor claimed that the enforcement of Washington law was contrary to California's public policy embodied in section 20010 of the California Franchise Relations Act (CFRA).[163] The court explained that section 20010 "only voids

154. Red Lion Hotels Franchising, Inc. v. MAK, LLC, 663 F.3d 1080, 1086 (9th Cir. 2011).
155. *Id.*
156. *Id.* at 1086–87.
157. *Id.* at 1087.
158. *Id.*
159. *Id.* at 1088–89.
160. *Id.*
161. *Id.* at 1089.
162. Thomas J. Collin & Matthew D. Ridings, 14 Bus. & Com. Litig. Fed. Cts. § 150:6 (5th ed. 2022).
163. Cal. Bus. & Prof. Code § 20021.

a choice of law provision which requires a franchisee to 'waive compliance' with the protections of the CFRA" and that the "critical inquiry is whether enforcement of the Washington choice of law provision would diminish [franchisee's] rights under the CFRA."[164] After comparing the CFRA with the Washington's FIPA, the court concluded that, because the CFRA was intended to protect franchisees, and the FIPA "affords a franchisee far greater protection from summary termination of a franchise[,]" application of Washington law was not barred by section 20010 of the CFRA.[165]

Franchisors also often include forum selection clauses in the franchise agreements that require litigation to occur in the franchisor's home forum. But some states have enacted similar laws that void any provisions that restrict venue or jurisdiction within the state. For example, section 29-110 of the Idaho Code provides that "[e]very stipulation or condition in a contract, by which any party thereto is restricted from enforcing his rights under the contract in Idaho tribunals, or which limits the time within which he may thus enforce his rights, is void as it is against the public policy of Idaho."[166] In *Kyani, Inc. v. Jordan*, the U.S. District Court for the District of Idaho explained that the statute "restricts contract clauses that create barriers to Idaho state courts."[167] In another example, section 20010 of the CFRA provides that any "provision purporting to bind any person to waive compliance with any provision of this law is contrary to public policy and void."[168] Further, section 20040.5 of the CFRA provides that 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."[169]

Choice-of-law and forum provisions can useful for both the franchisee and the franchisor so long as each party fully understands the impact the provision will have on their agreement and their conduct thereunder and the provision's enforceability under state law.

IV. Conclusion

In franchise disputes, the language of specific franchise provisions matters. Moreover, the landscape of franchise law is always subject to change, whether through new rules from the FTC, new laws from Congress or state legislatures, or new case law from the courts. Success favors the party that anticipates litigation, understands current law, and considers whether key provisions of the franchise agreement will be upheld in court.

164. 1-800-Got Junk? LLC v. Super. Ct., 116 Cal. Rptr. 3d 923, 935–36 (Ct. App. 2010).
165. *Id.* at 935.
166. Idaho Code § 29-110(2).
167. Kyani, Inc. v. Jordan, No. 4:17-cv-00251-SAB, 2017 WL 11458072, at *8 (D. Idaho 2017).
168. Cal. Bus. & Prof. Code § 20010.
169. *Id.* § 20040.5.

Perhaps the most challenging aspect of this task is assessing the interplay of state and federal law, especially given that each state law is different and subject to change. In facing this challenge, it is reasonable to focus on certain key provisions of a franchise agreement that are frequently raised in the context of litigation. Whether those terms are enforceable may depend on state law, federal franchise law, or both.

In sum, it is not unreasonable to take the terms of a franchise agreement on their face, at least initially, and assess their value based on whether they offer favorable economic opportunity. Best practices, however, require franchisors and franchisees alike to consider not only whether certain key provisions are favorable, but also whether and to what extent they will be upheld as valid in a court of law.

FranchiseLaw_Vol43_No2_Spring24.indd 152 6/6/24 9:43 AM

Attorney Fees in Franchise Disputes: Atypical Mechanisms for Obtaining a Fee Award

*Tyler Hartney & Silas Petersen**

I. Introduction

Mr. Hartney

Mr. Petersen

Rooted in common law, the American Rule regarding attorneys' fees is a bedrock principle that dates back to the eighteenth century.[1] Unlike the English Rule (under which courts are empowered to award attorneys' fees to the prevailing party),[2] under the American Rule "[e]ach litigant pays his own attorney's fees, win or lose, unless a statute or contract provides otherwise."[3] Modern litigation, especially complex litigation, can be exceedingly expensive. This expense creates significant impediments for some parties to bring otherwise meritorious claims, like when a party decides that the potential recovery is not enough to justify spending the legal fees necessary to win the case, or when a party settles a lawsuit sooner than it otherwise would due to cost. In addition, the American Rule creates an incentive for well-heeled parties to engage in aggressive litigation tactics, with the hope of grinding down the other party through attorney costs. Thus, many commercial parties negotiate for a contract provision, like a prevailing party or indemnification provision, that shifts a party's cost to its opponent. In

1. Baker Botts L.L.P. v. ASARCO LLC, 576 U.S. 121, 126 (2015) (internal citations omitted).
2. *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 n.18 (1975) ("It is now customary in England, after litigation of substantive claims had terminated, to conduct separate hearings before special 'taxing Masters' in order to determine the appropriateness and the size of an award of counsel fees.").
3. *Baker Botts*, 576 U.S. at 126 (quoting Hardt v. Reliance Standard Life Ins. Co., 560 U.S. 242, 252–53 (2010)).

**Tyler Hartney (thartney@larkinhoffman.com) and Silas Petersen (spetersen@larkinhoffman.com) are both associate attorneys practicing in the business litigation group at Larkin Hoffman in Minneapolis, Minnesota.* *The authors of this article want to thank Susan Tegt and Henry Pftuzenreuter for their assistance with this project. Susan was integral in forming the concept for this article, and Henry provided insightful comments during the drafting process.*

FranchiseLaw_Vol43_No2_Spring24.indd 153 6/6/24 9:43 AM

addition, many states have enacted various statutes that allow the recovery of attorney's fees by a prevailing plaintiff, again with the idea of preventing the opportunity costs of attorneys' fees from preventing the assertion of meritorious claims. However, some states and arbitral bodies have created some rather atypical approaches that parties in franchise disputes may utilize to recover their fees—namely, fee-shifting reciprocity statutes and arbitration rules selected by contract. Though these atypical approaches still invoke the "unless a statute or contract provides otherwise" exception to the American Rule, on their face, these statutes and contractual provisions can be easily overlooked by parties in litigation or by franchisors deciding how to prepare their franchise agreements.

Part II of this article briefly covers what are the "typical" or more well-known approaches to recovering attorneys' fee. Part III then discusses the "atypical" approaches to recovering attorneys' fees. Part IV identifies various practical considerations for litigators when faced with these issues, while Part V addresses what practical considerations transactional attorneys should keep in mind while drafting franchise and other agreements.

II. Typical Approaches

Parties may deviate from the American Rule through a contractual agreement. Outside of a contractual agreement, courts will only deviate from the American Rule where there is explicit statutory authority.[4] When it comes to franchise litigation, each party often has several routine approaches to evaluate and potentially seek attorneys' fees, such as the governing franchise agreement, state franchise relationship laws, and intellectual property statutes.

A. *Contract-Based*

There are multiple contractual schemes by which parties can shift the burden of attorneys' fees. The primary way in which this is accomplished is through a prevailing party clause.[5] These common provisions entitle the prevailing party in any litigation between the parties to recover reasonable attorneys' fees. Prevailing party clauses are enforceable and are often included in franchise agreements.[6]

Indemnification clauses may also aid in the recovery of attorneys' fees. An indemnification clause in a franchise agreement may require a franchisee to bear the cost of a franchisor's attorneys' fees when the franchisor is named in

4. *Id.* (citing Buckhannon Bd. & Care Home, Inc. v. W. Va. Dept. of Health & Human Res., 532 U.S. 598, 602 (2001) (quoting Key Tronic Corp. v. United States, 511 U.S. 809, 814 (1994)).

5. Deborah S. Coldwell & Himanshu M. Patel, *Recovery of Attorneys' Fees in Franchise Litigation: Success Is No Accident!*, ABA 46th Annual Forum on Franchising W-5, at 1 (2023).

6. *See, e.g.*, Kissinger, Inc. v. Singh, 304 F. Supp. 2d 944, 951–54 (W.D. Mich. 2003) (awarding franchisor its reasonable attorneys' fees pursuant to a prevailing party clause in the relevant franchise agreement).

FranchiseLaw_Vol43_No2_Spring24.indd 154 6/6/24 9:43 AM

third-party claims arising out of the franchisee's operations.[7] In addition, an indemnification clause may also cover attorneys' fees incurred in connection with first-party claims in disputes between the franchisor and franchisee, though it is important that the indemnification clause specify that it covers attorneys' fees in connection with such disputes.[8] Personal guarantees and survival clauses are also useful in ensuring that the franchisor's fees are borne by the franchisee or an affiliated entity or individual after the termination of the franchise relationship or when the franchisee lacks sufficient assets to satisfy its obligations under the agreement.[9]

B. *Statute-Based*

Franchise litigation often includes claims beyond breach of contract. Fortunately for a prevailing plaintiff, some of the most commonly asserted statutory causes of action include attorneys' fees provisions. In franchise disputes, those causes of action often fall under statutes regulating franchising, unfair or deceptive trade practices acts, antitrust statutes, and intellectual property statutes. Because many of these causes of action are typically asserted by franchisees against franchisors, their attorneys' fees provisions tend to benefit franchisees, unlike the contractual attorneys' fees provisions found in franchise agreements that are either mutual or just for the benefit of a franchisor.

1. Franchisee Claims

State statutes regulating franchise sales and relationships commonly include provisions allowing for a franchisee's recovery of attorneys' fees in lawsuits where a franchisor has violated the statute.[10] These statutes often require franchisors to register in the state before offering or selling franchises, to disclose information to prospective franchisees, and to take, or refrain from taking, various actions in the franchise relationships.[11]

State deceptive and unfair trade practices acts also commonly provide a right to attorneys' fees. These statutes, which vary from state to state, provide causes of action for deceptive or unfair business practices, as well as business practices that constitute unfair competition.[12] Under many of these

7. Coldwell & Patel, *supra* note 5, at 3.

8. *See* Patel v. 7-Eleven, Inc., No. 17-11414-NMG, 2023 WL 35357, at *4 (D. Mass. Jan. 4, 2023) (holding a franchisor could not invoke indemnification clause to recover attorneys' fees incurred in defending claims brought by its franchisees because the indemnification clause "ma[de] no mention of defense costs or attorneys' fees").

9. *See* Coldwell & Patel, *supra* note 5, at 4–5.

10. *See id.* at 6–11 (summarizing California, Florida, Georgia, Illinois, Michigan, New York, North Carolina, Ohio, and Texas laws containing attorneys' fees provisions).

11. *See* Mark H. Miller, *Unintentional Franchising*, 36 Saint Mary's L.J. 301, 310–12 (2005). When a franchise relationship law is unavailable, state business opportunity laws may provide a cause of action to franchisees in limited circumstances. *See* Coldwell & Patel, *supra* note 5, at 7–10. Such statutes often authorize attorneys' fees. *See, e.g.*, Ga. Code § 10-1-410(2)(A); N.C. Gen. Stat. § 66-94; Ohio Rev. Code § 1334.09(B).

12. Coldwell & Patel, *supra* note 5, at 11.

laws, a prevailing plaintiff may recover its attorneys' fees, though states differ as to whether an award is mandatory or discretionary.[13] Florida law, however, uniquely provides that both plaintiffs and defendants may recover attorneys' fees if they prevail on claims brought under the state's deceptive trade practices act.[14] More commonly, some states require a showing that the plaintiff's claim was brought in bad faith before a defendant is entitled to recover an award of attorneys' fees in actions brought under these laws.[15]

Antitrust statutes also provide an avenue for recovery of attorneys' fees in franchise litigation. At the federal level, the Clayton Act provides a private cause of action for violations of the Clayton Act, Sherman Act, and the Robinson-Patman Act.[16] Prevailing plaintiffs may recover reasonable attorneys' fees in suits for both damages under Section 4 of the Clayton Act,[17] and for injunctive relief under Section 16 of the Clayton Act.[18] Many states have antitrust statutes which also permit the recovery of attorneys' fees by the prevailing party.[19]

2. Franchisor Claims

Not all statutory claims that entitle the prevailing party to an award of fees favor the franchisee. Often more applicable to franchisors, intellectual property statutes have provisions allowing the recovery of attorneys' fees. The Lanham Act, which provides a cause of action for trademark infringement, allows an award of attorneys' fees in "exceptional cases."[20] The federal Patent Act also allows a prevailing party to recover its attorneys' fees in a patent infringement suit in "exceptional cases."[21] Despite this restrictive language, courts consider the totality of the circumstances and do not require bad faith to recover attorneys' fees.[22] The Copyright Act similarly allows an award of attorneys' fees to the prevailing party at the court's discretion.[23] In contrast, attorneys' fees are more difficult to recover under the federal Defend Trade Secrets Act (DTSA). For an award of attorneys' fees under the DTSA, a party must show that the trade secret was "willfully and maliciously misappropriated" or that a claim was made in bad faith.[24]

13. *Id.* at 12–13.
14. *See* Fla. Stat. § 501.2105(5).
15. Coldwell & Patel, *supra* note 5, at 13.
16. 15 U.S.C. § 15(a).
17. *Id.*
18. 15 U.S.C. § 26.
19. *See* Coldwell & Patel, *supra* note 5, at 17–18 (discussing antitrust laws in California, Florida, New York, and Texas that permit the recovery of attorneys' fees).
20. 15 U.S.C. § 1117(a).
21. 35 U.S.C. § 285.
22. Coldwell & Patel, *supra* note 5, at 23.
23. 17 U.S.C. § 505.
24. 18 U.S.C. § 1836(b)(3)(D).

III. Atypical Approaches

Outside of these aforementioned typical approaches, two alternative mechanisms to obtain an award of fees may be available to franchisors or franchisees depending on the circumstances: (1) unilateral fee-shifting reciprocity statutes, and (2) in the case of arbitration, the arbitration service's arbitration rules.

A. *Unilateral Fee-Shifting Reciprocity Statutes*

Many franchise agreements contain a unilateral fee-shifting provision stating that the franchisor is entitled to an award of fees if and when it is forced to commence legal action to enforce the franchise agreement (or certain provisions therein). While most courts will enforce a unilateral contractual fee-shifting provision deviating from the American Rule,[25] seven states have enacted laws requiring unilateral fee-shifting provisions to be applied reciprocally to the other contractual party. Currently, states with this public policy include (1) California,[26] (2) Florida,[27] (3) Hawaii,[28] (4) Montana,[29] (5) Oregon,[30] (6) Utah,[31] and (7) Washington.[32] These statutes were passed

25. *See, e.g.*, Allied Indus. Scrap, Inc. v. OmniSource Corp., 776 F.3d 452, 453 (6th Cir. 2015); Dunkin' Donuts Inc. v. Guang Chyi Liu, No. CIV.A. 00-3666, 2002 WL 31375509, at *2 (E.D. Pa. Oct. 17, 2002) (fee-shifting provision in franchise agreement upheld and enforced).

26. Cal. Civ. Code § 1717(a) ("In any action on a contract, where the contract specifically provides that attorney's fees and costs, which are incurred to enforce that contract, shall be awarded either to one of the parties or to the prevailing party, then the party who is determined to be the party prevailing on the contract, whether he or she is the party specified in the contract or not, shall be entitled to reasonable attorney's fees in addition to other costs").

27. Fla. Stat. Ann. § 57.105(7) ("If a contract contains a provision allowing attorney's fees to a party when he or she is required to take any action to enforce the contract, the court may also allow reasonable attorney's fees to the other party when that party prevails in any action, whether as plaintiff or defendant, with respect to the contract").

28. Haw. Rev. Stat. Ann. § 607-14 ("[I]n all actions on a promissory note or other contract in writing that provides for an attorney's fee, there shall be taxed as attorneys' fees, to be paid by the losing party and to be included in the sum for which execution may issue, a fee that the court determines to be reasonable. . . .").

29. Mont. Code Ann. § 28-3-704 (noting that "one party to the contract or obligation has an express right to recover attorney fees from any other party to the contract or obligation in the event the party having that right brings an action upon the contract or obligation, then in any action on the contract or obligation all parties to the contract or obligation are considered to have the same right to recover attorney fees and the prevailing party in any action, whether by virtue of the express contractual right or by virtue of this section, is entitled to recover reasonable attorney fees from the losing party or parties").

30. Or. Rev. Stat. § 20.096(1) ("In any action or suit in which a claim is made based on a contract that specifically provides that attorney fees and costs incurred to enforce the provisions of the contract shall be awarded to one of the parties, the party that prevails on the claim shall be entitled to reasonable attorney fees in addition to costs and disbursements, without regard to whether the prevailing party is the party specified in the contract and without regard to whether the prevailing party is a party to the contract.").

31. Utah Code Ann. § 78B-5-826 ("A court may award costs and attorney fees to either party that prevails in a civil action based upon any promissory note, written contract, or other writing executed after April 28, 1986, when the provisions of the promissory note, written contract, or other writing allow at least one party to recover attorney fees.").

32. Wash. Rev. Code. Ann. § 4.84.330 ("[W]here such contract or lease specifically provides that attorneys' fees and costs, which are incurred to enforce the provisions of such contract or

FranchiseLaw_Vol43_No2_Spring24.indd 157 6/6/24 9:43 AM

to "level the playing field between parties of unequal bargaining power and sophistication."[33] Franchisors relying on unilateral attorneys' fees provisions in their franchise agreements may be surprised to find that a franchisee will be entitled to its attorney's fees if it prevails in an action applying the law of any of these seven states.[34]

B. *Arbitration-Based*

For franchisors, arbitration is often the preferred method of dispute resolution. There are several reasons to utilize arbitration instead of litigation. For starters, arbitration is perceived as quicker, less costly, and more final.[35] Arbitration rules generally are less formal than civil procedure.[36] Moreover, unlike judicial proceedings, arbitration proceedings are not public.[37]

Many parties agree to arbitrate with an administrative service provider, such as the American Arbitration Association (AAA), the International Institute for Conflict Prevention and Resolution (CPR), or the Judicial Arbitration and Mediation Services (JAMS). All have promulgated procedural rules governing the arbitrations they administer, which often defer considerable discretion to the arbitrator and are thus sometimes overlooked. Notably, the AAA Commercial Arbitration Rules (AAA Rules) and CPR Arbitration Rules (CPR Rules) expressly authorize arbitrators to award attorneys' fees in certain circumstances, regardless of the existence of an independent statutory or contractual basis. JAMS, on the other hand, does not.[38]

---

lease, shall be awarded to one of the parties, the prevailing party, whether he or she is the party specified in the contract or lease or not, shall be entitled to reasonable attorneys' fees in addition to costs and necessary disbursements.").

33. Port-A-Weld, Inc. v. Padula & Wadsworth Constr., Inc., 984 So. 2d 564, 570 (Fla. Dist. Ct. App. 2008) (citing Precision Tune Auto Care, Inc. v. Radcliffe, 815 So. 2d 708, 710–11 (Fla. Dist. Ct. App. 2002)).

34. Delivery.com Franchising, LLC v. Moore, No. 20-20766-CIV, 2020 WL 3410347, at *14 (S.D. Fla. June 19, 2020), *report and recommendation adopted*, No. 20-20766-CIV, 2020 WL 4464674 (S.D. Fla. July 14, 2020) (applying Florida's statute to render a franchisor's unilateral fee-shifting provision bilateral).

35. Ben Hanuka, *The Ins and Outs of Franchise Arbitration: What Parties to a Franchise Arbitration Agreement Need to Know*, Law Works, https://www.lawworks.ca/franchise-disputes/franchise-arbitration-agreement-guide/#:~:text=Arbitration%20is%20usually%20confidential%2C%20and,other%20franchisees%20and%20the%20public (last visited Jan. 29, 2024).

36. *Id*.

37. *Id*. While the proceeding and its filings may be private, the FTC Rule may still require an arbitration to be disclosed in Item 3. 16 C.F.R. § 436.1(a) (defining "Action" as both "a judicial action or proceeding, . . . or arbitration") & 436.5(c) (Item 3 disclosure obligations).

38. Many arbitral bodies that handle international arbitrations also have rules governing the allocation of attorneys' fees. *See, e.g.*, Int'l Chamber of Commerce, 2021 Arbitration Rules, art. 38(4)–(5) (Jan. 1, 2021), https://iccwbo.org/dispute-resolution/dispute-resolution-services/arbitration/rules-procedure/2021-arbitration-rules/#block-accordion-38 ("The final award shall fix the costs of the arbitration and decide which of the parties shall bear them or in what proportion they shall be borne by the parties. . . . [T]he arbitral tribunal may take into account such circumstances as it considers relevant."); Int'l Dispute Resolution Procedures art. 34 (June 1, 2014), https://www.adr.org/sites/default/files/ICDR%20Rules_0.pdf ("The tribunal may allocate such costs among the parties if it determines that allocation is reasonable, taking into account the circumstances of the case."). As the focus of this article is domestic franchise disputes, these rules will not be discussed in detail.

FranchiseLaw_Vol43_No2_Spring24.indd 158 6/6/24 9:43 AM

1. AAA Rules

The AAA Rules provide a basis for an award of attorneys' fees that is independent of contract or statute. Specifically, Rule 49(d)(ii) states that the award of an arbitrator may include "an award of attorneys' fees *if all parties have requested such an award* or it is authorized by law or the parties' arbitration agreement."[39] Thus, under Rule 49(d)(ii), an arbitrator is authorized to issue an award of attorneys' fees merely on the basis that all parties made such a request in their arbitration pleadings. Because this rule applies regardless of whether the party requesting fees has a statutory or contractual entitlement to fees, in practice, making a request for fees is functionally equivalent to offering a prevailing party fee-shifting arrangement to the other party in the dispute.

Ultimately, a party who simply requests fees and then prevails may be awarded fees even in instances where the party has no other statutory or contractual entitlement to fees beyond satisfaction of the AAA rule. The basis for the fee award is essentially a mutual agreement by way of Rule 49(d)(ii). Courts have upheld awards of attorneys' fees issued in arbitration based solely on Rule 49(d)(ii) with no independent contractual or statutory basis.[40]

Generally, courts have held that selection of the AAA arbitration process in an arbitration agreement thereby incorporates by reference all AAA rules.[41] In *Carlton & Associates, Inc. v. Simmers*, the defendant argued the identical predecessor to Rule 49(d)(ii) does not create "an independent basis for awarding fees." The court, the U.S. District Court for the Middle District of Florida, disagreed. It held that agreements containing a provision calling for the arbitration to be administered by the AAA incorporated by reference all AAA rules, including what is now Rule 49(d)(ii).[42] The court held that, under the AAA rules, an arbitrator does not need a statutory or contractual basis to award fees; rather "[t]he parties' requests for fees itself empowered the arbitrator to award fees and costs."[43]

---

39. Am. Arb. Ass'n, Commercial Arbitration Rules and Mediation Procedures, R-49(d) (Sept. 1, 2022), https://www.adr.org/sites/default/files/Commercial-Rules_Web.pdf (emphasis added) [hereinafter "AAA Rules"].

40. Carlton & Assocs., Inc. v. Simmers, No. 8:20-CV-851-VMC-CPT, 2023 WL 204833, at *8 (M.D. Fla. Jan. 17, 2023); *see also* NetKnowledge Techs., L.L.C. v. Rapid Transmit Techs., No. 3:02-CV-2406-M, 2007 WL 518548, at *7 (N.D. Tex. Feb. 20, 2007), *aff'd sub nom.* Netknowledge Techs. LLC v. Rapid Transmit Techs., 269 F. App'x 443 (5th Cir. 2008) (holding arbitrator did not exceed his authority by awarding attorneys' fees, "[s]ince both parties requested attorneys' fees from the Arbitrator, [and] the Arbitrator was permitted to award fees pursuant to the AAA's Rules").

41. *See, e.g.*, Airbnb, Inc. v. Doe, 336 So. 3d 698, 704 (Fla. 2022), *cert. denied*, 143 S. Ct. 484 (2022) ("[W]hen an agreement incorporates a set of arbitral rules, such as the AAA Rules, those rules become part of the agreement.").

42. The language of this rule has remained unchanged over the past two decades; however, in the various editions of the *AAA Rules of Commercial Arbitration*, the rule number has changed. In the AAA's 2003, 2005, 2007, and 2010 editions, this rule was R-43. In the 2013 edition, this rule was R-47. In 2022, this rule was changed to R-49.

43. *Calton & Assocs*, 2023 WL 204833, at *9.

The U.S. District Court for the Southern District of New York came to the same conclusion in *B/E Aerospace, Inc. v. Jet Aviation St. Louis, Inc.*[44] The court there found that, despite an agreement between the parties explicitly stating "[e]ach party shall be solely responsible for its own attorneys fees," the parties had expressly incorporated the AAA Rules into their agreement, and the AAA permits an award of attorneys' fees where, as was the case here, all parties requested such an award.[45]

The Eighth Circuit has also upheld an award of fees under the AAA Rules, even where there is no statutory or contractual basis for such an award. In *Wells Fargo Bank, N.A. v. WMR e-PIN, LLC*, the appellants contended that the district court erred in affirming the arbitrators' award of attorneys' fees, arguing that there was no legal basis to award fees and that the arbitration panel exceeded its authority by awarding fees to the prevailing party.[46] However, the respondent argued that the parties had agreed that the arbitration would be governed by the AAA Rules—which include what is now Rule 49(d)(ii).[47] The Eighth Circuit agreed with the respondent, finding that both parties had submitted requests for attorneys' fees before the arbitration panel announced its decision; the appellants did so through the submission of an affidavit requesting fees, and the respondent "had made a similar request," and thus Rule 49(d)(ii) provided the arbitration panel with a basis to award fees.[48]

Courts have faced this exact issue in the franchise context as well. In *Careminders Home Care, Inc. v. Sandifer*, the U.S. District Court for the Northern District of Georgia upheld an award of fees pursuant to the AAA Rules, finding that the arbitrator did not exceed his authority because the AAA Rules were incorporated into the franchise agreement by reference.[49] In this case, the franchisor had prevailed on a franchisee's claims for fraud in the inducement, breach of fiduciary duty under Georgia law, and several claims asserted under provisions of the Wisconsin Franchise Investment Law. The franchise agreement did contain a unilateral fee-shifting provision in favor of the franchisor.[50] The court here noted that the arbitrator's decision to award fees subject to that particular contractual provision could be "arguably incorrect" based upon the contractual interpretation of the limitations set forth in the language of the fee-shifting provision of the franchise agreement. However, because the arbitrator had the authority under the AAA Rules that "were incorporated in the Franchise Agreement," the

44. B/E Aerospace, Inc. v. Jet Aviation St. Louis, Inc., No. 11 CIV. 8569 SAS, 2012 WL 1577497 (S.D.N.Y. May 3, 2012).

45. *Id.* at *4

46. Wells Fargo Bank, N.A. v. WMR e-PIN, LLC, 653 F.3d 702, 713 (8th Cir. 2011) (finding the AAA rules permitted the arbitrator panel to award attorneys' fees because "all parties requested" an award of fees).

47. *Id.*

48. *Id.* at 714.

49. CareMinders Home Care, Inc. v. Sandifer, No. 1:14-CV-03573-WSD, 2015 WL 4040464, at *4 (N.D. Ga. June 29, 2015).

50. *Id.* at *1.

interpretation of the fee-shifting provision was rendered unnecessary, and the fee award was confirmed.[51]

2. CPR Rules

The CPR Rules contain a more direct rule that authorizes an award of attorneys' fees. Rule 19.1 authorizes the arbitrator to fix the costs of arbitration in its award, including the following:

a. The fees and expenses of members of the Tribunal;
b. The costs of expert advice and other assistance engaged by the Tribunal;
c. The travel and other expenses of witnesses to such extent as the Tribunal may deem appropriate;
d. *The costs for legal representation* and assistance and experts incurred by a party *to such extent as the Tribunal may deem appropriate*;
e. The CPR Administrative Fee with respect to the arbitration;
f. The costs of a transcript; and
g. The costs of meeting and hearing facilities.[52]

Specifically, Rule 19.1(d) authorizes the arbitrator to issue an award that includes attorneys' fees. However, Rule 19.2 states that the arbitrator can apportion the costs of arbitration in any manner he or she deems reasonable, but only in the absence of "any agreement between the parties to the contrary."[53]

Some arbitrators have found, and courts have upheld, that this provision of the CPR Rules creates an independent basis to award attorneys' fees and costs.[54] They have reached this conclusion despite Rule 10 of the CPR Rules stating that the tribunal shall apply the substantive law(s) or rules of law designated by the parties and shall have the authority to grant any remedy or relief within the scope of the parties' agreement.[55] Thus, it would appear that arbitrators under the CPR Rules may be permitted to issue an award of attorneys' fees to the prevailing party "as the Tribunal may deem appropriate" so long as there is no contrary contractual agreement.

51. *Id*. at *4 n.2.

52. CPR Disp. Resolution, Administered Arbitration Rules 19.1 (Mar. 1, 2019), https://drs.cpradr.org/rules/arbitration/administered-arbitration-rules-2019 (emphasis added) [hereinafter CPR Rule]. The arbitrators' broad discretion in awarding attorneys' fees under the CPR Rules is a common feature of international arbitration rules. *See supra* note 38.

53. CPR Rule 19.2 (emphasis added).

54. *See* Contech Constr. Prod., Inc. v. Heierli, 764 F. Supp. 2d 96, 110 (D.D.C. 2011) (finding that "the fact that the Arbitrator may have misapplied Delaware law or the CPR Rules is not a basis for vacating the award under the FAA").

55. CPR Rule 10.1-10.3.

3. JAMS

The JAMS Rules do not provide the arbitrator with authority to award attorneys' fees without a statutory or contractual basis. Rule 24(g) of the JAMS rules states:

> The Award of the Arbitrator may allocate attorneys' fees and expenses and interest (at such rate and from such date as the Arbitrator may deem appropriate) *if provided by the Parties' Agreement or allowed by applicable law*. When the Arbitrator is authorized to award attorneys' fees and must determine the reasonable amount of such fees, he or she may consider whether the failure of a Party to cooperate reasonably in the discovery process and/or comply with the Arbitrator's discovery orders caused delay to the proceeding or additional costs to the other Parties.[56]

Thus, unlike the AAA or CPR rules, the JAMS rules explicitly require such an award to be authorized by the parties' agreement or by law.

IV. Practical Considerations for Litigators

Litigators should consider at the outset whether attorneys' fees may be recoverable and, if so, develop a strategy to secure them. This analysis, of course, includes a review of the relevant contractual provisions that might provide attorneys' fees, as well as the potential causes of action that grant a right to attorneys' fees. In the franchise context, plaintiffs should consider whether any of the statutes upon which they are basing their claims allow for recovery of attorneys' fees, keeping in mind that states have different standards of recovery.[57] Litigants, especially those that do not have a contractual right to attorneys' fees, should be aware of which claims have fee-shifting reciprocity statutes and be prepared to seek attorneys' fees if they prevail.

Franchisees without a contractual right to attorneys' fees should pay special attention to state statutes that make the unilateral fee provision in the franchise agreement bilateral.[58] Where the contractual choice of the law in a franchise agreement selects California, Florida, Hawaii, Montana, Oregon, Utah, or Washington, a franchisee will have the ability to recover fees that it did not bargain for under the explicit terms of the franchise agreement if the agreement has a franchisor-favoring unilateral fee-shifting provision.[59] Franchisors, on the other hand, should be cognizant of the risk that they will be liable for a prevailing franchisee's attorneys' fees if the law of one of the above-mentioned states applies. For this reason, franchisors should consider avoiding having the law of these jurisdictions govern their disputes.[60] In addition, franchisors and franchisees should be cognizant of where and when

56. JAMS Comprehensive Arbitration Rules and Procedures 24(g) (June 1, 2021), https://www.jamsadr.com/rules-comprehensive-arbitration (emphasis added), [hereinafter JAMS Rules].
57. *See supra* Section II, B.
58. *See supra* Section III, A.
59. *See id.*
60. *See infra* Section V.

they file suit, as the choice of venue will often have a meaningful impact on what law is chosen.[61]

In the arbitration context, franchise litigators must confront the potential conundrums presented by rules like AAA Rule 49(d)(ii) and CPR Rule 19.1.[62] AAA Rule 49(d)(ii) in essence allows the parties to create a bilateral prevailing-party attorneys' fee provision that applies only to that specific dispute.[63] While it might seem obvious to ask for attorneys' fees in any situation where they may be available, and many litigators include a request for attorneys' fees by default in their prayer for relief or demand, litigators should make a considered decision about requesting fees when proceeding before the AAA and should make sure to check the applicable rules of the arbitral body before reflexively seeking fees. Likewise, the defendant/respondent should verify if the plaintiff/claimant requested attorneys' fees in its initial pleadings; if that party has a claim or contract that entitles them to fees or is simply including them as a "just in case," they likely will have requested fees and inadvertently offered the respondent the same benefit.

Consider the following example: A franchisor terminates one of its franchisees after the franchisee fails to pay royalties. However, the franchisor failed to provide proper notice before terminating. The franchise agreement includes a unilateral fee-shifting provision in favor of the franchisor in connection with efforts to collect past due amounts owed under the franchise agreement, and the choice-of-law provision is for a jurisdiction without a franchise relationship statute. The franchisee initiates AAA arbitration for wrongful termination. Despite not having a contractual or statutory basis, the franchisee requests an award of attorneys' fees. The franchisor asserts a compulsory counterclaim for de minimis unpaid royalties. Contractually, the franchisor is entitled to fees should it prevail on its unpaid royalties, but should the franchisor request attorneys' fees under the circumstances?

A franchisor attorney, ignorant of Rule 49(d)(ii), may reflexively request attorneys' fees in the arbitration. But a request for attorneys' fees in an AAA arbitration is not merely an assertion of a party's contractual or statutory right to attorneys' fees; it is akin to an offer to the opposing party for a *bilateral* prevailing-party provision that governs only the instant dispute. The franchisor's contractual right to an award of fees would be limited to the fees incurred exclusively related to its breach of contract claim—not for *all* claims.[64] Under the facts of this hypothetical, the franchisee's entitlement

61. *See generally* Stephanie J. Blumstein & John M. Doroghazi, *The Litigation Before the Litigation*, ABA 46th Annual Forum on Franchising W-9 (2023).

62. *See* AAA Rules, R-49(d)(ii); *see supra* Section III, B(1).

63. While CPR Rule 19.1(d), like AAA Rule 49(d)(ii), allows an arbitrator to award attorneys' fees independent of a specific contractual or statutory right to fees, a party's decision of whether to request fees does not impact the other party's right to fees, as is true under AAA Rule 49(d)(ii). Thus, there are no potential pitfalls with requesting attorneys' fees in a CPR arbitration. *See supra* Section III, B.

64. *See, e.g.*, Gopher Oil Co., Inc. v. Union Oil Co. of Cal., 955 F.2d 519, 527–28 (8th Cir. 1992) ("Under these circumstances, the defendant should not incur liability for fees related to the fraud claim, notwithstanding the interrelationship of that legal work with the environmental

FranchiseLaw_Vol43_No2_Spring24.indd 163 6/6/24 9:43 AM

to fees on claims for breach of the franchise agreement would likely greatly exceed the fees associated with the franchisor's claim. With the franchisee having requested attorneys' fees, the franchisor has effectively provided a legal basis for the franchisee to recover attorneys' fees that it was not otherwise entitled to recover if the franchisee prevails on its underlying claim—all for the chance of recovering fees in a much smaller portion of the greater dispute.

The lesson here is that, before requesting attorneys' fees in an AAA arbitration, a party should first take a hard look at its chances of prevailing. Of course, the likelihood of prevailing is often not known with certainty at the outset of an arbitration when discovery is yet to be conducted. But even when the chances of prevailing seem about even, the alternative to asserting a contractual right to attorneys' fees is only a return to the American Rule: each side bears its own fees. When the probability of prevailing in arbitration is obscured, franchisors should still consider whether they prefer a bilateral attorneys' fees provision to the American Rule, knowing that a unilateral right to attorneys' fees will not be possible under Rule 49(d)(ii).

Needless to say, there are a number of situations where parties do not face the Rule 49 conundrum. This includes situations where a party does not have a right to attorneys' fees independent of Rule 49 and the opposing party does, in which case there is nothing to lose. This also includes when the parties' right to attorneys' fees is already bilateral. And when the information available to a party indicates a high likelihood that it will prevail, there is minimal risk in requesting attorneys' fees.

V. Practical Considerations for Transactional Attorneys

The selection of arbitration rules should be made after consideration of several factors. Recommended considerations include the availability of a roster of arbitrators;[65] discovery;[66] costs;[67] need for a default award;[68] available motion practices;[69] location of the dispute;[70] and the need to secure third-party witnesses.[71] It is time to add one more consideration to the mix: the availability of an independent basis to receive an award of attorneys' fees.

claims. Accordingly, we remand for a redetermination or an apportionment of attorney fees to exclude work related to the fraud litigation.").

65. Liz Kramer, *ArbitrationNation Roadmap: When Should You Choose JAMS, AAA, or CPR Rules?*, Arb. Nation (June 27, 2013), https://www.arbitrationnation.com/arbitrationnation-roadmap-when-should-you-choose-jams-aaa-or-cpr-rules.

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. Erika C. Birg, *Arbitration 101: Choosing the Right Forum for Dispute Resolution*, https://www.nelsonmullins.com/storage/1cca45c43be131de469c52dd147cb1af.pdf (last visited Feb. 24, 2024). *Id.*

71. Leonard S. Levy, *Customize Your Arbitration by Comparing Arbitration Provider Rules*, Advoc. Mag. (Sept. 2022), https://www.advocatemagazine.com/article/2022-september/customize-your-arbitration-by-comparing-arbitration-provider-rules.

The availability of an independent basis for fees could be both favorable or unfavorable, depending on the client's position.

As discussed above, franchisors often can rely on the franchise agreement to provide a contractual right to an award of attorneys' fees as well as certain statutes establishing a right to fees for certain claims; alternatively, franchisees have a number of statutes that may entitle them to fees—including the aforementioned reciprocity statutes. Transactional attorneys, having a unique understanding of their clients' position and dispute history, should carefully assess this possibility as a factor when deciding on which state's laws to select. Because arbitration is a "creature of contract,"[72] the parties possess the ability to contractually limit an arbitrator's authority with respect to the permissible scope of an award, and the Federal Arbitration Act requires courts to enforce the parties' agreed-upon terms for arbitration.[73] Contracting parties can agree to limit an arbitrator's ability to award attorneys' fees.[74] In fact, Rule 1 of the AAA Rules expressly states that "[t]he parties, by written agreement, may vary the procedures set forth in these Rules."[75] Thus, transactional attorneys seeking to operate under the AAA (or CPR) Rules but wanting to avoid the implications of AAA Rule 49(d)(ii) (or CPR Rule 19.1) may look to draft a contractual arbitration provision that specifically limits the arbitrator's authority to award attorneys' fees solely where "authorized by law or the parties' [franchise] agreement,"[76] or to be even more explicit and simply state that Rule 49(d)(ii) does not apply.

Though many considerations and legal requirements may overshadow the issue of future entitlement to fees in litigation or arbitration, transactional attorneys may want to consider whether the selected jurisdiction has a contractual fee-shifting reciprocity statute while drafting a forum selection clause. The combination of and interaction between jurisdictional and arbitration rule selections can greatly vary the number of possibilities parties have for seeking fees. For example, franchisors with a unilateral fee-shifting provision operating under Florida law have little additional risk associated with selecting the AAA rules: the jurisdiction's reciprocity statute will likely provide both parties with an independent contractual basis to seek an award of attorneys' fees in arbitration even without the invocation of Rule 49(d)(ii). Alternatively, franchisors that select, for example, both AAA Rules and Minnesota law risk a prevailing franchisee, without a contractual or statutory

72. Cat Charter, LLC v. Schurtenberger, 646 F.3d 836, 843 (11th Cir. 2011).

73. *Id*. (citing to Volt Info. Scis., Inc. v. Bd. of Trustees, 489 U.S. 468, 478 (1989)); Szuts v. Dean Witter Reynolds, Inc., 931 F.2d 830, 831–32 (11th Cir. 1991) ("[T]he parties, when incorporating any set of arbitration rules by reference in an arbitration agreement, are free to include provisions in conflict with certain provisions of rules incorporated by reference; the specific provisions in the arbitration agreement take precedence and the arbitration rules are incorporated only to the extent that they do not conflict with the express provisions of the arbitration agreement.").

74. *See* CBA Indus., Inc. v. Circulation Mgmt., Inc., 578 N.Y.S.2d 234, 237 (App. Div. 1992).

75. AAA Rules, R-1.

76. *Id.*, R-49(d).

basis for fees, being awarded fees on the independent basis established by Rule 49(d)(ii) of the AAA rules.

VI. Conclusion

The typical mechanisms for obtaining an award of attorneys' fees in franchise disputes are well-known to practitioners. Those routes commonly include a contractual fee-shifting arrangement or indemnification provision as well as statutory provisions associated with various commonly asserted claims.

However, two atypical fee mechanisms need to be considered, both while litigating and while drafting franchise agreements, so that franchise attorneys can properly assess and allocate the risk of attorneys' fees. These atypical mechanisms are based on (1) the combination of choice-of-law provisions and state-specific unilateral fee-shifting reciprocity statutes, and (2) the selection of certain arbitration services (and their rules).

Counsel must be considerate of the governing law selected within the franchise agreement. Seven states have statutes that will render reciprocal a fee-shifting provision that is facially unilateral. The selection of those states' laws may inadvertently grant a franchisee a mutual right to fees, regardless of the franchise agreement's unilateral language. Likewise, under the AAA and CPR rules, if a party has a contractual or statutory right to fees either under its franchise agreement (potentially reciprocated via statute) and/or the asserted claims, then a specific request for attorneys' fees is advisable. Beware, doing so under these rules is the practical equivalent of offering the other side an agreement that the prevailing party can receive an award of fees. Attorneys should add this into the consideration of which arbitration rules best suit their client's needs and, if the AAA (or CPR) rules are the selection, litigators need to make a thorough assessment of their case before requesting (or not requesting) fees.

Trends in Punitive Damages: From Nightmare to Restraint, Reprehensibility, and Proportionality

*David S. Catuogno, Caitlin C. Conklin & Aidan Nowak**

Mr. Catuogno

Ms. Conklin

Mr. Nowak

Punitive damages, like a masked loner in a 1980s movie at an underpopulated summer camp, are abjectly terrifying.[1] Certainly, like a chainsaw, punitive damages can wreak unspeakable, and unsurvivable damage upon a litigant. Outsized punitive awards can threaten the continuing profitability and even viability of a vulnerable entity. Just as terrifying as catastrophic economic injury, however, is the unknown. The landscape of potential negative outcomes in an environment where it seems that there are no rules—or where the rules are so malleable and amorphous that they can be manipulated and interpreted to allow a wide range of adverse results. The inability to accurately predict potential damages is especially disruptive to risk management and litigant strategy. Often, parties make tactical decisions in litigation (and in business) based on perceived risk and reward. The inability to predict the magnitude of damages that might be awarded makes it difficult to accurate price a case for settlement or to otherwise determine whether going forward makes sense.

1. *See*, *e.g.*, FRIDAY THE 13TH PART II (Paramount Pictures 1981).

**David Catuogno (David.Catuogno@klgates.com) is a partner in K&L Gates' Newark office where he is a member of the finance/restructuring insolvency practice group. Caitlin Conklin (Caitlin.Conklin@klgates.com) is an associate in K&L Gates' Newark office where she is a member of the finance/restructuring insolvency practice group. Aidan Nowak (Aidan.Nowak@sonesta.com) is an Associate General Counsel at Sonesta International Hotels Corporation.*

FranchiseLaw_Vol43_No2_Spring24.indd 167 6/6/24 9:43 AM

Over the last thirty years, the law surrounding punitive damages has evolved so that the risk from them may be somewhat more manageable, at least in the context of potential franchise disputes. Under the rubric of due process, the Supreme Court has established ground rules more clearly defining the circumstances where punitive damages may be allowable, and further restraining the size of such awards. Among other things, there is a requirement of reprehensibility in conduct and proportionality in damage that set outer limits on the size and scope of punitive awards. Punitive damages, crucially, must be understood as a creature of tort and not contract. That is, where parties have bargained for contractual rights, that contract should be the vehicle for the recovery of economic loss in that contractual relationship and not some suspension of disbelief that conveniently transmogrifies contract claims into more lucrative, and more terrifying tort claims. With proper planning and drafting, franchise litigation need not be a nightmare fraught with peril.

I. Thirty+ Years of Supreme Court Cases Regarding Punitive Damages

Since its 1989 decision in *Browning-Ferris v. Kelco*,[2] the Supreme Court has slowly developed case law regarding punitive or exemplary damages. The case law fails, however, to create any hard cap on punitive damages. As of today, the basic parameters set forth by the Supreme Court about punitive damages are that (1) punitive damage awards must be reasonable; (2) a jury may not consider harm to victims who are not named plaintiffs; (3) the offensiveness of defendant's conduct can be considered; and (4) juries should be provided guidelines on how to evaluate punitive damage awards.[3]

Browning-Ferris v. Kelco was the first Supreme Court decision interpreting punitive damages laws. In *Browning-Ferris v. Kelco* the defendant in an antitrust action appealed from an order of the U.S. District Court for the District of Vermont, which upheld a jury's award of $51,000 in compensatory damages and $6,000,000 in punitive damages.[4] The defendant challenged the award of exemplary damages based on the Eighth Amendment that prohibits excessive, cruel, and unusual punishment.[5] The Court held that the Eighth Amendment's excessive fines clause does not apply to awards of punitive damages in cases between private parties.[6]

2. Browning-Ferris Indus. of Vt., Inc. v. Kelco Disposal, Inc., 492 U.S. 257 (1989).

3. *See*, *e.g*, Johnson & Johnson v. Gail Ingham, No. 20-1223 (U.S. 2021); Exxon Shipping Co. v. Baker, 554 U.S. 471 (2008); Philip Morris USA v. Williams, 549 U.S. 346 (2007); Cooper v. Leatherman Tool Grp., 532 U.S. 424 (2001); BMW of N. Am. Inc. v. Gore, 517 U.S. 559 (1996); Pac. Mut. Life Ins. Co. v. Haslip, 499 U.S. 1 (1991); Browning-Ferris Indus. of Vt., Inc. v. Kelco Disposal, Inc., 492 U.S. 257 (1989).

4. *Browning-Ferris*, 492 U.S. at 261.

5. *Id.* at 259.

6. *Id.* at 260.

FranchiseLaw_Vol43_No2_Spring24.indd 168 6/6/24 9:43 AM

In 1991, the Court again was faced with a case involving punitive damages. In *Pacific Mutual Life Insurance Co. v. Haslip*,[7] the Court answered the question of whether punitive damages laws in and of themselves violate the due process requirements of the Fourteenth Amendment.[8] The Court held that the punitive damages award "were not violative of the Due Process Clause of the Fourteenth Amendment."[9] The Court reasoned that, although the punitive damages were large compared to the compensatory damages claim, the punitive damages did not violate due process because the award furthered the purposes of punitive damages[10] and "had the benefit of the full panoply of Alabama's procedural protections."[11] First, the trial court's instructions furthered the punitive damages' purpose of "retribution and deterrence" as the jury was required to consider "the character and degree of the wrong as shown by the evidence and necessity of preventing similar wrong."[12] Second, "the trial court conducted a post-verdict hearing that conformed with" *Hammond v. Gadsden*, 493 So. 2d 1374 (Ala.) (setting forth a standard ensuring meaningful and adequate review of punitive damages awards).[13] Third, the Alabama Supreme Court, in applying the *Hammond* standard, approved the verdict and further evaluated the factors from *Green Oil Co. v. Hornsby*, 539 So.2d 218 (1989), to ensure that the award does "not exceed an amount that will accomplish society's goals of punishment and deference."[14] Based on this rationale, the Court upheld an award of punitive damages in the amount of four times the compensatory damages awarded.[15] The Court did, however, find that a punitive damage award may violate due process if it is grossly excessive.[16]

In 1993, in *TXO Production Corp. v Alliance Resources Corp.*,[17] the Court rejected a call for specific proposed tests, such as an "objective test" or "rational basis test."[18] Instead, a plurality of the Court stated that the proper approach was to consider whether there was a "reasonable relationship" test to jury consideration of punitive damages.[19] The plurality further indicated that juries may consider the potential harm resulting from the defendant's actions.[20] In upholding the $10 million award of exemplary damages following an award of $19,000 in compensatory damages, the Court considered the potential monetary harm of TXO's conduct, rather than the actual damages

7. *Pac. Mut. Life Ins. Co.*, 499 U.S. at 9.
8. *Id.* at 19.
9. *Id.*
10. *Id.* at 21.
11. *Id.* at 23.
12. *Id.* at 19.
13. *Id.* at 23.
14. *Id.* at 21.
15. *Id.* at 23.
16. *Id.* at 18.
17. TXO Prod. Corp. v. All. Res. Corp., 509 U.S. 443 (1993).
18. *Id.* at 455–56.
19. *Id.* at 460.
20. *Id.* at 459 (quoting Garnes v. Fleming Landfill, Inc., 413 S.E.2d. 897, 909 (W. Va. 1991)).

awarded.[21] Three of the other justices joined in the judgment, but not in the reasoning, each offering critics of this reasonableness analysis.[22]

Beginning in 1996, the Court made a series of rulings that, in retrospect, operated as something of a sea change in the landscape of punitive damages awards, certainly as viewed through the prism of commercial disputes. In *BMW of North America Inc. v. Gore*,[23] the Court outlined a three-part test for evaluating a punitive damages award: (1) the reprehensibility of defendant's conduct; (2) the ratio of punitive damages to actual harm; and (3) the size of the award compared to statutory sanctions for similar conduct.[24] In *Gore*, the offensive conduct was a manufacturer's representations as to the status and nature of a vehicle that was sold as "new."[25] In that case, the Court struck down a $2 million punitive damages award where compensatory damages were only $4,000: the award was grossly excessive in light of the low level of reprehensibility of conduct.[26]

The *Gore* Court found that "[p]erhaps the most important indicium of the reasonableness of a punitive damages award is the degree of reprehensibility of the defendant's conduct. . . . This principle reflects the accepted view that some wrongs are more blameworthy than others."[27] In *Gore*, Justice Stevens noted that the operative harm was "purely economic in nature," and "evinced no indifference to or reckless disregard for . . . others."[28] *Gore* also recognized that it is impractical to adopt a "mathematical formula" or "categorical approach," and thus left it for case-by-case decision whether awards of punitive damages are so out of line with the actual damages that they no longer bear a "reasonable relationship" to one another.[29]

In 2003, the Court in *State Farm Mutual Insurance Co. v. Campbell*,[30] held that a punitive damages award should have a single-digit ratio to the compensatory damages award.[31] The Court reasoned that "[s]ingle-digit multipliers are more likely to comport with due process."[32] In overturning a $145 million punitive damages award that had been reinstated by the Utah Supreme Court, the U.S. Supreme Court reiterated that "courts must ensure that the measure of punishment is both reasonable and proportionate to the amount of harm to the plaintiff and to the general damages recovered."[33] The Court also held that "[t]he wealth of a defendant cannot

21. *Id.* at 462.
22. *Id.* at 466–72 (Kennedy, Thomas, and Scalia, JJ., concurring).
23. BMW of N. Am., Inc. v. Gore, 517 U.S. 559 (1996).
24. *Id.* at 575–83
25. *Id.* at 563–64.
26. *Id.* at 562.
27. *Id.* at 575.
28. *Id.* at 575–76.
29. *Id.*
30. State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408 (2003).
31. *Id.* at 424–26.
32. *Id.* at 425.
33. *Id.* at 426.

FranchiseLaw_Vol43_No2_Spring24.indd 170 6/6/24 9:43 AM

justify an otherwise unconstitutional punitive damages award,"[34] ironically, in reinstating the massive punitive award that the Utah Supreme Court was attempting to apply the standards articulated in *Gore*.[35] Needless to say, the Supreme Court disagreed with the manner in which the *Gore* factors had been applied, noting that its determination to reverse was "neither close nor difficult."[36] Primarily, the Court took issue with the Utah court using the case as a vehicle to "expose, and punish, the perceived deficiencies of . . . [the actor's] operations throughout the country" as opposed to conduct directed towards the Plaintiffs.[37] Indeed, Justice Kennedy chastised the Utah courts because they "awarded punitive damages to punish and deter conduct that has no relation to" the harm suffered by the plaintiff.[38] This consideration was further amplified in 2007 when, in *Philip Morris USA v. Williams*,[39] the Supreme Court held that harm to named victims only can be considered; a court may not award punitive damages for conduct against people who are not a party to the suit.[40]

In 2008, in *Exxon Shipping Co. v. Baker*,[41] the Supreme Court rejected $2.5 billion in punitive damages following a $500 million compensatory award.[42] After providing an excessive analysis, the Court ultimately concluded that the appropriate punitive damage award was one that equaled the compensatory damages award.[43]

II. Developments in State Court Punitive Damages Litigation

In the context of franchisor/franchisee deputies, claims for punitive damages may be brought under state or federal statutes regulating the franchisor-franchisee relationship, as tort claims, or under state unfair and deceptive practices statutes.[44] In *Shiv-Ram, Inc. v. McCaleb*,[45] a motel guest was injured by a projecting piece of a metal bed frame and sued the motel's new owner alleging negligence and wantonness.[46] The trial court entered judgment in the amount of $500,000 against the franchisee on common law tort and contract claims thereby awarding compensatory and punitive damages.[47] The motel owner appealed.

34. *Id.* at 428.
35. *Id.* at 415.
36. *Id.* at 418.
37. *Id.* at 420.
38. *Id.* at 419.
39. Philip Morris USA v. Williams, 549 U.S. 346 (2007).
40. *Id.* at 353.
41. Exxon Shipping Co. v. Baker, 554 U.S. 471 (2008).
42. *Id.* at 515.
43. *Id.* at 488–515.
44. Edward Wood Dunham, *Applying Constitutional Limits on Punitive Damages to Franchise Disputes*, 22 Franchise L.J. 203, 205 (2003).
45. Shiv-Ram, Inc. v. McCaleb, 892 So. 2d 299, 313 (Ala. 2003).
46. *Id.* at 303.
47. *Id.* at 304.

The Alabama Supreme Court affirmed the lower court's punitive damages award.[48] First, the court analyzed Alabama state law, finding no statutorily imposed punitive damage cap in place for purposes of a punitive damages award for the guest.[49] Second, the court found that the owner acted wantonly and with a reckless conscious disregard in having not made any reasonable inspections and choosing "to turn a blind eye and a deaf ear to the situation and to forgo making even the most cursory inspections or inquiries concerning the safety of the guest rooms."[50] Third, the court held that, despite the motel franchisor having conducted an inspection not disclosing the problem, the new owner's intentional omission of its independent duty to furnish a safe premises justified a finding that the new owner acted with a reckless or conscious disregard of the rights or safety of others.[51]

Fourth, the court then found that the punitive damages award did not violate the constitutional standards set forth by the U.S. Supreme Court in *Gore*, and each of the guideposts justified the trial court's punitive damages judgment.[52] The Alabama Supreme Court determined the new manager's conduct to be reprehensible as the new owner was "well experienced in the management of motels, yet intentionally refused to expose itself to any information concerning the safety of its guest rooms."[53] Further, the ratio of punitive damages to compensatory damages was not unreasonable, and civil penalties could be imposed for comparable misconduct.[54] Fifth, a remittitur was not required because only one of the Alabama remittitur factors favored a finding of excessiveness.[55]

Franchisors should be aware that not only did the supreme court apply the *Gore* factors, but also state law factors arising out of the *Hammond v. City of Gadsden*[56] and *Green Oil Co. v. Hornsby*[57] cases referenced by the Alabama Supreme Court in *Haslip*. Specifically, in addition to the *Gore* factors, the *Hammond/Green Oil* factors require examination of (1) the reprehensibility of defendant's conduct; (2) the relationship of the punitive-damages award to the harm that actually occurred, or is likely to occur, from defendant's conduct; (3) defendant's profit from its misconduct; (4) defendant's financial position; (5) the cost to plaintiff of the litigation; (6) whether defendant has been subject to criminal sanctions for similar conduct; and (7) other civil actions defendant has been involved in arising out of similar conduct.[58] After considering the *Hammond/Green Oil* factors, the Alabama Supreme Court concluded that only one factor weighed in favor of a finding of excessiveness:

48. *Id.*
49. *Id*. at 313.
50. *Id.* at 315.
51. *Id.*
52. *Id.* at 317.
53. *Id.* at 316.
54. *Id.* at 317.
55. *Id.* at 319.
56. Hammond v. City of Gadsden, 493 So. 2d 1374, 1379 (Ala. 1986).
57. Green Oil Co. v. Hornsby, 539 So. 2d 218, 223 (Ala. 1989).
58. *Shiv-Ram*, 892 So. 2d at 317–18.

the fact that defendant has not profited from its misconduct, thus weighing against a finding of excessiveness.[59] Despite declining to eliminate or reduce the punitive damages here, this case serves as a telling example for franchisees that substantial analysis is required for an award of punitive damages.

In *JRS Products v. Matushita*,[60] a franchisor terminated a franchisee, and the franchisee responded by bringing claims for breach of contract and intentional interference with prospective economic advantage action.[61] The trial court entered summary judgment in the franchisor's favor on the breach of contract claim.[62] On the tort claim, however, the trial court entered judgment on a jury award of compensatory damages of $720,620 and punitive damages of $2,500,000 in favor of the franchisee.[63] On appeal, the California Court of Appeal examined the appropriateness of the awarded punitive damages. The court held that the franchisee was not entitled to punitive damages because the franchisee's remedy for the wrongful termination of its franchise was limited to contract damages.[64] It is well settled in California that "motive, regardless of how malevolent, remains irrelevant to a breach of contract claim and does not convert a contract action into a tort claim exposing the breaching party to liability for punitive damages."[65] Because the franchise termination was rooted in contract, not tort, the franchisee was thus unable to recover punitive damages.[66]

Even where the wrongdoing is contractual in its essential nature, circumstances where affirmative fraud and/or fraud in the inducement may render the transgression(s) "extra contractual."[67] Indeed, where there is an allegation of fraud in the inducement, even though the nature of the claim is essentially still a manifestation of disappointing expectations of deliverables under a contract, there is a substantial argument that a duty exists, independent of any contractual duty, not to wrongfully induce another to enter into an agreement.[68] This sensibility, in concert with public policy considerations favoring a particularized right of recovery for intentional misrepresentations, could elevate a claim into the realm of punitive damages, even in the commercial context, where the alleged misrepresentation was in the context of a contractual relationship and the harm was solely economic.

59. *Id.* at 319.
60. JRS Prods., Inc. v. Matsushita Elec. Corp. of Am., 115 Cal. App. 4th 168 (2004).
61. *Id.* at 170.
62. *Id.* at 173.
63. *Id.*
64. *Id.* at 183.
65. *Id.* (citing Arntz Contracting Co. v. St. Paul Fire & Marine Ins. Co., 47 Cal. App. 4th 464 (1996)).
66. *Id.*
67. *Id.*
68. Formosa Plastics Corp. USA v. Presidio Eng'rs, 960 S.W.2d 41, 47 (Tex. 1998) (There is "an independent legal duty, separate from the existence of the contract itself, [that] precludes the use of fraud to induce a binding agreement.").

In *Holiday Inn Franchising v. Hotel Associates*,[69] for instance, a hotel franchisee brought a fraud action against the franchisor following a re-licensure denial. Following a jury trial, the trial court entered judgment in favor of the franchisee including punitive damages of $12,000,000.[70] On appeal, the Arkansas Court of Appeals held that (1) the evidence supported jury instructions on punitive damages, and (2) the punitive damages award did not violate due process.[71]

The franchisor contended that the jury should not have been instructed on punitive damages because the franchisee did not prove malice or intent to injure.[72] The court found no abuse of discretion as:

> [p]unitive damages may be proved not only by showing that the defendant intentionally pursued a course of conduct for the purpose of causing injury but also by showing that the defendant knew or should have known . . . in light of surrounding circumstances, its conduct would naturally and probably result in injury and that it continued the conduct in reckless disregard of circumstances, from which malice may be inferred.[73]

The court went onto explain that:

> [the franchisor] had a long-standing relationship with [the franchisee] and has assured [the franchisee] of relicensure if [it] operated the hotel appropriately; that [the franchisor] was aware that [franchisee] was applying for early relicensure in 2001 and that [the franchisee] intended to spend millions of dollars in intended to spend millions of dollars in improvements as a result; that [the franchisor], knowing that its files contained a marketing report advocating licensure of another facility, provided that report to [the franchisee]'s competitor but stood by while [the franchisee] spent the PIP money and pursued relicensure, without providing the report to [the franchisee]; that [the franchisor's] personnel knew that [the franchisee] should have received the report under the circumstances; and that some [franchisor] personnel made what appeared to be false statements and manipulated the Franchise Approval Committee's consideration of the competing application by implying that [the franchisee] had no interest in relicensing.[74]

Based upon the foregoing, the court found that the franchisor had "knowledge that its conduct would naturally and probably result in injury but that it continued its conduct in reckless disregard of the consequences to [the franchisee]."[75]

Second, in evaluating the punitive damages award, the court examined both state law and whether it violates the Due Process Clause as analyzed by the U.S. Supreme Court in *Gore*.[76] The court initially upheld the jury's punitive damages ruling under state law. Under the Due Process Clause, the court found that the franchisor's actions were highly reprehensible based

69. Holiday Inn Franchising, Inc. v. Hotel Assocs., Inc., 382 S.W.3d 6 (Ark. Ct. App. 2011).
70. *Id.*
71. *Id.*
72. *Id.* at 16.
73. *Id.*
74. *Id.* at 16–17.
75. *Id.* at 17.
76. *Id.* at 18.

FranchiseLaw_Vol43_No2_Spring24.indd 174 6/6/24 9:43 AM

upon its "deliberate attempt by certain [franchisor] employees to reap their own economic benefits by keeping [the franchisee] in the dark."[77] The court of appeals further found that the ratio of punitive damages to compensatory damages amounting to 1.19–to–1 was not excessive.[78] The court lastly noted that, despite no comparable civil penalties, "when balancing the reprehensibility of the defendant's conduct and a punitive-to-compensatory ration, the analysis compels a net result in favor of the jury's full punitive-damages award."[79]

In *Chin v. Advanced Fresh Concepts Franchise Corp.*,[80] a franchisee brought an action against a franchisor for breach of contract. The franchise agreement contained a damages limitation provision limiting recovery to actual compensatory damages while barring noneconomic and punitive damages.[81] The California Court of Appeal held that such a provision was not unconscionable where the damages limitation was facially mutual and no damages were available under statutory law.[82]

In *Jimico Enterprises., Inc. v. Lehigh Gas Corp.*,[83] a franchisee filed an action asserting that the franchisor violated the Petroleum Marketing Practices Act, and thereafter the U.S. District Court for the Northern District of New York granted summary judgment on liability, awarded $141,892.79 in compensatory damages and $30,000 in punitive damages, along with attorney fees and costs.[84] The franchisor appealed challenging the award. The Second Circuit, on a purely statutory basis, analyzed the Petroleum Marketing Practices Act, thereby finding no error in the district court's punitive damages award based on the finding of a willful disregard of the Act's requirements.[85]

In *Marchionda v. Embassy Suites Franchise*,[86] a hotel guest sued a hotel franchisor, franchisee, and hotel management company for negligence and punitive damages under Iowa law following a sexual assault at the hotel.[87] The defendants moved for summary judgment on the punitive damages claim. The defendants contended that "no reasonable fact finder could find by a preponderance of clear, convincing and satisfactory evidence that Defendants' alleged conduct . . . is based on malicious conduct that could give rise to punitive damages against Defendants."[88] The U.S. District Court for the Southern District of Iowa, in analyzing Iowa's codified standard for punitive damages, found genuine issues of material fact regarding the franchisee's

77. *Id.* at 20
78. *Id.* at 21.
79. *Id*.
80. Chin v. Advanced Fresh Concepts Franchise Corp., 194 Cal. App. 4th 704, 712 (2011).
81. *Id.* at 711.
82. *Id.* at 712.
83. Jimico Enters., Inc. v. Lehigh Gas Corp., 708 F.3d 106 (2d Cir. 2013).
84. *Id.* at 108.
85. *Id.* at 110.
86. Marchionda v. Embassy Suites Franchise, LLC, 359 F. Supp. 3d 681 (S.D. Iowa 2018).
87. *Id.* at 692.
88. *Id.* at 702.

negligence claim and punitive damages claim, thus precluding summary judgment on the punitive damages claim.[89]

In *Dolphin Kickboxing v. Franchoice*,[90] a franchisee brought an action against a franchise matching service alleging that the service committed fraud through false representations to the franchisee for the purpose of inducing the franchisee into the purchase of a franchise.[91] The franchisee sought to amend the complaint to assert a claim for punitive damages, based upon Minnesota statutory law. The U.S. District Court for the District of Minnesota held that, under Minnesota law, (1) a franchisee was not entitled to amend its complaint to add a claim for punitive damages related to withholding of information and the franchisor's illegal marketing techniques; (2) the franchise matching service's failure to conduct due diligence regarding the franchisor constituted at most gross negligence as to its duty to the franchisee and thus did not warrant awarding punitive damages; and (3) the franchisee was entitled to add a claim for punitive damages related to specific alleged fraudulent representations.[92]

First, the court held that the franchisee's proposed amended complaint failed to plausibly allege a claim for punitive damages based upon withholding of information and franchisor's illegal marketing techniques as such claims were conclusory.[93] Second, the court held that the failure to conduct due diligence did not rise to a level sufficient to sustain a claim of punitive damages.[94] Instead, "the representations made by Defendants to Plaintiffs offering to match them 'only with franchises that Defendants had investigated' and then not conducting 'any serious, systematic or professional due diligence upon [the franchise] or taking [the franchisor]'s representations at face value at most amounts to gross negligence on the part of Defendants as to their duty to Plaintiffs."[95] Additionally, there were no allegations that would have given the defendants a reason not to believe the franchisor's representations.[96] "The mere showing of negligence, even gross negligence, is not sufficient to sustain a claim of punitive damages."[97] Lastly, the court held that the franchisee was entitled to add a claim for punitive damages based upon fraudulent misrepresentations. The court reasoned that, because the franchisee contends that the defendants "knew" that the representations were false, these allegations were sufficient to plausibly set forth a claim for punitive damages.[98]

89. *Id.*
90. Dolphin Kickboxing Co. v. Franchoice, Inc., 335 F.R.D. 393 (D. Minn. 2020).
91. *Id.* at 395.
92. *Id.* at 397–98.
93. *Id.*
94. *Id.* at 402.
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id*. at 403.

FranchiseLaw_Vol43_No2_Spring24.indd 176 6/6/24 9:43 AM

III. Strategies for Avoiding Punitive Damages Claims

The best way to avoid punitive damages claims and awards is to minimize the opportunity for such claims to arise. Franchisors should not wander into the proverbial barn full of sharp objects during a power outage. Too much can go wrong.

The first step is comprehensive, well-drafted agreements. There is an identifiable judicial pre-disposition towards remedying contractual claims within the four corners of a contract. The more complete and exhaustive the contract, the less latitude there will be for a plaintiff to pursue claims outside of it. The franchisor and franchisee are both sophisticated participants capable of striking a bargain. All things being equal, a court will hold the parties to that bargain. If the remedies for breach are well-defined, reasonable, and mutually agreeable, there is little reason why a court should feel a need to deviate from that voluntary bargain.

The more comprehensive the contract, the more likely the dispute will remain centered on the contract, as opposed to wandering into the minefield of extrapolated tort claims. Spartan and generic contracts are a recipe for potential disaster. Where there is ambiguity, there is opportunity for mischief. In contrast, where there is clarity and particularized contractual provisions directly on point, the conflict is more manageable, more predictable, and less frightening. Indeed, comprehensive contractual provisions could provide a vehicle for early motions to eliminate stray tort claims at the outset of litigation, thereby limiting catastrophic possibilities and allowing franchisors to keep the focus on the contract, where it belongs.

The next step is a recognition of the collaborative nature of the franchise relationship. At the risk of switching genres, the overriding goal of the franchise relationship is for the parties to "be excellent to each other."[99] While both a franchisor and a franchisee are in the business of making a profit, it is not a zero-sum proposition. They are not making money at the expense of the other; rather, in a perfect world, they are both making money in a collaborative and mutually beneficial relationship where each party is optimizing its business goals. Of course, this is an imperfect world, and there will always be tension between contracting parties and attempts to maximize self-interest and advantage, the most obvious and fundamental by-product of a franchisor "being excellent" to its franchisee is that excellent conduct cannot be found to be reprehensible and, without reprehensible conduct, there is no foundational element for a punitive award under the *Gore* standards.

The next consideration is consistency. There will always be tensions in the relationships. Franchisors will need to make operational and priority decisions in the best interests of the company and franchisees as a whole, which decisions could be opposed by one or more disappointed franchisee. There will be disagreements; hence it is important to note that punitive

99. Bill and Ted's Excellent Adventure (Orion Pictures 1989).

damage awards will necessarily require a plaintiff to prove an intent to injure or reckless disregard to the possibility or likelihood of injury, i.e., to establish a baseline of reprehensibility. The prudent policy is to treat similarly situated franchisees in a similar fashion. If accommodation is denied to one franchise while granted to another, that disparate treatment could give rise to an allegation of actual malice or an intent/indifference to the injury of that franchisee above and beyond the potential contractual breaches—stated otherwise, conduct that could be found to be reprehensible and outside the four corners of the contract.

Implicit in this concept is the truism that franchisors must also be vigilant to maintain appropriate records memorializing communication with franchisees. If the communications to all franchisees show a uniformity of treatment among similarly situated franchisees and consistent messaging in conformance with the company's macro-objectives, it would be exceedingly difficult for a disappointed franchisee to establish that it was treated in a sufficiently aberrant and reprehensible fashion to justify the assessment of extra-contractual punishment upon the franchisor. Where possible, the communications should reference the franchisor's charge to make difficult decisions in the best interest of the entire system and supporting such statements with objective corroboration. Additionally, where there are particularized communications with an ostensibly aggrieved franchisee, much like documenting a personnel file, those communications should make a clear record of what is being discussed and further make a clear record of the reasons supporting the franchisor's course of action. It should go without saying that the best way to contest vague and sensational allegations of ill-motivated and unfair actions, is a contemporaneous paper trail demonstrating well-supported decisions in conjunction with ongoing notice and communication.

It is said that there is nothing in the dark that is not there in the light. While the specter of punitive damages indeed may be cause for concern, it need not be as terrifying as an abandoned cabin on a dark and stormy night. With prudent planning, comprehensive contracts, and open and honest collaboration and communication, franchisors can maneuver punitive damages claims into the light where they are far less terrifying and where closet doors can be opened without nightmarish consequences.

FranchiseLaw_Vol43_No2_Spring24.indd 178 6/6/24 9:43 AM

LADR Case Notes (December 2023–February 2024) and FLJ Currents (Fall 2023)

*Andrew M. Malzahn, Matthew J. Soroky & Matthew S. DeAntonio**

Mr. Malzahn

Mr. Soroky

Mr. DeAntonio

LADR CASE NOTES

JANUARY 2024 LADR CASE NOTES

***Breadeaux's Pisa, LLC v. Beckman Bros.*, 83 F.4th 1113 (8th Cir. 2023)**[1]

Franchisor filed a lawsuit in court against its franchisee seeking injunctive and declaratory relief related to violation of a non-compete. Franchisee operated a pizza restaurant in Iowa. After the franchise agreement was not renewed in 2021, the franchisee continued to operate a pizza restaurant in the same location. The franchise agreement allowed the franchisor to enforce the franchise agreement's non-compete provisions by filing for equitable relief in court or initiating mediation and arbitration.

The franchisee asserted counterclaims against the franchisor for declaratory relief, as well as breach of contract. The franchisor moved to compel mediation and arbitration of the franchisee's counterclaims, which the district court granted.

The franchisor then moved for a preliminary injunction on its original claims, but the court denied the request for preliminary injunction. The franchisee sought

1. Andrew M. Malzahn and his firm represented the franchisee in this matter.

**Andrew M. Malzahn (amalzahn@dadygardner.com) is a partner at Dady & Gardner, P.A. in Minneapolis, Minnesota, representing franchisees and dealers nationwide in all aspects of their relationships with franchisors and manufacturers, primarily as a litigator. Matthew J. Soroky (msoroky@lewitthackman.com) is a shareholder at Lewitt Hackman in Los Angeles, California, representing franchisors and franchisees in transactional, litigation and regulatory compliance matters. Matthew S. DeAntonio (mdeantonio@bradley.com) is a partner in the Charlotte, North Carolina office of Bradley Arant Boult Cummings LLP.*

FranchiseLaw_Vol43_No2_Spring24.indd 179 6/6/24 9:43 AM

discovery, which the franchisor objected to as frivolous because the franchise agreement provided that the parties consented to equitable relief. But the district court disagreed, explaining that denial of the preliminary injunction meant that discovery on damages and enforceability of the non-compete was necessary.

The next day, the franchisor filed a demand for arbitration seeking injunctive and declaratory relief (the same relief originally sought in court). The franchisor also moved to stay the court action pending arbitration.

Lower court decision: The district court denied the franchisor's request to stay all proceedings pending arbitration and again rejected the franchisor's objections to discovery. The franchisor sought an interlocutory appeal of the denial of the stay.

Eighth Circuit's decision: The Eighth Circuit agreed with the district court and refused to stay the case for arbitration, highlighting that the franchisor, as the plaintiff, elected to litigate in court. It only sought to move to arbitration after receiving adverse rulings. After litigating the preliminary injunction request, mediating, and participating in discovery, the franchisor filed a demand for arbitration. The court viewed this as the franchisor trying to re-litigate the preliminary injunctive relief in arbitration and avoid adverse discovery rulings.

The Federal Arbitration Act, Section 3, is typically applicable to defendants for purposes of staying litigation pending arbitration (not plaintiffs). The Eighth Circuit disagreed that the arbitration provision in the franchise agreement required all claims to be arbitrated other than the franchisor's equitable claims. The franchisor elected to enforce the franchise agreement through judicial process. In fact, the Eighth Circuit concluded that the franchisor's request for declaratory relief invited the court to examine whether the franchisee was in breach of the non-compete provision—thus inviting the court to "peek" at arbitrable issues.

Focusing on the franchisor's actions, the Eighth Circuit held the franchisor waived its right to arbitrate. The franchisor knew of its right to arbitrate but acted inconsistently with that right by seeking relief that would "require a determination of arbitrable issues" and by failing to seek arbitration after its preliminary injunctive request was denied. Notably, the Eighth Circuit acknowledged that if arbitration had been sought at that earlier point—after denial of preliminary injunction but before the other steps taken in the case—it very well may have been allowed.

***Pioneer Hotel Group, Inc. v. Choice Hotels International, Inc.*, No. 1:23-CV-00173-REP, 2023 WL 7135059 (D. Idaho Oct. 30, 2023)**

Franchisor filed a demand for arbitration against the plaintiffs for breach of a franchise agreement. The franchise agreement contained an arbitration provision.

The plaintiffs, however, disputed that they ever entered into a franchise agreement with the franchisor. Specifically, the plaintiffs claimed that they

FranchiseLaw_Vol43_No2_Spring24.indd 180 6/6/24 9:43 AM

had no record of the franchise agreement and that one of the plaintiffs was confident that he never signed it. The plaintiffs claimed they did not operate a hotel under franchisor's brand—one operated a hotel under a competing brand and the other never ran a hotel. They submitted declarations on their role as passive investors that had nothing to do with operations. Accordingly, the plaintiffs filed an objection and moved to dismiss the arbitration, as well as filed this lawsuit in court seeking relief based on plaintiffs' contention that they cannot be compelled to arbitrate based on a non-existent agreement.

Franchisor moved to dismiss the plaintiffs' complaint for improper venue because the claims should be arbitrated. Franchisor submitted evidence that one plaintiff signed a franchise agreement via DocuSign and that the other plaintiff signed a related guaranty via DocuSign. Plaintiffs disputed the authenticity of these documents.

District Court's decision: The district court denied the franchisor's motion. The court found that there was a dispute whether the parties entered a franchise agreement and, without a franchise agreement that included an arbitration provision, there was no arbitration provision to enforce.

Arbitration is a matter of contract, which requires agreement by the parties. Because the plaintiffs disputed the very existence of a franchise agreement (or guaranty), arbitrability was not the issue—the issue was whether there was an arbitration agreement at all. Construing the contested facts in the plaintiffs' favor, the court was not in a position to conclude as a matter of law that the parties entered into the franchise agreement (and guaranty). As such, whether an agreement exists between the parties was an issue that the court must resolve upfront, and discovery would be necessary to determine the answer to that question.

SEPTEMBER 2023 LADR CASE NOTE

Sasoro 13, LLC v. 7-Eleven, Inc. No. 3:22-cv-2313, 2023 WL 2290788 (N.D. Tex. Feb. 27, 2023)

A recent decision from the Northern District of Texas rejects a franchisee's efforts to allege a breach of the duty of good faith and fair dealing by a franchisor and vindicates a franchisor's right to enforce the terms of its franchise agreement. In *Sasoro 13, LLC v. 7-Eleven, Inc.*, the court dismissed claims for declaratory judgment, breach of contract, violations of the Texas Uniform Commercial Code (UCC), violations of the Petroleum Marketing Practices Act (PMPA), and violations of the Texas Deceptive Trade Practices Act (DTPA) as asserted by franchisee Sasoro 13, LLC (Sasoro) against franchisor 7-Eleven, Inc. (7-Eleven).

Sasoro and 7-Eleven were parties to a franchise agreement (Franchise Agreement) that allowed Sasoro to operate a 7-Eleven gas station franchise in Las Vegas, Nevada. The parties agreed that Texas law applied to all disputes arising out of the Franchise Agreement. The Franchise Agreement included a termination right under which 7-Eleven could terminate the Franchise Agreement upon the occurrence of four instances of any noncompliance

in a two-year period. The Franchise Agreement explicitly stated that any four instances of noncompliance in a two-year period constitute a material breach of the Franchise Agreement without regard to any post-notification corrections made by Sasoro. In October 2022, 7-Eleven notified Sasoro that it was exercising its termination right after Sasoro failed to comply with the Franchise Agreement on at least four occasions in a two-year period. Notably, Sasoro admitted that at least four instances of non-compliance occurred in the relevant time period. Sasoro nonetheless alleged that 7-Eleven's termination breached the terms of the Franchise Agreement and violated the duty of good faith and fair dealing.

Texas law generally refuses to imply a duty of good faith and fair dealing in a contract that is not governed by the UCC. Tex. Bus. & Com. Code § 1.304. Texas courts recognize a duty of good faith and fair dealing in non-UCC contracts only when the agreement expressly incorporates the duty or "a special relationship of trust and confidence exists between the parties to the contract." *TBK Consulting, Inc. v. Dex Media, Inc.*, No. 4:17-cv-924, 2018 WL 11434567, at *4 (N.D. Tex. Aug. 17, 2018). In this case, the court dismissed Sasoro's claims brought under the UCC for breach of the duty of good faith and fair dealing because the Franchise Agreement was not a contract for goods. The court explained that "the heart of the [franchise] transaction is Sasoro's use of 7-Eleven's trademark. Though Sasoro purchases branded goods from 7-Eleven under the [Franchise] Agreement . . . it does so in connection with its contractual rights to use the 7-Eleven name." The court also refused to imply a duty of good faith and fair dealing because the Franchise Agreement did not expressly incorporate such a duty and because Texas courts including the Texas Supreme Court have regularly denied to extend "special relationship" status to the franchisor-franchisee relationship. *See, e.g.*, *Subaru of Am., Inc. v. David McDavid Nissan, Inc.*, 84 S.W.3d 212, 225 (Tex. 2002).

The court ultimately determined that Sasoro's remaining claims must also be dismissed. First, the court looked to the language of the Franchise Agreement and found that Sasoro failed to allege any facts that alleged breach. Sasoro's primary theory of breach was that instances of its noncompliance were not material and that 7-Eleven would be "excused from performing under a contract only if the other party commits a material breach." *Greene v. Farmers Ins. Exch.*, 446 S.W.3d, 761, 767 (Tex. 2014). Because the Franchise Agreement explicitly set forth that four instances of noncompliance with the Franchise Agreement in a two-year period constituted a material breach, the court rejected Sasoro's argument and dismissed Sasoro's claim for breach of contract. The court also dismissed Sasoro's claim for violation of the PMPA because Sasoro did not meet the definition of a retailer or distributor under the PMPA. In dismissing Sasoro's PMPA claim, the court cited the consignment structure of gasoline sales from 7-Eleven to consumers at Sasoro's franchise location and held that such transactions did not constitute purchase of gasoline by Sasoro from 7-Eleven, which was in turn

necessary to trigger application of the PMPA. *See* 15 U.S.C. §§ 2801(1)(A), 2801(6)(A)–(B), 2801(7). Sasoro further conceded that its remaining claims for declaratory judgment and violation of the DTPA were duplicative of its other claims and accordingly withdrew them.

In having its claims dismissed, Sasoro joins the many franchisees who have failed to convince courts applying Texas law that franchisors' conduct must adhere to a standard of good faith and fair dealing. And, as with other cases, the court refused to look beyond plain and unambiguous language of a franchise agreement to resolve a franchisee's allegations of breach of contract by the franchisor.

CURRENTS

ANTITRUST

Deslandes v. McDonald's US, LLC, Bus. Franchise Guide (CCH) ¶ 17,357, 81 F.4th 699 (7th Cir. 2023)

In a case examining the antitrust implications of anti-poaching provisions in franchise agreements, the Seventh Circuit unanimously revived a claim by two McDonald's workers alleging that anti-poaching provisions in McDonald's franchise agreements violated Section 1 of the Sherman Antitrust Act.

One plaintiff, Leinani Deslandes, worked for a McDonald's franchisee near Orlando, Florida. The second plaintiff, Stephanie Turner, worked for an affiliate-owned, non-franchised McDonald's restaurant near Covington, Kentucky. In their complaint, the employees alleged that every McDonald's franchise agreement contained no-poaching provisions restricting franchisees from soliciting or employing anyone who was employed by a different McDonald's restaurant within the previous six months. The employees contended these provisions prevented them from taking higher paying jobs with other McDonald's franchisees. The employees filed a putative class-action complaint against McDonald's Corporation and McDonald's USA, LLC, alleging the anti-poaching provisions violated Section 1 of the Sherman Antitrust Act.

The U.S. District Court for the Northern District of Illinois dismissed the employees' claims, finding that they did not sufficiently plead a violation of Section 1 under either available theory: that the anti-poaching provisions were naked restraints and therefore *per se* unlawful, or that the anti-poaching provisions were unlawful under a Rule of Reason theory.

In rejecting the employees' *per se* unlawful theory, the district court reasoned the anti-poaching provisions were ancillary to the success of a cooperative venture, namely, the franchise agreements, which increase output of burgers and fries. The district court held the anti-poaching provisions were therefore not *per se* unlawful naked restraints and dismissed that claim pursuant to Federal Rule of Civil Procedure 12(b)(6). But the Seventh Circuit disagreed, finding the district court's approach incorrectly "treats benefits

to consumers (increased output) as justifying detriments to workers (monopsony pricing)." The Seventh Circuit questioned whether anti-poaching provisions truly promoted the production of restaurant food. The Seventh Circuit reasoned that it was possible that the provisions helped the restaurants increase their profits "without adding to output," in which case the anti-poaching restrictions could not be considered "ancillary" in the antitrust law sense. On the other hand, the court suggested it could be possible that the anti-poaching clauses helped the restaurants recover training costs, thereby making "training worthwhile to both franchise and worker." In that case, the provisions would be ancillary to the success of a cooperative venture between worker and employer and would therefore be justified. Ultimately, the court concluded these "complex questions" required "careful economic analysis" and could not be resolved on the face of the pleadings. The workers' complaint plausibly alleged a *per se* violation of Section 1, and the Seventh Circuit reversed the trial court's dismissal of that claim.

The workers' second theory, relying on the Rule of Reason, fared worse. The district court dismissed that claim pursuant to Federal Rule of Civil Procedure 12(c) because the workers failed to allege McDonald's and its franchisees had sufficient power in the relevant labor market. The district court invited the workers to amend their complaint to allege the requisite market power, but they failed to do so. On appeal, the workers argued no amendment was necessary because McDonald's power in the market for "workers at McDonald's" was obvious. The Seventh Circuit rejected this argument, reasoning that this proposed market was too narrow. The court could not "treat employment for a single enterprise as a market all its own." The workers were free to choose to work for other restaurants. And there were dozens of quick-serve restaurants within three miles of one of the plaintiff's homes and hundreds of similar restaurants within ten miles. Absent any allegations of market power in this broader labor market, "the Rule of Reason is out of this suit."

The Seventh Circuit remanded the action for further proceedings on the workers' *per se* theory. The trial court's earlier ruling denying class certification was not before the Seventh Circuit. However, because the denial of class certification was based, at least in part, on the district court's belief that the *per se* theory was not viable, the appellate court suggested the trial court "may think it wise to reconsider" that decision.

Circuit Judge Kenneth F. Ripple issued a concurring opinion to clarify the scope of the Seventh Circuit's reasoning. He suggested that the court's analysis should "be helpful to the district court" in determining whether the anti-poaching provisions were ancillary to a cooperative venture, but that the Seventh Circuit did not decide the merits of that question. Rather, the Seventh Circuit remanded the question to the district court to make that decision, subject to the district court's own determination as to the "relative usefulness of the various considerations" affecting that decision.

McDonald's appealed the Seventh Circuit's decision to the United States Supreme Court, which denied certiorari.

FranchiseLaw_Vol43_No2_Spring24.indd 184 6/6/24 9:43 AM

ARBITRATION

***Munoz v. Earthgrains Distribution, LLC*, Bus. Franchise Guide (CCH) ¶17,370, 2023 WL 5986129 (S.D. Cal. Sept. 13, 2023)**

Former baked goods distributors brought a class action lawsuit against the producers of baked goods (Earthgrains), alleging California Labor Code violations due to Earthgrains' misclassification of the former distributors as independent contractors rather than employees. The U.S. District Court for the Southern District of California held that the arbitration provisions in the distribution agreement were unenforceable for lack of mutual consent and because they were unconscionable.

Each individual distributor entered into a thirty-four page agreement (Distribution Agreement) to purchase exclusive rights to sell and distribute baked goods within specified geographic areas in California. Each agreement contained a Dispute Resolution Provision (DRP) providing for binding arbitration "governed by the Federal Arbitration Act and the law of the Commonwealth of Pennsylvania to the extent that Pennsylvania law is not inconsistent with the FAA." Each agreement included a waiver of the right to bring any class action in any forum. Along with the Distribution Agreement, the plaintiffs received Franchise Disclosure Documents (FDDs), which contained an addendum for the state of California (California Addendum). The California Addendum stated, "The Distribution (Franchise) Agreement requires that all disagreements be resolved by binding arbitration . . . . This provision may not be enforceable under California law."

Earthgrains filed a motion to compel arbitration, citing terms of the Distribution Agreement. The plaintiff distributors contested the validity of the arbitration provision. The distributors argued there was no mutual assent to the DRP due to a discrepancy between the Distribution Agreement and the California Addendum. Although there was an integration clause and the California Addendum was not part of the agreement, the court determined that extrinsic evidence could be considered where the validity of the agreement was in dispute.

The court relied on *Laxmi Investments, LLC v. Golf USA*, 193 F.3d 1095, 1096 (9th Cir. 1999), where the franchise agreement was preceded by an offering circular which read: "The Franchise Agreement also requires binding arbitration . . . [in the] State of Oklahoma. This provision may not be enforceable under California law." Due to the contradictory terms in the offering circular and franchise agreement, the *Laxmi* court held that the franchisees had no reasonable expectation that it had agreed to a forum other than California. In this case, the Distribution Agreement and addendum were presented to the distributors together and were contradictory. For this reason, the court held there was no meeting of the minds as to the DRP. As California residents, the distributors had no reasonable expectation that they agreed to arbitrate.

The court distinguished *Meadows v. Dickey's Barbeque Restaurants Inc.*, 144 F. Supp. 3d 1069 (N.D. Cal. 2015), which was cited by Earthgrains. In that

case the plaintiffs signed a franchise agreement with a Texas choice-of-law provision, and the FDD accompanying the franchise agreement contained a disclaimer that read: "The franchise agreement requires application of the laws of Texas. This provision may not be enforceable under California law." Immediately preceding the FDD in *Meadows* was a table listing the important provisions of the franchise agreement and a State Cover Page, both of which reiterated the franchisor's intention to apply Texas law. In enforcing the choice-of-law provision, the *Meadows* court explained that the two additional representations made clear that the franchisor would insist on the application of Texas law. Unlike the plaintiffs in *Meadows*, the distributors were not provided with a separate table identifying the arbitration provision as important to the Distribution Agreement. Moreover, in Earthgrains' FDD, the disclosure regarding binding arbitration in the State Cover Page was not readily identifiable from the rest of the text that was also in all capital letters. The disclosure regarding arbitration also appeared in the middle of the page without distinguishable font style or size from the surrounding text. The court found that the producers did not present the distributors with additional and clear representations that the producers would insist on applying the arbitration clause.

The court also found that the DRP, as a whole, was unconscionable. It was a contract of adhesion where the drafting party, a sophisticated and multi-billion-dollar enterprise, had superior bargaining power to individual distributors of limited means and education. Nothing distinguished the arbitration provision itself from any other provision in the thirty-four page agreement. There was no further clarification on the applicability of the arbitration agreement in light of the inconsistencies between the Distribution Agreement and the California Addendum.

In addition, the Distribution Agreement required sixty days' written notice of a dispute or there would be full and complete waiver of the disagreement. The court found this to be substantively unconscionable given that the plaintiffs alleged unwaivable California Labor Code violations that had limitations periods of up to four years. The Distribution Agreement also contained a $10,000 liquidated damages provision for individuals attempting to circumvent arbitration.

To discourage future exploitation of weaker parties, the court refused to sever the unconscionable provisions from the Distribution Agreement and found the DRP unenforceable in its entirety. The DRP contained multiple unconscionable provisions that significantly hindered the distributors' ability to bring claims, imposed a hefty financial burden on the distributors alone, and excluded from arbitration those claims the producers were most likely to bring.

***Fuentes v. Jiffy Lube International, Inc.*, Bus. Franchise Guide (CCH) ¶ 17, 368, 2023 WL 5984284 (E.D. Pa. Sept. 14, 2023)**

The U.S. District Court for the Eastern District of Pennsylvania enforced a mandatory arbitration agreement (Arbitration Agreement) contained within

FranchiseLaw_Vol43_No2_Spring24.indd 186 6/6/24 9:43 AM

the paperwork given to newly hired employees of the Jiffy Lube® franchisee. The court held that the plaintiff-intervenor's electronic acknowledgment of receiving the Arbitration Agreement and his continued employment after said acknowledgment were sufficient to create an enforceable agreement to arbitrate.

Jiffy Lube International, Inc. (Jiffy Lube) is the largest chain of quick oil change and automotive repair services in the United States. Over 2,000 franchises exist across the country. Each Jiffy Lube location is owned and operated by an independent business that entered into a franchise agreement with Jiffy Lube. From 2014 until December 2018, Jiffy Lube's franchise agreement contained a "no-poach" clause that prohibited franchisees from soliciting or hiring employees from other Jiffy Lube franchises.

In November 2018, former Jiffy Lube franchisee employee Victor Fuentes sued Jiffy Lube on behalf of a nationwide class. The complaint asserted that the no-poach provision restricted competition between Jiffy Lube franchises and depressed employees' wages. The Fuentes matter settled in July 2022.

Following the announcement of this settlement, Oscar Jimenez, a former employee of a California-based Jiffy Lube franchisee, Alamitos Enterprises, LLC (Alamitos), moved to intervene as a representative of the nationwide class or, at a minimum, a California subclass. In support of his motion, Jimenez attached a new complaint against Jiffy Lube that alleged violations of antitrust laws on behalf of himself and a class of former Jiffy Lube employees. Jimenez and the purported class alleged that the no-poach agreement placed severe limitations on individual Jiffy Lube franchisees and restricted an employee's ability to obtain better compensation and benefits. The court granted Jimenez's motion to intervene. Jiffy Lube subsequently moved to compel Jimenez to arbitration and to dismiss the complaint for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6).

The court analyzed Jiffy Lube's motions under the motion to dismiss standard. The court, citing a Third Circuit opinion, stated that "when it is apparent, based on the face of a complaint, and documents relied upon in the complaint, that certain of a party's claims are subject to an enforceable arbitration clause, a motion to compel arbitration should be considered under a Rule 12(b)(6) standard without discovery's delay." Here, the court determined that the arbitration agreement was integral to Jimenez's claims and applied the Rule 12(b)(6) standard.

Jiffy Lube's motions were based on the mandatory arbitration provision in the agreement, which contained the aforementioned Arbitration Agreement, on Alamitos's employee electric on-boarding platform (ADP platform or account). Jiffy Lube argued that Jimenez was subject to arbitration because: (1) the Arbitration Agreement became binding after thirty days of employment; and (2) Jiminez's claims fell within the scope of the Arbitration Agreement. Although Jiminez did not sign the agreement containing the Arbitration Agreement, Jiffy Lube submitted screenshots, along with a franchisee affidavit, of Jimenez's ADP account to demonstrate that the user

account associated with Jimenez "acknowledged" receipt of the agreement containing the Arbitration Agreement.

Jimenez submitted an affidavit stating that he was unaware of the existence of the Arbitration Agreement and that he would have opted out had he known of its existence. He further argued that the Arbitration Agreement did not bind him because he did not sign it and was not given sufficient notice that his continued employment would constitute acceptance.

The court determined that California law clearly established that continued employment, following notice of an employer's arbitration agreement, constitutes implied consent to arbitrate (under a preponderance of the evidence standard). The court also noted that California courts "routinely" uphold arbitration agreements despite a party's protest that they do not recall agreeing to them.

The court then held that, even if Jiminez did not sign the agreement containing the Arbitration Agreement, Jiminez's acknowledgment that he received and read the agreement containing the Arbitration Agreement followed by his continued employment constituted acceptance of the Arbitration Agreement. Despite these arguments, the court could not overlook Jimenez's failure to dispute the validity or scope of the arbitration provision, his failure to opt out, his receipt of acknowledgment of the Agreement through his ADP account, or his continued employment for over thirty days after the acknowledgment. These facts weighed in favor of enforcing the Agreement.

Consequently, the court granted Jiffy Lube's motion to compel arbitration and resolved Jimenez's other claims as moot.

BANKRUPTCY

In re Thornhill Brothers Fitness, L.L.C., Bus. Franchise Guide (CCH) ¶ 17,392, 85 F.4th 321 (5th Cir. 2023)

The Fifth Circuit reversed and remanded the bankruptcy court's ruling authorizing the partial assignment of an executory contract under Chapter 11. A franchisee-debtor filed for Chapter 11 bankruptcy because of a personal injury action brought in Louisiana state court. The tort victim in the underlying action was allegedly injured while using an inversion machine at the franchisee-debtor's fitness facility. The franchisee debtor and the tort victim reached a settlement of the underlying tort claim. The settlement included partial assignment of an executory contract between the franchisor and franchisee to the tort victim. Contrary to the requirements of Chapter 11, the bankruptcy court approved the settlement and partial assignment of the franchise agreement.

The underlying tort claim was filed by William Flynn in Louisiana state court against the fitness facility franchise owner—Thornhill Brothers Fitness, LLC (Thornhill)—and franchisor—Anytime Fitness, LLC (Anytime)—for injuries sustained while using an inversion machine at the fitness facility

FranchiseLaw_Vol43_No2_Spring24.indd 188 6/6/24 9:43 AM

owned and operated by Thornhill. Anytime disputed its involvement in the matter, arguing that the inversion machine's presence at the fitness facility was not authorized by the franchise agreement between Thornhill and Anytime. Anytime filed a motion to dismiss, arguing that it was not liable for injuries resulting from an unauthorized piece of fitness equipment. A Louisiana trial court dismissed Anytime with prejudice. An intermediate Louisiana appellate court affirmed. The tort claim matter proceeded between Flynn and Thornhill.

Before trial, Thornhill filed a voluntary petition for bankruptcy. The bankruptcy petition disclosed the Flynn litigation as the only significant non-insider liability for an amount above $1 million. Less than forty-eight hours after filing the bankruptcy petition, Thornhill's counsel emailed the bankruptcy court, informing it that the parties had reached a settlement. Counsel requested a "wet signature" from the court approving the settlement. The court sent counsel a photograph of the signed draft order approving the settlement.

The settlement between Flynn and Thornhill awarded Flynn $1 million plus judicial interest—the maximum amount allowed by Thornhill's insurance policy. Notwithstanding the Louisiana state court's order dismissing Anytime with prejudice, the Flynn settlement allowed Flynn to sue Anytime. The settlement documents also contained an admission by Thornhill to $7 million in total liability to Flynn. Thornhill further agreed to assign all rights it had against Anytime—including those arising from the indemnity provision contained in the franchise agreement. Thornhill would retain all other obligations and benefits associated with the franchise agreement. The settlement further required that Thornhill remain listed as a defendant in name only. Flynn waived his right to pursue any claims against Thornhill. Anytime became aware of the settlement two weeks after the bankruptcy court approved the settlement.

As a result of the settlement, Flynn filed a new lawsuit (New Suit) against Anytime in Louisiana court. The New Suit alleged that Thornhill's admission in the settlement documents, the assignment of Thornhill's rights against Anytime, the indemnity provision of the Agreement, and the bankruptcy court's approval, supported a finding that Anytime was liable to Flynn for $7 million in damages.

Anytime contested the bankruptcy court's approval of the settlement, claiming that it violated Anytime's notice and hearing rights pursuant to Federal Rule of Bankruptcy Procedure 9109(a). The bankruptcy court withdrew its approval and permitted Anytime to contest the settlement. The bankruptcy court entered a new order reaffirming its prior decision. Anytime appealed this order, and the district court affirmed.

On appeal, the Fifth Circuit reviewed the bankruptcy court's ruling relating to the application of 11 U.S.C § 365 and the assignment of executory contracts. There was no dispute that the franchise agreement between Thornhill and Anytime was an executory contract (a contract that neither

party has finished performing). The court agreed that a franchise agreement—in a general sense—could be considered an executory contract because it specifies ongoing obligations between the franchisee and franchisor. 11 U.S.C. § 365(a) addresses executory contracts and states that a trustee in control of a post-petition debtor may, "subject to the court's approval," "assume or reject any executory contract" of the pre-petition debtor. A debtor must clear various statutory hurdles before a trustee can assume an executory contract. For example, if there is a default under the contract, the debtor must either cure the default or provide adequate assurances that the trustee will promptly cure the default. 11 U.S.C. § 365(b)(1). The debtor must also provide adequate assurances of future performance under such a contract. *Id*. An executory contract that is assumed will remain in effect on the assuming party. A debtor may also assign its rights and obligations under an executory contract to others. However, the debtor must assume the contract in accordance with statutory requirements of 11 U.S.C. § 365(f), and the non-bankruptcy party to the contract must be given adequate assurance of the assignee's future performance.

The Fifth Circuit observed that an executory contract must be assumed or rejected in its entirety. A debtor may not choose, or piecemeal, the parts of the agreement to be assumed, especially when the contract contains several agreements. Assignment under 11 U.S.C. § 365(f) is only intended to change who performs the obligations under the contract, not the contract itself. The Fifth Circuit acknowledged that the Bankruptcy Code contains various catch-all provisions but explained that such provisions do not provide the bankruptcy court with the ability to create rights or actions that are otherwise unavailable. The Fifth Circuit noted that if a debtor could sever an agreement and assign specific provisions, the trustee or debtor could assume property that it did not have before the petition, and it would "derogate the counterparty's contractual rights that would have existed outside of bankruptcy." A debtor cannot use 11 U.S.C. § 365 to create an entirely different contract.

Thus, the Fifth Circuit concluded that Thornhill impermissibly used Chapter 11 to partially assign specific rights to Flynn. Thornhill did not assign the entirety of the Agreement to Flynn. What is more, the Agreement forbade assignment without Anytime's consent, which Thornhill did not receive, as evidenced by Anytime's opposition to the assignment and terms of the settlement. The Fifth Circuit found that the bankruptcy court erroneously permitted the partial assignment of an executory contract and failed to discern whether Thornhill assigned nonexistent rights.

Finally, the Fifth Circuit stated that Thornhill's reliance on *In re Jackson Brewing Co.*, 624 F.2d 599 (5th Cir. 1980), in support of its argument that any defect in the bankruptcy court's order was cured by its order approving the settlement was unavailing. *In re Jackson* prescribed a balancing test to govern the court's approval of a Federal Rule of Bankruptcy Procedure 9109

FranchiseLaw_Vol43_No2_Spring24.indd 190 6/6/24 9:43 AM

compromise, not a Chapter 11 assignment of an executory contract. The Fifth Circuit further stated that compliance with the holding in *In re Jackson* is not a substitute for compliance with Chapter 11. A bankruptcy court's rulings must comply with legal precedent and the applicable Bankruptcy Code provisions—compliance with one hurdle does not immediately clear another. The court held that since the bankruptcy court did not satisfy 11 U.S.C. § 365, it did not matter whether they satisfied the rule from *In re Jackson*.

The Fifth Circuit reversed the bankruptcy court's order approving the settlement between Flynn and Thornhill and remanded for further proceedings.

BREAKAWAY FRANCHISEES

***JTH Tax LLC v. Foster*, Bus. Franchise Guide (CCH) ¶17,371, 2023 U.S. Dist. LEXIS 161631 (W.D. Pa. Sept. 12, 2023)**
This case is discussed under the topic heading "Non-Compete Agreements."

CHOICE OF FORUM

***Munoz v. Earthgrains Distribution, LLC*, Bus. Franchise Guide (CCH) ¶17,370, 2023 WL 5986129 (S.D. Cal. Sept. 13, 2023)**
This case is discussed under the topic heading "Arbitration."

CHOICE OF LAW

***Functional Hiit Fitness, LLC v. F45 Training Inc.*, Bus. Franchise Guide (CCH) ¶ 17,379, 2023 WL 6367691 (E.D. Mich. Sept. 28, 2023)**
This case is discussed under the topic heading "Fraud."

CLASS ACTIONS

***Munoz v. Earthgrains Distribution, LLC*, Bus. Franchise Guide (CCH) ¶ 17,370, 2023 WL 5986129 (S.D. Cal. Sept. 13, 2023)**
This case is discussed under the topic heading "Arbitration."

CONTRACT ISSUES

***Functional Hiit Fitness, LLC v. F45 Training Inc.*, Bus. Franchise Guide (CCH) ¶ 17,379, 2023 WL 6367691 (E.D. Mich. Sep. 28, 2023)**
This case is discussed under the topic heading "Fraud."

***Massage Heights Franchising, LLC, v. Hagman*, Bus. Franchise Guide (CCH) ¶ 17,393, 679 S.W.3d 298 (Tex. App. 2023)**
This case is discussed under the topic heading "Vicarious Liability."

***JTH Tax LLC v. Foster*, W.D. Pa., Bus. Franchise Guide (CCH) ¶ 17,371, 2023 U.S. Dist. LEXIS 161631 (W.D. Pa. Sept. 12, 2023)**
This case is discussed under the topic heading “Non-Compete Agreements.”

DAMAGES

***Massage Heights Franchising, LLC, v. Hagman*, Bus. Franchise Guide (CCH) ¶ 17,393, 679 S.W.3d 298 (Tex. App. Ct. 2023)**
This case is discussed under the topic heading “Vicarious Liability.”

DEFINITION OF FRANCHISE

***Cognex Corp. v. Air Hydro Power, LLC*, Bus. Franchise Guide (CCH) ¶ 17,363, F. Supp. 3d , 2023 WL 5833112 (D. Mass. Sept. 8, 2023)**
In a multi-jurisdiction dispute over the non-renewal of a distribution agreement, the U.S. District Court for the District of Massachusetts dismissed all of the distributor’s claims, holding, among other things, that the manufacturer and its distributor had no franchise relationship.

The plaintiff, Cognex, manufactures products used in automated manufacturing. It had a distribution agreement with the defendant, Air Hydro, that was scheduled to expire on December 1, 2021, unless the parties jointly agreed in writing to extend its term. On November 1, 2021, Cognex notified Air Hydro that it would not renew the distribution agreement.

Air Hydro then sued Cognex in Florida state court for breach of the distribution agreement. Before Air Hydro served Cognex with the Florida complaint, Cognex sued Air Hydro in the U.S. District Court for the District of Massachusetts. In the Massachusetts action, Cognex alleged Air Hydro breached the distribution agreement’s forum-selection clause, which required all claims to be brought in Massachusetts, and breached the implied covenant of good faith and fair dealing. Air Hydro then dismissed the Florida action and asserted its counterclaims in the Massachusetts action. Cognex moved to dismiss each of Air Hydro’s counterclaims, and the court granted Cognex’s motion in its entirety.

The district court dismissed Air Hydro’s counterclaim for violation of the Florida Franchise Act (FFA) because the distribution agreement contained a choice of law provision providing the agreement would be governed by Massachusetts law, which barred the FFA claim. The court observed that Massachusetts courts give effect to choice of law provisions unless that provision is contrary to a fundamental policy of a state. Reasoning that, unlike several other Florida statutes with explicit anti-waiver provisions, the FFA conspicuously lacked an anti-waiver provision, which could have prohibited the parties from contractually waiving application of the statute. Therefore, consistent with other federal district courts reaching the same conclusion, the Massachusetts choice of law provision barred the FFA claim.

The district court next dismissed Air Hydro's counterclaims for violation of the Florida Deceptive and Unfair Trade Practices Act, the Indiana Franchise Act, and the Indiana Deceptive Franchise Practices Act because each of those claims required Air Hydro to establish that it had a franchise relationship with Cognex. Whether a franchise relationship existed rested on whether the parties' contract required Air Hydro to make a "required payment" to Cognex or a "franchise fee," which is defined as "all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise."

Air Hydro identified four purported "franchise fees" or "required payments" that it contended, but the district court found none of them qualified. First, Air Hydro claimed its contract required it to purchase demonstration equipment. But the plain language of the contract showed that these purchases were not mandatory, but were instead optional incentives that, if purchased, entitled Air Hydro to discounts on other items. Thus, these payments were not a "condition of obtaining or commencing operation of the franchise."

Second, Air Hydro claimed it was required to pay licensing fees for a software product that facilitated resale of Cognex's products. But the parties' contract did not include this requirement. At most, it required Air Hydro to notify customers that the products for sale included copyrighted software. Under the contract, this was a notice requirement, not a required payment.

Third, without identifying any specific payments, Air Hydro contended it incurred costs in the form of hiring and training employees. It asked the district court to infer that these costs were mandatory payments to Cognex. But because Air Hydro never alleged that it was required to pay Cognex for this training, the district court was unwilling to infer that these payments were mandatory.

Fourth, Air Hydro argued that its costs to build demonstration facilities constituted a required payment. But Air Hydro never alleged it paid these costs to Cognex. The district court viewed these costs, as well as the training and hiring costs, as mere costs of doing business, and not any required payments to Cognex.

Because Air Hydro could not plausibly allege it made a required payment to Cognex, the district court dismissed its claims brought under each of these statutes.

The district court next addressed Air Hydro's claim for breach of the implied covenant of good faith and fair dealing. Air Hydro argued Cognex breached the implied covenant by not compensating Air Hydro for the value of unsold demonstration equipment. However, in the contract, Air Hydro expressly waived any right to "seek indemnity from Cognex for any unsold or unusable inventory." Even if the demonstration equipment was not inventory, Air Hydro pleaded no facts establishing it had any reasonable

FranchiseLaw_Vol43_No2_Spring24.indd 193 6/6/24 9:43 AM

expectation that it would be compensated for unused equipment. Thus, the district court dismissed its claim for breach of the implied covenant.

Air Hydro's claims for tortious interference with business relationship and promissory estoppel were both barred by the express terms of the parties' contracts. Cognex did not wrongfully divert customers away from Air Hydro because the contract expressly stated that Air Hydro's rights were "nonexclusive" and that Cognex had the right to "sell or license any of the Products within [Air Hydro's] Territory." Similarly, Air Hydro's promissory estoppel claim was not supported by Cognex's alleged oral representations that it intended to renew the distribution agreement. Air Hydro could not have reasonably relied on any such oral representation because the contract required all renewals to be in writing. Thus, the district court dismissed both of these claims.

Air Hydro's final counterclaim for unjust enrichment, which alleged that Cognex received the benefit of Air Hydro's purchase of demonstration equipment and general investment in the Cognex brand, also failed. In dismissing this counterclaim, the district court cited the well-established principle that a claim for unjust enrichment cannot survive when a valid express contract covers the same subject matter.

EARNINGS CLAIMS

***Functional Hiit Fitness, LLC v. F45 Training Inc.*, Bus. Franchise Guide (CCH) ¶ 17,379, 2023 WL 6367691 (E.D. Mich. Sept. 28, 2023)**

This case is discussed under the topic heading "Fraud."

FRAUD

***Functional Hiit Fitness, LLC v. F45 Training Inc.*, Bus. Franchise Guide (CCH) ¶ 17,379, 2023 WL 6367691 (E.D. Mich. Sept. 28, 2023)**

The U.S. District Court for the Eastern District of Michigan dismissed several of a franchisee's claims against its franchisor and several individuals responsible for negotiating its franchise agreements, while allowing several other of the franchisee's claims to proceed. Specifically, the court dismissed the franchisee's claims for breach of the implied covenant of good faith and fair dealing, unjust enrichment, violations of the California Franchise Investment Law (CFIL), and violations of the Delaware Uniform Deceptive Trade Practices Act. Holding that Michigan, not Delaware, law applied to the dispute, the franchisee's claims for breach of contract, fraud and misrepresentation, negligent misrepresentation, and violations of the Michigan Franchise Investment Law (MFIL) survived the franchisor's motion to dismiss.

F45 Training Inc. (F45), a franchisor of fitness studios, entered into three franchise agreements for the operation of three F45 studios in Michigan with the franchisee, Functional HIIT Fitness (FHF). FHF alleged that it

received and relied on an outdated Franchise Disclosure Document (FDD) when entering into the first two agreements, and did not receive any FDD before entering into the third agreement. FHF also alleged that individual defendants made written and oral financial performance representations at various times that were not included in the FDD, and inaccurately inflated the profitability of F45 studios.

In its breach of contract claim, FHF alleged that F45 charged fees and costs that were not identified in the applicable franchise agreements. In particular, F45 allegedly breached by overcharging for heart rate monitors, failing to disclose the cost of music licensing fees, and incorrectly listing the costs of leasehold improvements in the FDD as being substantially less than the amount FHF paid at one of its studios.

F45 and the individual defendants moved to dismiss all claims, and four of the five individual defendants brought a motion to dismiss the complaint for lack of personal jurisdiction.

The court first determined whether personal jurisdiction existed over the individual defendants. Four of the defendants involved in the franchise sales process were not Michigan residents; instead, they were each Australian citizens. One defendant lived in Australia, two lived in Texas, and one lived in California. The court found that being officers of the franchisor was insufficient to create personal jurisdiction. Rather, FHF needed, and failed to present, evidence that the individual defendants were actively and personally involved in the conduct giving rise to the claims for the court to exercise personal jurisdiction.

Regarding FHF's claims under California, Delaware, and Michigan law, the court proceeded to analyze which state's law applied. Although the franchise agreements provided for Delaware law and would govern all disputes under the franchise agreement, the court concluded that applying Delaware law would be contrary to a "fundamental public policy" of Michigan, and the MFIL applied and Michigan law governed the dispute in its entirety. Unlike Delaware law, which the court noted does not require pre-contractual notice or disclosure, Michigan law expressly provides for protecting franchisees from "superior bargaining power" of franchisors under the MFIL.

Having determined that Michigan law applied, the court held that the franchisee had sufficiently stated a claim for fraud, fraudulent inducement, and misrepresentation. The franchisee also alleged sufficient facts to state a claim for breach of contract. The court declined to determine whether the franchisee's contract claims over music licensing and leasehold improvement amounts in the FDD should proceed. The issue of whether the franchise agreements fully incorporated the FDDs was better addressed at a later stage of the litigation, not on a motion to dismiss.

Finally, the court dismissed the franchisee's claims under the CFIL and Delaware Uniform Deceptive Trade Practices Act simply because Michigan law governed the dispute.

GOOD FAITH AND FAIR DEALING

***Cognex Corp. v. Air Hydro Power, LLC*, Bus. Franchise Guide (CCH) ¶ 17,363, F. Supp. 3d , 2023 WL 5833112 (D. Mass. Sept. 8, 2023)**
This case is discussed under the topic heading "Definition of a Franchise."

INJUNCTIVE RELIEF

***JTH Tax LLC v. Foster*, W.D. Pa., Bus. Franchise Guide (CCH) ¶ 17,371, 2023 U.S. Dist. LEXIS 161631 (W.D. Pa. Sept. 12, 2023)**
This case is discussed under the topic heading "Non-Compete Agreements."

JURISDICTION

***Functional Hiit Fitness, LLC v. F45 Training Inc.*, Bus. Franchise Guide (CCH) ¶ 17,379, 2023 WL 6367691 (E.D. Mich. Sept. 28, 2023)**
This case is discussed under the topic heading "Fraud."

LABOR AND EMPLOYMENT

National Labor Relations Board—Rule on Joint-Employer Status and Potential Effects on the American Franchise Model
On October 26, 2023, the National Labor Relations Board (NLRB) issued its Final Rule (Rule) addressing the standard for determining Joint-Employer Status under the National Labor Relations Act (NLRA). The Rule went into effect on December 26, 2023. The new standard will only apply to cases filed after December 26, 2023.

Under the Rule, Joint-Employer Status can be established if each entity has an employment relationship with a group of employees and they share, or jointly influence, one or more of an employee's essential terms or conditions of employment. The Rule identifies "essential terms or conditions" as:

(1) Wages, benefits, and other compensation;
(2) Hours of working and scheduling;
(3) The assignment of duties to be performed;
(4) The supervision of the performance of duties;
(5) Work rules and directions governing the manner, means, and methods of the performance of duties and the grounds for discipline;
(6) The tenure of employment, including hiring and discharge; and
(7) Working conditions related to the safety and health of employees.

See 29 CFR 103.40(c).

The key aspect of the Rule's "share" or "codetermine" requirement means that the employer possesses the "authority to control (whether directly, indirectly, or both), or to exercise the power to control (whether directly,

indirectly, or both) one or more of the employees' essential terms and conditions of employment." This provision subsequently raises the question of whether *indirect* or *reserved* control is sufficient, on its own, to establish joint-employer status.

Separately, an entity that is considered a joint employer due to its control over essential employment terms will be required to bargain over those terms and conditions in addition to other areas it exercises control over. Opponents of the Rule argue that it is overbroad and expands a franchisor's liability exposure to claims typically handled by franchisees. Many fear that the Rule seeks to alter the American franchise model for the worse. Proponents of the Rule argue that it is a pragmatic approach to ensure that employers who exercise control over an employee's "essential terms or conditions" of employment respect its obligations and bargaining requirements under the NLRA. Nonetheless, the Rule is undergoing congressional review and will (and already has been) subjected to legal challenges.

***Munoz v. Earthgrains Distribution, LLC*, Bus. Franchise Guide (CCH) ¶ 17,370, 2023 WL 5986129 (S.D. Cal. Sept. 13, 2023)**
This case is discussed under the topic heading "Arbitration."

***Massage Heights Franchising, LLC, v. Hagman*, Bus. Franchise Guide (CCH) ¶ 17,393, 679 S.W.3d 298 (Tex. App. Ct. 2023)**
This case is discussed under the topic heading "Vicarious Liability."

NON-COMPETE AGREEMENTS

***JTH Tax LLC v. Foster*, W.D. Pa., Bus. Franchise Guide (CCH) ¶ 17,371, 2023 U.S. Dist. LEXIS 161631 (W.D. Pa. Sept. 12, 2023)**
The U.S. District Court for the Western District of Pennsylvania held that a tax return preparation franchisor could not enforce non-competition and non-solicitation covenants of its franchise agreement with a Pennsylvania franchisee after the time restriction in the covenant had passed. The court concluded that the franchisor's claims of recent discovery of covenant violations that occurred years earlier reflected a lack of diligence in monitoring and enforcing its contractual rights. Despite the franchisor's delay, the equities relating to its request for return of the operations manual, customer lists and contact information, customer tax returns and files, could still support the franchisor overcoming a laches defense raised by the franchisee.

In September 2015 JTH Tax/Liberty Tax Service (Liberty) entered into a franchise agreement with the franchisee (Foster) for the operation of a tax preparation business in Pennsylvania. In May 2020, Liberty issued notice of breaches, including failure to pay monies owed, failure to open a franchise for business pursuant to the franchise agreement's schedule, and failing to actively operate her office. In June 2020, after Foster failed to cure, Liberty terminated the franchise agreement. In January 2023, Liberty filed suit

against Foster for breach of the franchise agreement and promissory notes, violations of the Defend Trade Secrets Act (DTSA), conversion, and unjust enrichment. Liberty sought injunctive relief to prevent Foster's operation of a tax service business in Foster's former territory and diverting or attempting to divert Liberty's customers for two years following entry of injunctive relief. Liberty alleged that it only recently discovered that Foster was operating a separate tax company since at least January 2020, that Foster had solicited Liberty's clients during the 2020 tax season, and that Foster created a website for the separate company while still a franchisee.

In response to Liberty's motion to dismiss, Foster argued Liberty's claims for breach of the notes and for conversion were barred by the statute of limitations, and that the doctrine of laches barred the injunctive relief sought.

The district court determined it had subject matter jurisdiction due to Liberty's DTSA claim. Liberty's assertions surrounding its tax service system and its franchised income tax preparation centers located throughout the United States were sufficient to support the necessary nexus between its tax preparation services and interstate commerce, therefore supporting federal question jurisdiction.

The court then exercised supplemental jurisdiction over Liberty's state law claims. However, the court had to decide which state's law to apply. The franchise agreement and promissory notes contained a Virginia choice of law provision, but did not contain an express statement of intent to apply Virginia's statutes of limitation. In accordance with Pennsylvania's choice of law rules, the court looked to Pennsylvania law to resolve Foster's statute of limitations defense.

The court denied Foster's motion to dismiss Liberty's claim for breach of the promissory notes. The court determined that, whether the notes were under seal, and therefore subject to a potential twenty-year limitations period, was a question of fact, not law, and therefore not appropriate to determine at the dismissal stage. The court could not determine from Foster's complaint whether Foster's assertion that Foster rejected Liberty's request to include a seal with a signature was sufficient to rebut a presumption under Pennsylvania law that Foster adopted the seal. However, Pennsylvania's two-year statute of limitations for conversion barred that claim.

With respect to Liberty's claims for injunctive relief, the court refused to enforce the non-competition and non-solicitation clauses beyond their contractual expiration date. Under Virginia law, which governed the franchise agreement, a prospective injunction may issue beyond the expiration date only where the party seeking the injunction did not contribute unnecessarily to the delay that led to the expiration of the original non-compete covenant. The court found no such narrow exception applied in this case, because there was no delay outside of Liberty's control in filing the action.

In response to Foster's laches defense, and notwithstanding the court finding that Liberty lacked diligence in enforcing its rights, it drew a distinction from Liberty's request for return of property. The court found it to be

a relatively simple and straightforward request that was not certain to affect matters of proof.

STATUTE OF LIMITATIONS

***JTH Tax LLC v. Foster*, Bus. Franchise Guide (CCH) ¶ 17,371, 2023 U.S. Dist. LEXIS 161631 (W.D. Pa. Sept. 12, 2023)**

This case is discussed under the topic heading "Non-Compete Agreements."

STATUTORY CLAIMS

***Cambria Co., LLC v. M&M Creative Laminates, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,351, 995 N.W.2d 426 (Minn. Ct. App. 2023)**

After a buyer (M&M) of quartz countertops failed to timely pay the manufacturer's (Cambria) invoices, Cambria terminated the parties' contracts (a series of "business-partner agreements" or "BPAs") and sued for damages. M&M counterclaimed, alleging among other things that the termination violated the Minnesota Franchise Act (MFA). The Minnesota Court of Appeals affirmed Cambria's victories at summary judgment and trial, holding the parties' relationship was not a "franchise" under the MFA.

Cambria, manufactures and sells quartz countertops. Under its contracts with M&M, Cambria agreed to fabricate and polish countertops based on M&M's purchase orders, which M&M would then install in homes and commercial buildings. M&M regularly failed to timely pay Cambria's invoices. Eight years into the parties' relationship, M&M was more than $150,000 in arrears. Cambria terminated the parties' contracts and sued for the outstanding balance.

M&M asserted counterclaims premised on its relationship with Cambria constituting a "franchise" under the MFA. M&M alleged that Cambria violated the MFA because it did not have the requisite "good cause" to terminate the parties' relationship and because Cambria failed to provide ninety days' notice of the termination.

In its motion for summary judgment, Cambria argued the MFA did not apply because the parties' relationship did not meet the statutory definition of a "franchise." Cambria's argument turned on whether M&M paid a "franchise fee" to Cambria. The MFA defines a "franchise fee" as "any payment for goods or services," but expressly excludes "the purchase of goods or agreement to purchase goods at a bona fide wholesale price." M&M argued its payments to Cambria did not fall within the exclusion because the payments were not only for goods (countertops), but also for services (fabrication). According to M&M, because every payment included, in part, a payment for services, the exception did not apply.

The appellate court found minimal case law on whether the purported "fee" constituted a "franchise fee" under the MFA and, therefore, looked to Uniform Commercial Code cases. Reasoning that paying for a product with

some added service "does not transform a contract of sale into a contract for services," the appellate court concluded the predominant purpose of M&M's payments to Cambria was to purchase goods, i.e., countertops. The inclusion of ancillary fabrication services did not convert the payment into one for services. Thus, the payments fell within the exception and did not constitute a "franchise fee." The appellate court therefore affirmed the trial court's entry of summary judgment against M&M on its claim for violation of the MFA.

The Minnesota Court of Appeals decided several other issues in Cambria's favor. First, M&M brought claims against Cambria for tortious interference with contract and unfair competition, alleging Cambria's improper termination of the contracts caused it to lose customers. The trial court granted summary judgment on these claims, ruling they were barred by a contractual limitation of liability provision stating Cambria would not be liable for "lost profits . . . however caused and on any theory of liability arising out of this agreement, or this termination," whether based in contract or tort. The appellate court affirmed that ruling, finding as a matter of contract interpretation that the plain language of the limitation of liability provision covered these two claims.

Next, the court affirmed the trial court's award of more than $75,000 in costs to Cambria. After filing suit, Cambria served M&M with an offer of judgment under Minnesota Rule of Civil Procedure 68.01(d). The offer of judgment proposed the parties would dismiss all claims and counterclaims with prejudice with no exchange of money. At the resulting trial, the jury awarded Cambria damages that, after accounting for offset, exceeded $200,000. Because that award was less favorable to M&M than the offer of judgment, the trial court ordered M&M to reimburse Cambria for its costs. M&M appealed, arguing a confession of judgment with no dollar figure was ineffective. The appellate court swiftly rejected this theory and affirmed the trial court, reasoning that the confession of judgment was the equivalent of a "zero-dollar offer."

Finally, the Minnesota Court of Appeals affirmed a sanctions award against M&M's attorney for violating a protective order. The protective order stated that all confidential information would be used "solely for the purpose of this action" and should not be communicated to any person other than the parties, attorneys, or court staff. M&M's counsel disclosed a summary of a witness's confidential testimony to another law firm, which then published that information to the International Trade Commission. Both a special master and the district court found that the attorney violated the protective order "for whatever benefit he could get for his client." The appellate court, under a deferential abuse of discretion standard of review, affirmed the sanctions award against the attorney.

***Functional Hiit Fitness, LLC v. F45 Training Inc.*, Bus. Franchise Guide (CCH) ¶ 17,379, 2023 WL 6367691 (E.D. Mich. Sept. 28, 2023)**

This case is discussed under the topic heading "Fraud."

TERMINATION AND NONRENEWAL

***Cognex Corp. v. Air Hydro Power, LLC*, Bus. Franchise Guide (CCH) ¶ 17,363, F. Supp. 3d , 2023 WL 5833112 (D. Mass. Sept. 8, 2023)**
This case is discussed under the topic heading "Definition of a Franchise."

TORTIOUS INTERFERENCE

***Cambria Co., LLC v. M&M Creative Laminates, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,351, 995 N.W.2d 426 (Minn. Ct. App. 2023)**
This case is discussed under the topic heading "Statutory Claims."

***Cognex Corp. v. Air Hydro Power, LLC*, Bus. Franchise Guide (CCH) ¶ 17,363, F. Supp. 3d , 2023 WL 5833112 (D. Mass. Sept. 8, 2023)**
This case is discussed under the topic heading "Definition of a Franchise."

UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES

***Cognex Corp. v. Air Hydro Power, LLC*, Bus. Franchise Guide (CCH) ¶ 17,363, F. Supp. 3d , 2023 WL 5833112 (D. Mass. Sept. 8, 2023)**
This case is discussed under the topic heading "Definition of a Franchise."

VICARIOUS LIABILITY

***Massage Heights Franchising, LLC, v. Hagman*, Bus. Franchise Guide (CCH) ¶ 17,393, 679 S.W.3d 298 (Tex. App. Ct. 2023)**
In a lawsuit brought by the customer of a franchised massage parlor, the Houston division of the Texas Court of Appeals upheld a compensatory damages award against the franchisor, finding that a franchisor can be vicariously liable for the negligent actions of the franchisee in hiring an individual with a known violent criminal record. However, the court held that an individual cannot recover punitive damages from a franchisor when the cause of such damages is rooted in the criminal actions of another individual.

Appellant Massage Heights Franchising, LLC (MH Franchising) licenses its trademarks, service marks, and business systems to franchisees, who subsequently operate businesses offering massage and professional therapeutic services to the public. These businesses operate under the name "Massage Heights." The relationship between MH Franchising and its franchisees is governed by the franchise agreement and MH Franchising's operations manual (Manual). The franchisee involved in this case, MH Alden Bridge, LLC (MH Alden Bridge) is located in The Woodlands, Texas, and is owned by OMG MH Holdings, LLC (OMG Holdings). Eric Oliver is the president of OMG Holdings.

Appellee Danette Hagman initiated suit against her masseuse, Mario Rubio (who had a criminal record for assault and robbery), MH Franchising,

Oliver, and OMG Holdings alleging negligence, premises liability, respondeat superior, violations of the Texas Deceptive Trade Practices Act, and gross negligence. Hagman alleged that Rubio sexually assaulted her during a massage and prevailed at trial. The jury ultimately found MH Franchising to be fifteen percent at fault. The jury awarded Hagman $1.5 million in damages and $1.8 million in punitive damages. MH Franchising appealed the jury verdict and award.

MH Franchising argued that it was not liable to Hagman under a negligence cause of action because (1) it did not retain control over MH Alden Bridge's employment practices (e.g., hiring, firing, and supervision); (2) MH Franchising was unaware of any complaints regarding Rubio; (3) Texas required that Rubio be licensed by the state, undergo professional training, and submit a background check; (4) MH Alden Bridge's supplemental background check failed to reveal any sexually motivated crimes; (5) Rubio's criminal act was a superseding cause of Hagman's damages, and, as such, the chain of causation was broken; and (6) there was no evidence of breach and causation.

The appellate court upheld the jury's finding that MH Franchising breached its duty owed to Hagman. In support of this finding, the appellate court reasoned that although MH Franchising did not exert direct control over the hiring process implemented by MH Alden Bridge, the MH Franchising franchise agreement provided an avenue by which MH Franchising could have exercised such control, and MH Franchising failed to exercise such control. Specifically, the franchise agreement and Manual contained various provisions controlling the work performed by masseuses and client interactions. Notably, the franchise agreement and Manual did not contain any provisions addressing the employment of individuals with a criminal record. Despite this, the court determined that the franchise agreement and Manual granted MH Franchising the contractual right to exercise control over the "means, methods, and details of the massages provided by masseuses in its franchisees' locations as well as the interactions between the masseuses and clients." The court further stated that the franchise agreement's authorization for a franchisee to make independent decisions regarding the hiring, firing, and training of the franchisee's staff did not excuse "MH Franchising from the duty to act reasonably with regard to the detail over which it did retain control—providing massages to customers by masseuses."

According to the *Hagman* court, Texas law supports the existence of such a duty. Specifically, employers have a duty to investigate potential employees who would be given access to individuals in vulnerable positions. Here, the court reiterated that an individual who removes all—or most—of her clothes to receive a service (such as a massage) is placed in a vulnerable position—a point that MH Alden Bridge and MH Franchising did not dispute during trial. Based on the above, the court determined that MH Franchising had the ability to exert control to protect the franchisee's customers from foreseeable harm but failed to do so.

As to causation, the court found that MH Franchising's negligence was the proximate cause of Hagman's injuries. The court reiterated that MH Alden Bridge hired Rubio *because* MH Franchising permitted the hiring of masseuses with any kind of criminal record. Even though Rubio's past criminal offenses were not sexual in nature, the court found sufficient evidence to support the argument that, had MH Franchising exercised its control and prevented individuals with "violent offenses" (like Rubio) from obtaining employment, then Hagman would not have been assaulted. Finally, the court concluded that placing "a violent criminal with a history of poor impulse control in a position of power over an undressed and trusting customer behind a closed door poses a foreseeable risk of harm to the customer." The danger of a sexual assault by a masseuse is a foreseeable harm.

Despite MH Franchising's arguments that Rubio's criminal action was a "new and independent cause," the court rejected MH Franchising's superseding cause argument. A superseding cause is one that "intervenes between the original wrong and the final injury so that the injury is attributed to the new cause rather than the original and more remote cause." "To be a new and independent cause, the intervening cause must be both unforeseeable and a superseding cause of the injury." The court held that Rubio's act arose from MH Franchising's negligence in permitting the placement of a violent criminal in a position of power. Furthermore, the court held that the danger of a sexual assault by a masseuse was, and is, a foreseeable risk. The court rejected MH Franchising's superseding cause argument.

Finally, the court reversed the trial court's award of punitive damages to Hagman. Texas Civil Practice and Remedies Code § 41.005(a) prohibits the award of punitive damages for negligence occurring concurrently with a criminal act (or in matters involving harm caused by a criminal act). The court found that her injuries were indivisible to Rubio's criminal act. Accordingly, the court reversed the award of exemplary damages.

***Matter of Thornhill Brothers Fitness, L.L.C.*, Bus. Franchise Guide (CCH) ¶ 17,392, 85 F.4th 321 (5th Cir. 2023)**

This case is discussed under the topic heading "Bankruptcy."

FranchiseLaw_Vol43_No2_Spring24.indd 204

6/6/24 9:43 AM