

Franchising Law: What You Need to Know

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1. INTRODUCTION

A franchise relationship is not a single relationship, but a series of interwoven relationships: franchise seller/prospective franchisee, licensor/licensee, independent contractor, wholesaler/retailer, and debtor/creditor. As franchising parties, and as advisors who assist them, it is important to have a good understanding of the basics of this heavily-regulated business model and the laws that apply to the various aspects of the franchise relationship.

Generally speaking, a “franchise” is a license to use the franchisor’s business format and operating system (which may include the franchisor’s trade secrets, recipes, methods of operation, access to key suppliers, customer base, and/or distribution network) and to operate under the franchisor’s trademark. Therefore, at its very core, a franchise agreement is a trademark license. To the extent that the franchise conveys the right to use the franchisor’s copyrights and/or patented processes or inventions, it is also a copyright and patent license. To the extent that the franchise conveys the right to use trade secrets or confidential information, the franchise agreement is a nondisclosure agreement.

From the franchisee’s perspective, acquiring franchise rights is valuable because it shortens the business start-up phase. By providing the franchisee initial training, an operations manual, site selection assistance, supplier relationships (and possibly volume purchasing capabilities), and advertising and marketing support, a franchise enables the franchisee to hit the ground running, which (in theory) results in a faster return on investment.

From the franchisor’s perspective, the challenge is to ensure that all customers enjoy the same customer experience, regardless of location. To this end, franchisors will require franchisees to adhere to uniform operating procedures (which may include pricing models), to buy from designated or approved suppliers, and to participate in advertising campaigns. When the relationship ends, the challenge is to preserve the business goodwill at the franchise location, so that the location or area can be refranchised or operated corporately. To this end, the franchisor will have a post-term option to assume the lease for the franchised business location and the right to purchase the business assets, and to acquire telephone numbers, directory listings, etc. The franchisee will be bound by a post term noncompete covenant for a certain period following the end of the franchise relationship, typically up to two years.

Because franchisees do not necessarily have access to the information necessary to perform due diligence on their franchisors, and because the franchisor has the contractual right to control significant aspects of the franchisee’s method of operations, it is generally acknowledged that franchisors have more leverage than the franchisee during both the franchise sales process and the franchise relationship. For this reason, the federal government and certain states have enacted legislation aimed at educating franchisees before the franchise is sold (these are referred to as “franchise sales laws”) and certain states have enacted legislation aimed at protecting the franchisee in the context of termination, nonrenewal, or transfer of the franchise (these are referred to as “franchise relationship laws”).

This paper provides an overview of the basics of franchising, including a discussion on the franchise agreement in terms of the intellectual property rights that it conveys and the federal and state regulatory scheme. It also provides an overview of federal and state antitrust laws that may limit a franchisor’s right to dictate pricing or designate suppliers, a summary of employment law issues that may impact the franchise relationship, and of the various laws affecting the enforceability of typical franchisor remedies, such as noncompete and liquidated damages provisions.

2. THE LICENSE

At the core of the franchise agreement is a trademark license. A well-regarded trademark can hold enormous value. For example, in 2015 Interbrand, an appraisal company, valued the Apple brand at \$170 billion and the GOOGLE brand at \$120 billion.¹ The value of a trademark is often referred to as “goodwill,” and an important aspect of the franchise agreement is the franchisee’s ability to tap into the licensed trademark’s goodwill. Thus, trademarks are the corner stone of a franchise system.²

Trademarks are governed by both state and federal laws in the United States. The Lanham Act is the source of federal trademark law.³ The Lanham Act was enacted in 1946 to create a “national system for registering and protecting trademarks used in interstate and foreign commerce.”⁴ Congress’ purpose in enacting the Lanham Act was to advance two goals of trademark law: (1) to “protect the public so it may be confident that, in purchasing a product bearing a particular trademark which it favorably knows, it will get the product which it asks for and wants to get”⁵ and (2) “to ensure that a [trademark owner] can protect his investment from [. . .] misappropriation by pirates and cheats.”⁶

The Lanham Act defines a “trademark” as any word, name, symbol, or device, or any combination thereof.⁷ This definition encompasses both the traditional trademarks, such as slogans and logos, as well as nontraditional marks, such as shapes (*e.g.*, COCA-COLA bottle), sounds (*e.g.*, NBC’s three chimes), fragrances (*e.g.*, Plumeria blossoms on sewing thread), and colors (*e.g.*, green-gold pads for use with dry cleaning).⁸ The distinctive trade dress elements in a franchise system can also be protected by trademark law.⁹ Trade dress is the “total image” of a product or service, which “may include features such as size, shape, color or color combinations, texture, graphics, or even particular sales techniques.”¹⁰ The Supreme Court explained that “almost anything at all that is capable of carrying meaning” may be used as a “symbol” or “device” in a way that constitutes trade dress.¹¹ Some examples

¹ INTERBRAND RANKINGS, <http://interbrand.com/best-brands/best-global-brands/2015/ranking/> (last visited June 1, 2016).

² *Susser v. Carvel Corp.*, 332 F.2d 505, 516 (2nd Cir. 1964).

³ 15 U.S.C. § 1501 et seq.

⁴ *In re Tam*, 808 F.3d 1321, 1328 (Fed. Cir. 2015).

⁵ *Id.* (quoting *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 782 n.15, (1992) (Stevens, J., concurring) (quoting S. Rep. No. 79-1333, at 3 (1946))).

⁶ *Id.*; see also *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.*, 456 U.S. 844, 854 n.14 (1982) (“By applying a trademark to goods produced by one other than the trademark’s owner, the infringer deprives the owner of the goodwill which he spent energy, time, and money to obtain. At the same time, the infringer deprives consumers of their ability to distinguish among the goods of competing manufacturers.” (citations omitted)).

⁷ 15 U.S.C. § 1127.

⁸ Cheryl L. Mullin & Sophilia H. Wu, *The Wheels on the Bus: Is There Protection for the Franchise Operating System?*, 35 Franchise L.J. 623, 624 n.2 (2016) (citing Coca-Cola Bottle Shape Design, Registration No. 696,147; NBC Chimes, Registration Nos. 523,616 and 916,522; *In re Clarke*, 17 U.S.P.Q.2D 1238, 1240 (TTAB 1990) (registration for scent of Plumeria blossoms used in connection with sewing thread); *Qualitex v. Jacobsen Prods. Co., Inc.*, 514 U.S. 159, 160 (1995) (concluding that the Lanham Act permits the registration of a trademark that consist purely of color)).

⁹ *Id.* at 624 n.5; 15 U.S.C. § 1125(a)(3); 15 U.S.C. § 1125(c)(4).

¹⁰ Mullin, *supra* note 8, at 624 n.6 (citing *Two Pesos, Inc.*, 505 U.S. at 764 n.1. See also *Original Appalachian Artworks, Inc. v. Toy Loft, Inc.*, 684 F.2d 821 (11th Cir. 1982), (involving the sale of soft-sculpture dolls through a marketing technique comprised of adoption procedures and a birth certificate. There, the Eleventh Circuit held that the adoption procedure qualified as protectable trade dress because it was part of the dolls’ “packaging,” “both in the sense that dolls are never sold without the adoption papers and birth certificate and because the adoption procedure is designed to make [the plaintiff’s] dolls distinctive in the marketplace.” *Id.* at 831.)

¹¹ *Qualitex Co. v. Jacobson Products Co.*, 514 U.S. 159, 160 (1995); TMEP § 1202.02 (Oct. 2015).

of protectable trade dress in the franchise context include McDonald's Golden Arches, IHOP's blue roof, and the color of Stanley Steemer's van.¹²

The Lanham Act grants important rights and benefits to owners of trademark registrations.¹³ The owner of a trademark registration has "a right to exclusive nationwide use of that mark where there was no prior use by others."¹⁴ Under state common law, the owner of a trademark only has exclusive rights to use the trademark in the geographic area in which actual use has actually taken place.¹⁵ Thus, federal trademark registration extends an important substantive right that could not otherwise be obtained by the trademark owner.¹⁶ Additional benefits include the presumption that a registered mark is valid,¹⁷ and the owner of the registered trademark can sue in federal court to enforce his trademark rights.¹⁸ The owner may recover treble damages if he is able to prove that the trademark infringement was willful.¹⁹ The owner can also gain assistance from the U.S. Customs and Border Patrol in terms of restricting the entry of imported infringing or counterfeit goods.²⁰

On the state level, trademark rights are subject to state regulations as well as state common law.²¹ Under state statutes, trademark owners can apply for state trademark registrations. However, such registrations provide very little protection for trademark owners. Under state common law, trademark owners gain rights through the use of trademarks, even without filing any formal paperwork.

On both the federal and state level, trademark rights hinge on use rather than registration. Under state and federal laws, the existence of protectable trademark rights follow use of a trademark in the ordinary course of offering the trademark owner's goods or services to the public.²² To prove the validity of the use of the trademark, evidence of the following are required: the dates of first use, and perhaps, the manner and frequency of use of the mark; who used the trademark (*i.e.*, if the trademark is used by licensees or other related entities); inherent or acquired distinctiveness of the trademark; and other facts that may be relevant to proving validity and ownership.²³ If a third party is able to assert superior rights through evidence of use that pre-dates that of the federal trademark applicant or registrant, then the federal trademark application or registration is vulnerable to attack. However, the third party seeking to assert superior rights based on prior use only has exclusive rights to use the trademark in the geographic area in which actual use has taken place.²⁴ This underscores the importance of conducting a thorough

¹² McDonald's Golden Arch Design, Registration No. 0893440; *IHOP Corp. v. Langley*, 2008 U.S. Dist. LEXIS 112056, at *4 (E.D.N.C. Apr. 11, 2008) (fact that defendant repainted the roof of his breakfast restaurant "in the same shade of blue as is common to see on the roofs of IHOP restaurants" contributed to a finding of likelihood of confusion); The color yellow-orange, which is the approximate equivalent of Pantone Matching System 143C. Registration No. 3182240.

¹³ *B&B Hardware, Inc. v. Hargis Ind., Inc.*, 135 S. Ct. 1293, 1300 (2015).

¹⁴ *In re Tam*, 808 F.3d at 1328; See 15 U.S.C. §§ 1072, 1115.

¹⁵ 15 U.S.C. §§ 1072, 1115; see 5 J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition § 26:32 (4th ed.).

¹⁶ *In re Tam*, 808 F.3d at 1328.

¹⁷ 15 U.S.C. § 1057(b); *In re Tam*, 808 F.3d at 1328.

¹⁸ 15 U.S.C. § 1121; *In re Tam*, 808 F.3d at 1328.

¹⁹ 15 U.S.C. § 1117; *In re Tam*, 808 F.3d at 1328.

²⁰ 15 U.S.C. § 1124; *Id.* § 1526; *In re Tam*, 808 F.3d at 1328.

²¹ Lee Ann W. Lockridge, *Abolishing State Trademark Registrations*, 29 Cardozo Arts & Ent L.J. 597, 599-600 (2012).

²² See Restatement (Third) of Unfair Competition §§ 9 (defining a trademark), 18 (discussing use) (1995).

²³ Lockridge, *supra* at note 4, at 601 n.11 (citing *Emergency One, Inc. v. Am. Fire Eagle Engine Co.*, 332 F.3d 264, 267-70 (4th Cir. 2003); *Allard Enters., Inc. v. Advanced Programming Res., Inc.*, 249 F.3d 564, 572-75 (6th Cir. 2001); *Sengoku Works, Ltd. v. RMC Int'l, Ltd.*, 96 F.3d 1217, 1220 (9th Cir. 1996); *First Bank v. First Bank Sys., Inc.*, 84 F.3d 1040, 1044-46 (8th Cir. 1996)).

²⁴ *In re Tam*, 808 F.3d at 1328; See 15 U.S.C. §§ 1072, 1115; see 5 J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition § 26:32 (4th ed.).

trademark search of the federal trademark database as well as common law use of the trademark prior to adopting a new trademark and investing resources into building up a new brand.

3. FEDERAL AND STATE FRANCHISE SALES LAWS

A. Federal Franchise Law

Franchising is regulated at the federal level by the Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising as amended in 2007 (the “Amended FTC Rule”), which is enforced by the Federal Trade Commission.²⁵

The Amended FTC Rule applies to the offer and sale of a “franchise” that will be located in the United States. It defines a “franchise” as “any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that: (1) the franchisee will obtain the right to operate a business that is identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark; (2) the franchisor will exert or has authority to exert a significant degree of control over the franchisee’s methods of operation, or provide significant assistance in the franchisee’s method of operation; and (3) as a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment [currently \$500, but increasing to \$570 as of July 1, 2016] or more to the franchisor or its affiliate.”²⁶ In May 2008, the FTC published the *Franchise Rule Compliance Guide*²⁷ which, among other things, further explains and provides examples of what constitutes “significant control” and “significant assistance” for purposes of determining whether a franchise exists.

Federal law requires delivery of a franchise disclosure document at least 14 calendar days before a prospective franchisee signs a binding agreement or pays any consideration for the franchise, (2) requires that the franchisee be given execution copies of the franchise agreements, with all blanks filled in, at least seven days before signing, (3) prohibits sharing any financial information with prospective franchisees (orally or in writing) except to the extent Item 19 of the FDD contains a formal financial performance representation, and (4) contains additional prohibitions.

Certain sales are exempt from the law’s purview. These include sales where total payment to the franchisor is less than \$500 (or \$570 as of July 1, 2016), “fractional franchises” (where the parties anticipate that the sales arising from the relationship will not exceed 20% of the franchisee’s total dollar volume), “leased department” arrangements (for example, where a specialty jeweler leases space in a department store), purely oral agreements (so long as none of the material terms are written down), large franchise investment (where at least one individual makes an initial investment of at least \$1 million (or \$1,143,100 as of July 1, 2016)), sales to “large” franchisees (such as airports, hospitals, and universities, that have been in business for at least five years and have a net worth of at least \$5 million (or \$5,715,500 as of July 1, 2016)), and sales to “insiders” (defined as officers, directors, general partners, managers and owners of the franchisor).

The Amended FTC Rule dictates the content and presentation format of the disclosure document (which is broken out into 23 “Items”), and prohibits franchisors from including in the disclosure document anything other than the prescribed information. Failure to follow the instructions for preparing and delivering disclosure documents and failure to comply with the Amended FTC Rule’s other

²⁵ 16 C.F.R. Part 436 (2007).

²⁶ *Id.*

²⁷ Available at <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf>

prohibitions are considered unfair or deceptive acts or practices under Section 5 of the Federal Trade Commission Act.²⁸

Federal law requires that the franchisor's disclosure document be updated within 120 days of the franchisor's fiscal year end²⁹, as well as in the event of a "material change" (i.e., a significant change which could likely influence a prospective franchisee's decision whether or not to enter into the franchise relationship). As a practical matter, the most common material changes that would prompt an amendment to the disclosure document include the following: (1) changes in fee structure, (2) changes in management personnel, (3) new litigation, and (4) a materially adverse change in the franchisor's financial condition.

B. State Franchise Law

In addition to federal law (which applies to the offer and sale of franchises in all 50 states), there are 15 states that regulate the offer and sale of franchises. These states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin (the "Registration and Disclosure States"). All states except Oregon also require that the franchise be registered or that the franchisor make a filing with the appropriate state agency before a franchise is offered or sold in the state.

The Registration and Disclosure States' laws potentially apply to the offer and sale of a franchise in the following circumstances:

- [when] the offer or sale of a franchise is made in the state;
- [when] the offer is accepted in the state;
- [when] the franchised business will be operated in the state; or
- [when] the franchisee is domiciled in the state.

The controlling measure for whether state franchise law applies to a particular offer or sale is whether the offer or sale took place "in the state." The term "in the state" refers to:

- The location where the offer to sell originated;
- The location where the acceptance of that offer was communicated from;
- The location where the prospective franchisee resides; or
- The location where the franchised business will be located.

Although jurisdiction is generally determined by the above factors, it is important to keep in mind that there are significant variations among the states.

The definition of a "franchise" also varies by state.

Twelve of the Registration and Disclosure States' define a "franchise" similar to federal law in that a "franchise" will be deemed to exist whenever there is a trademark license, control over a franchisee's method of operation (or franchisee's adherence to a "marketing plan prescribed in substantial part by the franchisor"), and payment of a fee.³⁰

The California Franchise Investment Law, for example, defines a "franchise" a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

²⁸ 15 U.S.C. § 45.

²⁹ 16 C.F.R. § 436.7(a).

³⁰ California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, Virginia, Washington, and Wisconsin (under the Wisconsin Franchise Investment Law).

(1) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services *under a marketing plan or system prescribed in substantial part by the franchisor*; and (2) the operation of the business is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and (3) the franchisee pays a fee.³¹ Under the "marketing plan" approach, the franchisor groups outlets together as a whole and presents them as having uniform standards relating to advertising, hours of operation, training, and site selection, to name a few.³² However, most states consider the marketing plan element present only when the franchisor mandates that its franchisees instill its marketing plan in their business operations.³³

Three Registration and Disclosure States, namely, Hawaii, Minnesota, and South Dakota, replace the "control" or "marketing plan" element with a "community of interest" standard. The Hawaii Franchise Investment Law, for example, defines a "franchise" as an "oral or written contract or agreement, either expressed or implied, in which a person grants to another person, a license to use a trade name, service mark, trademark, logotype or related characteristic in which there is a *community of interest* in the business of offering, selling, or distributing goods or services at wholesale or retail, leasing, or otherwise, and in which the franchisee is required to pay, directly or indirectly, a franchise fee. The "community of interest" definition casts a wider net than the "control" or "marketing plan" element because no right of control is needed for a franchise to exist.

The "community of interest" definition also appears in relationship statutes (discussed below) such as the Nebraska and New Jersey Franchise Practices Act.

Similar to federal law, the Registration and Disclosure States require pre-sale disclosure. Most states' laws follow the federal law timing requirement (i.e., 14 calendar days); however a few of the states' laws differ: Michigan law requires delivery of a disclosure document at least "10 business days" prior to the sale; New York and Rhode Island laws require delivery of a disclosure document at the earlier of (a) the first personal meeting between the franchisor and franchisee; or (b) 10 business days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor; and Hawaii law requires delivery of a disclosure document seven days prior to the execution of any agreements, or any payment by the prospective franchisee, whichever occurs first.

As stated above, 14 of the Registration and Disclosure States requires that a franchise be registered, or that a filing be made, before a franchise is offered or sold in the state. Registration and filing requirements vary widely by state. Michigan, for example, requires an annual filing of a notice of franchise offering. Wisconsin requires an annual online filing of the disclosure document, but there is no review process (registrations are effective upon receipt). Indiana and South Dakota have adopted a limited review process. California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia, and Washington require registration involving a comprehensive review process.

Registrations and filings must be maintained on an annual basis. In some states, this means renewing the registration. In other states, this means filing an annual notice or amending the registration to include updated information. In most of the Registration and Disclosure States, registration also must be amended in the event of a "material change."³⁴

³¹ See, for example, Cal. Franchise Investment Law, Corporations Code § 31005.

³² See e.g., Ill. Comp. Stat. 121½, ¶ 1703, § 3(18). See *Petereit v. S.B. Thomas, Inc.*, 853 F. Supp. 55, Bus. Franchise Guide (CCH) ¶ 10,379 (D. Conn. 1993), *aff'd in part, rev'd in part*, 63 F.3d 1169 (2d Cir. 1995).

³³ See e.g., *Charts v. Nationwide Mut. Ins. Co.*, 397 F. Supp. 2d 357, Bus. Franchise Guide (CCH) ¶ 13,200 (D. Conn. 2005); *Edmands v. Cumo, Inc.*, 892 A.2d 938, Bus. Franchise Guide (CCH) ¶ 13,302 (Conn. 2006).

³⁴ See e.g., Ill. Admin. Code tit. 14A, § 135.353; Minn. R. 2860.2400; 21 Va. Admin. Code § 5-110-10.

As with federal law, certain types of sales are exempt from registration and disclosure requirements. While exemptions vary greatly by state, the sale of a franchise by an existing franchisee will almost always be exempt from registration and disclosure requirements (unless the franchisor facilitates or materially participates in the sale), as will the renewal of an existing franchise. Most of the Registration and Disclosure States also have some form of seasoned franchisor exemption that applies if the franchisor meets certain minimum net worth requirements and has a minimum number of years' franchising experience. Most of the Registration and Disclosure States also have some form of existing franchisee and/or sophisticated franchisee exemption that applies if the sale is to an existing franchisee or to a person related to the franchisor, or where the franchisee meets certain net worth or minimum investment criteria.

4. STATE BUSINESS OPPORTUNITY LAWS

In addition to the Amended FTC Rule and the state franchise laws, certain states' business opportunity laws may apply to the offer and sale of franchises. Business opportunity laws are typically broad in scope, and apply to the offer and sale of franchises, unless such sales are expressly excluded or exempted from coverage. Business opportunity laws typically impose registration and disclosure requirements, and may impose bonding and/or escrow requirements on the franchise seller.

Twenty-five states have one of a variety of business opportunity statutes. These states are: Alabama, Alaska, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, and Washington.

Some business opportunity laws, such as those Connecticut, Maine and North Carolina, do not apply to the offer and sale of a franchise if the franchisor's marketing plan is associated with a federally-registered trademark.³⁵ A franchisor without a federally registered trademark – even if it has applied for registration – must register its franchise as a business opportunity under the laws of these states. Other state business opportunity laws, such as those in Florida, Georgia, Louisiana, and South Carolina, generally do not apply to the offer and sale of a franchise if the franchisor's marketing plan is associated with a registered trademark.³⁶ In these states, registration on the state trademark registry may qualify the franchise for exemption.

The business opportunity laws of California, Illinois, Indiana, Maryland, South Dakota, Virginia, and Washington, do not apply to franchises registered according to the state's franchise laws. The business opportunity laws of Ohio and Oklahoma exempt the offer and sale of "franchises," but only if made in compliance with federal law. The business opportunity laws of Kentucky, Nebraska, Texas, and Utah exempt the offer and sale of business opportunities meeting the FTC Rule definition of a franchise, so long as the franchisor has complied with federal law and has filed an exemption notice with the state.

Even if the offer or sale of a "franchise" qualifies for exemption, the offering may still fall within a state's business opportunity law if the franchisor makes certain promises or representations in connection with the sale, such as offering to refund the franchisee's money if the franchisee is dissatisfied with his or her purchase.

³⁵ See e.g., *Business Opportunity Registration Guidelines: What is a Business Opportunity?*, Connecticut Department of Banking, available at http://www.ct.gov/dob/cwp/view.asp?a=2230&q=297810&dobNAV_GID=1662.

³⁶ See e.g., Meiklejohn. *supra* n. 34, at 618.

5. STATE FRANCHISE RELATIONSHIP LAWS

In addition to franchise sales laws, several states have enacted laws that regulate the franchise relationship. These laws typically prohibit a franchisor from terminating or failing to renew a franchise without “good cause,” “just cause,” or “reasonable cause.”³⁷ Definitions of these terms vary from state to state and, in some states, the terms are not defined at all. Some relationship laws specifically state that some practices will be deemed to be “good cause,” including the franchisee’s voluntary abandonment of the franchised business, conviction of a crime, impairment of the franchisor’s trademarks, bankruptcy, repetitive breaches of the same event, seizure or foreclosure by a government authority, and failure to pay monies owed.

Franchise relationship laws also typically protect a franchisee’s right to transfer the franchised business. For example, the Hawaii Franchise Rights and Prohibitions Act prohibits a franchisor from refusing to permit a transfer of ownership of a franchise, except for good cause.³⁸ Similarly, the Iowa Franchise Act permits a franchisee to transfer the franchised business and franchise to a transferee, provided that the transferee satisfies the reasonable current qualifications of the franchisor for new franchisees.³⁹ The Michigan Franchise Investment Law declares void any provision in a franchise agreement, which permits a franchisor to refuse a transfer of ownership of a franchise, except for good cause.⁴⁰

Five states – four by statute (Hawaii, Illinois, Indiana and Washington) and one by rule (Minnesota) – generally prohibit (with certain exceptions) unfair or unreasonable discrimination between franchisees in, among other things, the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any other business dealings.⁴¹ Other “prohibited practices” may include requiring or prohibiting any change in the management of the franchisee, unless the franchisor can show “reasonable cause,” or prohibiting franchisees from associating with one another.

The Iowa Franchise Act is considered to be the most far reaching of the laws, and includes restrictions on encroachment and independent sourcing. If a franchisor develops or grants to a franchisee the right to develop a new outlet or location, which sells essentially the same goods or services under the same marks as an existing franchisee, and the new outlet has an adverse effect on the gross sales of the existing franchisee’s location, the Iowa Act provides a cause of action for monetary damages.⁴² The Iowa Franchise Act also permits franchisees to obtain equipment, fixtures, supplies, and services used in the franchised business from sources chosen by the franchisee, provided that such goods and services satisfy the franchisor’s standards for such items.⁴³ This does not apply to reasonable quantities of inventory goods or services that a franchisee must buy from the franchisor or an affiliate if such items are “central” to the franchised business, and are produced by or incorporate the trade secrets of the franchisor or its affiliate.

To the extent that these laws provide a franchisee greater protection than the franchise agreement, the terms of the state law will supersede applicable provisions in the franchise agreement. For example, if the franchise agreement provides for termination without notice and the applicable state statute provides for 30 days’ notice, the terms of the state statute will prevail.

³⁷ Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 Bus. Law 289 (1989).

³⁸ See generally, Haw. Rev. Stat. § 482E-6 (2012).

³⁹ Iowa Code Ann. § 537A.10.5(a - j).

⁴⁰ Mich. Code Ann. § 445.1527(g).

⁴¹ See e.g., Haw. Rev. Stat. §§ 482E-6 (2012); 815 Ill. Comp. Stat. 705/18 (2012); Ind. Code § 23-2-2.7-1 (2013); Minn. Stat. § 80C.14 (2013); Wash. Rev. Code §§ 19.100.180 (2013).

⁴² Iowa Code Ann. § 523H.7 (2013).

⁴³ Iowa Code Ann. § 537A.10.1(d).

6. ANTITRUST LAWS

A. Overview

Antitrust laws (sometimes referred to as competition laws) are embodied in the Sherman Act of 1890, the Clayton Antitrust Act of 1914, and the Robinson-Patman Act of 1936.

The Sherman Act prohibits “every contract, combination, or conspiracy in restraint of trade,”⁴⁴ and any “monopolization, attempted monopolization, or conspiracy or combination to monopolize.”⁴⁵ The U.S. Supreme Court infers the word “unreasonable” when interpreting “restraint,” recognizing that the Sherman Act does not prohibit *every* restraint of trade, but only those that are unreasonable.⁴⁶ Nonetheless, certain practices have been deemed unreasonable *per se*, such as price fixing and bid rigging. According to the United States Department of Justice, “The courts have reasoned that these practices, which invariably have the effect of raising prices to consumers, have no legitimate justification and lack any redeeming competitive purpose and should, therefore, be considered unlawful without any further analysis of their reasonableness, economic justification, or other factors.”⁴⁷ Courts evaluate other offenses under a “Rule of Reason,” described as follows:

“For most other antitrust offenses, the courts have established an analytical approach labeled the ‘Rule of Reason.’ Under the Rule of Reason, the courts must undertake an extensive evidentiary study of (1) whether the practice in question in fact is likely to have a significant anticompetitive effect in a relevant market and (2) whether there are any procompetitive justifications relating to the restraint. Under the Rule of Reason, if any anticompetitive harm would be outweighed by the practice’s procompetitive effects, the practice is not unlawful.”⁴⁸

The Clayton Act targets certain practices that the Sherman Act does not clearly prohibit, such as mergers and acquisitions, where the effect “may be substantially to lessen competition, or to tend to create a monopoly.”⁴⁹ It also adds to the Sherman Act by outlawing practices of exclusive dealing and certain tying arrangements.⁵⁰ The Clayton Act has been amended several times over the years to include prohibitions against certain forms of price discrimination by a supplier to resellers, including franchisees, and discrimination in furnishing buyers with promotions and services.⁵¹

The Robinson-Patman Act of 1936 prohibits price discrimination with respect to commodities (but not services), and broadly prohibits brokers, agents, and other intermediaries between sellers and buyers from receiving payments that are not for services rendered.

In addition to these federal laws, nearly all states also have a “mini-Sherman Act.” Most state equivalents either mirror federal or require compliance under federal statutes.

Antitrust laws may apply to the controls and practices typically used in franchise relationships. Specifically, they can apply to a franchisor’s efforts to assign territories or customers (in antitrust terms, “market allocation”), to control a franchisee’s retail pricing (“price fixing” or “resale price maintenance”), and to require franchisees to purchase goods or services from the franchisor or a related party (“tying arrangements”). Certain claims also have been brought by franchisees alleging that franchisor rebates were illegal kickbacks violating Section 2(c) of the Robinson-Patman Act.

⁴⁴ 15 U.S.C. § 1.

⁴⁵ 15 U.S.C. § 2.

⁴⁶ *Standard Oil Co. v. United States*, 221 U.S. 1, 63-64 (1911).

⁴⁷ *Elements of the Offense*, OFFICES OF THE UNITED STATES ATTORNEYS, <https://www.justice.gov/usam/antitrust-resource-manual-7-elements-offense> (last visited June 6, 2016).

⁴⁸ *Id.*

⁴⁹ 15 U.S.C. § 8.

⁵⁰ *Id.* at § 14.

⁵¹ *Id.* at § 13(a)-(e).

B. Horizontal vs. Vertical Agreements

Understanding antitrust concerns begins with understanding the difference between horizontal and vertical agreements. Horizontal agreements are agreements among competitors. Vertical agreements are agreements in the vertical chain of distribution. Agreements among competitors are more likely to injure consumers, because they restrict interbrand competition and have little or no procompetitive effect. Vertical agreements may restrict *intra*brand competition, but typically promote *inter*brand competition, which benefits consumers. For this reason, horizontal agreements generally are more likely to be considered unreasonable *per se*, and vertical agreements are more likely to be judged under the Rule of Reason.

C. Anti-Trust Laws in Relation to Franchising

Through the late 1960s, antitrust laws posed a threat to many of the vertical restraints typically found in a franchise contract, which are briefly discussed in this section. A comprehensive discussion of antitrust laws and franchising, however, is beyond the scope of this paper.

i. *Price Fixing/Resale Price Maintenance*

Price-fixing involves an agreement between competitors to set the price of a product or service, or the terms and conditions of the sale.⁵² Up until the late 1990s, all price-fixing arrangements were illegal *per se* – even vertical price fixing in the context of franchising. Not only were agreements to fix prices illegal, but so were national price promotions and other business practices that discouraged deviations from the franchisor’s suggested retail prices.⁵³

But in 1997, the Supreme Court’s decision in *State Oil v. Khan* overruled *Albrecht v. Herald Co.*,⁵⁴ 390 U. S. 145 (1968), which absolutely proscribed against vertical maximum price maintenance.⁵⁴ According to *Albrecht*, it was illegal for wholesalers to require franchisees and retailers of their products to sell products at a certain price.⁵⁵ At issue in *Khan* was a franchise agreement, under which Khan (the franchisee) agreed to buy gasoline from State Oil (the franchisor) and to sell the gasoline at or below the retail price established by State Oil.⁵⁶ If Khan charged more than the suggested retail price, he was required to pay the overage to State Oil.⁵⁷ When Khan started falling behind on the monthly lease payments based in part on projected gasoline sales, State Oil attempted to terminate the franchise agreement.⁵⁸ The issue ultimately before the Supreme Court was whether the vertically imposed maximum price by State Oil violated the Sherman Act.⁵⁹ In a landmark decision, the Supreme Court determined that vertical price fixing is dealt more appropriately by a “Rule of Reason” analysis of each case, and overruled *Albrecht*’s hardline rule against vertical price fixing.

⁵² *Identifying Sherman Act Violations*, OFFICE OF THE UNITED STATE ATTORNEYS – UNITED STATES DEPARTMENT OF JUSTICE, <https://www.justice.gov/usam/antitrust-resource-manual-8-identifying-sherman-act-violations> (last visited May 31, 2016).

⁵³ See *Bender v. Southland Corporation*, 749 F.2d 1205 (6th Cir. 1984) (summary judgment for defendant reversed, stating that the franchisor’s practice of monitoring price compliance and inventory accounting practices that required its franchisees to report deviations from suggested retail pricing raised a genuine issue of fact as to whether the franchisor intended to fix prices).

⁵⁴ *State Oil Co. v. Khan*, 522 U.S. 3 (1997).

⁵⁵ 390 U. S. 145, 150.

⁵⁶ *Khan*, 522 U.S. at 6.

⁵⁷ *Id.* at 8.

⁵⁸ *Id.*

⁵⁹ *Id.* at 9.

For the next 10 years, vertical *maximum* price agreements were reviewed under the Rule of Reason, while vertical *minimum* price agreements remained illegal *per se*.⁶⁰ Then in 2007, the Supreme Court decided *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007) (a case involving a distribution arrangement for Brighton Collectibles), which held that minimum price restraints would also be reviewed under the Rule of Reason and determined that Brighton’s practice of establishing maximum prices did not constitute a Sherman Act violation.⁶¹

Horizontal price-fixing, however, remains *per se* illegal,⁶² which is still a concern for companies that both franchise and operate company-owned stores. A franchisor’s agreement with its franchisees constitutes a vertical agreement, likely to be judged under the Rule of Reason, but if the same agreement involves company-owned operations, it may become a horizontal agreement that is considered illegal *per se*.

While *Khan* and *Leegin* provide comfort at the federal level, vertical price fixing remains illegal under certain states’ laws. All states except Pennsylvania have their own version of the Sherman Act. Most states require following federal precedent, but some states do not. For example, California law, even post-*Leegin*, states that vertical price-fixing agreements are *per se* illegal under the Cartwright Act.⁶³ Similarly, Maryland amended its antitrust statute in October 2009 to clarify that agreements with retailers regarding retail price maintenance policies remain *per se* illegal under Maryland state law. In fact, on February 29, 2016, the Attorney General of Maryland filed a complaint against Johnson & Johnson Vision Care, Inc., a distributor, for violating the Maryland’s antitrust statute by entering into an agreement with a retailer that included a resale price maintenance policy.⁶⁴

ii. Tying Arrangements

Tying arrangements arise when a supplier furnishes a product (called a “tying product”) to a buyer only on the condition that the buyer also buys secondary products (called “tied product”) from the supplier. Tying is illegal when (1) the tying and tied products are separate and distinct, (2) the supplier has sufficient economic power in the market for the tying product to enable it to force buyers into purchasing the tied product, and (3) a “not insubstantial” amount of interstate commerce is affected.⁶⁵ Tying arrangements have been found illegal under Section 1 of the Sherman Act and Section 3 of the Clayton Act, but federal courts generally recognize the rule promulgated by *Jefferson Parish Hospital District v. Hyde*, 466 U.S. 2 (1984), which states that the court will not presume anticompetitive effects of a tying arrangement unless the seller (or franchisor) has more than 30 percent market share for the tying product.

There are many legitimate justifications for imposing sourcing requirements in a franchise relationship—to leverage volume pricing, to negotiate better distribution arrangements, and to assure uniformity of product offerings. In the 1960’s and 1970’s, franchisees achieved some success in arguing that all source restrictions constituted illegal tying arrangements, with the franchisor’s trademark serving as the tying product. In the 1970 opinion *Siegel v. Chicken Delight, Inc.*,⁶⁶ the Ninth Circuit held that the legal uniqueness of a franchisor’s registered trademark, like that of a patent or copyright, combined with

⁶⁰ *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

⁶¹ *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. at 885. Under this rule, the factfinder must weigh all the circumstances of the case in deciding whether the vertical restrictive practice should be illegal by considering certain factors, including specific information about the relevant business and restraint history, the nature of the restraint, the effect of the restraint, and the business’ market power. *Id.*

⁶² *Id.* at 886.

⁶³ *Darush v. Revision LP*, No. CV 12-10296 GAF (AGRx), 2013 U.S. Dist. LEXIS 186906, at *16 (C.D. Cal. 2013).

⁶⁴ *AG Frosh: Illegal Price-setting Agreement in Contact Lens Market Raises Customer Costs*, MARYLAND ATTORNEY GENERAL, <https://www.oag.state.md.us/Press/2016/030416.htm> (last visited May 31, 2016).

⁶⁵ *N. Pac. Ry. Co. v. United States*, 356 U.S. 1, 5-6 (1958).

⁶⁶ *Siegel v. Chicken Delight, Inc.* 311 F. Supp. 847 (9th Cir. 1970).

its power to impose the tie-in demonstrated sufficient economic power in the tying product market to render the arrangement illegal *per se*.

The modern view is that the franchise trademark license is not a distinct and separate product, and therefore, cannot be a tying product,⁶⁷ and recent attempts to advance the argument that a trademark is a tying product have failed. In 2006, in *Little Caesar Enters. v. Smith*, for example, a class of franchisees accused the franchisor of unlawful tying to the franchise for the sale of branded paper products.⁶⁸ The franchisee alleged that the tying product was the franchise and the tied products were logoed paper goods. The franchisor argued that the logoed products and other distinctive marks are not tied products because they would not have any market value and could not be sold anywhere else apart from a franchised restaurant. The court rejected the franchisor's argument and found that the franchise and paper products were not in separate markets and that other private distributors, unrelated to the franchisor, sold the goods necessary to run a Little Caesars franchised outlet.⁶⁹ In reaching its decision, the court evaluated whether it would be efficient for an organization to provide the ancillary products separate from the franchise and found that two distinct markets existed because, in the past, private distributors unrelated to Little Caesars sold all the good necessary to run a Little Caesars franchise.⁷⁰

Other challenges to proving an illegal tie include defining the relevant market and establishing that the franchisor possesses requisite market power. In *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, a group of franchisees (relying on the aftermarket theory advanced in *Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451 (1992)) claimed that the relevant market were the franchisees themselves, all of whom were invested in the franchise system, making it economically impractical for them to abandon the Domino's system and enter a different line of business. The district court dismissed the antitrust claims with prejudice, holding that the franchisees failed to allege a "relevant market" as required by the Sherman Act. On appeal, the Third Circuit affirmed the dismissal holding that there could be no tying claim where the defendant's "power" to "force" plaintiffs to purchase the alleged tying product stems not from the market, but from the parties' franchise contract, which includes sourcing restrictions.⁷¹

iii. *Market Allocation and Customer Restrictions*

Similar to the courts' view on price-fixing, however, the illegality of vertical market allocation has also softened over the years. In franchising, vertical market allocation (which includes granting exclusive or protected territories) and in-term noncompete provisions are common practices.

Horizontal allocation, that is market or customer allocation between competitors, remains illegal *per se*.⁷² In horizontal customer allocation, competitors at the same level of distribution agree among themselves to only service certain customers or classes of customers, and agree to not compete with each other (or limit the manner of competition) between them. But, the legality of vertical market allocation and customer allocation is analyzed under the Rule of Reason.⁷³

7. EMPLOYMENT CONCERNS

All businesses must comply with numerous federal, state, and local employment laws, including those affecting minimum wage, discrimination, unemployment, health insurance, and independent contractor relationships. All businesses are subject to regulation and oversight by federal agencies such as the Department of Labor, National Labor Relations Board, Occupational Safety Health Administration,

⁶⁷ See *Little Caesar Enters. v. Smith*, 34 F. Supp. 2d 459 (E.D. Mich. 1998); also see *Subsolutions, Inc. v. Doctor's Associates, Inc.*, 2006 WL 1778817 (D. Conn. 2006).

⁶⁸ *Little Caesar Enters.*, 34 F. Supp. 2d at 459.

⁶⁹ *Id.* at 469.

⁷⁰ *Id.*

⁷¹ *Queen City Pizza, Inc. v. Domino's Pizza*, 124 F.3d 430 (3rd Cir. 1997).

⁷² See *Texaco, Inc. v. Dagher*, 547 U.S. 1 (2006).

⁷³ See *Continental T.V., Inc. v. GTE Sylvania & Co.*, 388 U.S. 365 (1967).

Equal Employment Opportunity Commission, and the Internal Revenue Service, as well as state and local counterparts. Historically, however, it appeared well settled that franchisees were independent contractors, and solely responsible for their own employment practices. Within the last couple of years, however, this understanding has been unsettled by recent actions of the DOL and NLRB, attempting to hold franchisors accountable for their franchisee's employment practices under a theory of "joint employer" liability. This section provides an overview of the various employment laws and agencies, and addresses "joint employer" concerns as they affect the franchise relationship.

A. Overview of Federal Employment Laws

At the federal level, the Department of Labor ("DOL") administers and oversees compliance of over 180 federal laws, which are divided for oversight by numerous divisions of the DOL. The federal laws include the Fair Labor Standards Act ("FLSA"), the Family and Medical Leave Act ("FMLA"), the Occupational Safety and Health Act ("Osh Act"), the Migrant and Seasonal Agricultural Worker Protection Act ("MSPA"), and Immigration and Nationality Act ("INA").⁷⁴ The FLSA and the FMLA are worker protection acts. The FLSA introduced the 40-hour work week, established the national minimum wage, guaranteed time-and-a-half pay for overtime in certain jobs, and prohibited child labor.⁷⁵ The FMLA requires employers to provide employees with unpaid, job-protected leave for qualified medical and family reasons. Both statutes are under the purview of the Wage and Hour Division of the DOL ("WHD"). The OSH Act's purpose is to protect workers' safety and health through safe working conditions at work. This act is enforced by the Occupational Safety Health Administration ("OSHA"), which is an agency under the DOL.⁷⁶ Both OSHA and WHD may have their own procedures to rectify noncompliance and impose fines, but these do not always preclude a wronged plaintiff from bringing a separate lawsuit in a traditional court against an employer who has violated a particular statute.

If a business utilizes temporary workers or nonresident aliens on certain visa types, the DOL oversees those workers as well. MSPA "protects migrant and seasonal workers by establishing employment standards related to wages, housing, transportation, disclosures and recordkeeping," and requires farm labor contractors to register with the DOL.⁷⁷ INA oversees compliance regarding aliens authorized to work in the U.S. under certain nonimmigrant visa programs (such as H-1B, H-1B1, H-1C, and H2A).⁷⁸ Also important is the Immigration Reform and Control Act ("IRCA"), which designates the workers that are legal to hire and directs employers on how to verify the legal status of workers; this federal statute makes it illegal for any employers to knowingly hire foreign workers who are not authorized to work in the United States.⁷⁹

The other key federal agency with respect to labor and employment matters is the National Labor Relations Board ("NLRB"), which oversees compliance of the National Labor Relations Act ("NLRA"). The NLRA protects the rights of employees to act together in order to address workplace conditions, with or without a union.⁸⁰ The NLRA applies to most private sector employers, including manufacturers,

⁷⁴ *Summary of Major Laws of the Department of Labor*, THE DEPARTMENT OF LABOR, <https://www.dol.gov/general/aboutdol/majorlaws> (last visited May 23, 2016).

⁷⁵ *Compliance Assistance – Wages and Fair Labor Standards Act*, UNITED STATES DEPARTMENT OF LABOR – WAGE AND HOUR DIVISION, <http://www.dol.gov/whd/flsa/> (last visited May 23, 2016).

⁷⁶ *About OSHA*, UNITED STATES DEPARTMENT OF LABOR, <https://www.osha.gov/about.html> (last visited May 23, 2016).

⁷⁷ *Migrant and Seasonal Agricultural Worker Protection Act (MSPA)*, UNITED STATES DEPARTMENT OF LABOR – WAGE AND HOUR DIVISION, <http://www.dol.gov/whd/mspa> (last visited February 2, 2016).

⁷⁸ *Supra*, note 74.

⁷⁹ *Immigration Reform and Control Act of 1986*, U.S. CITIZENSHIP AND IMMIGRATION SERVICES, <https://www.uscis.gov/tools/glossary/immigration-reform-and-control-act-1986-irca> (last visited May 23, 2016).

⁸⁰ *What We Do*, NATIONAL LABOR RELATIONS BOARD, <https://www.nlr.gov/what-we-do> (last visited December 2, 2015).

retailers, private universities, and healthcare facilities.⁸¹ Traditionally, the NLRB has assisted unions in advocating for their members with their respective employers. However, recent trends show that the NLRB is becoming increasingly active and expanding its reach to non-union workplaces and into franchising systems.

As the administrative body enforcing the NLRA, the NLRB investigates charges, facilitates settlements, conducts hearings, decides cases, and enforces orders stemming from those cases.⁸² The NLRB General Counsel is responsible for investigating and prosecuting unfair labor practices cases and for supervising NLRB field officers' processing of cases.⁸³ Unlike a typical case in litigation before a conventional court, NLRB hearings are subject to their own rules and procedures.⁸⁴

Anti-discrimination statutes are another set of laws that must be considered. These include Title VII of the Civil Rights Act of 1964 ("Title VII"), Americans with Disabilities Act ("ADA"), and Age Discrimination in Employment Act ("ADEA"), which are all under the purview of the Equal Employment Opportunity Commission ("EEOC"). The purpose of these anti-discrimination statutes is to protect against work-related discrimination related to age, disability, sex, sexual orientation, race, color, national origin, religion, and acts of retaliation, harassment, and hostile work environments resulting from discrimination. The EEOC evaluates claims against employers through an internal process that begins with a "Charge of Discrimination." The EEOC then conducts an investigation into the claims in order to determine whether the claimant's allegations have merit. In the event that the EEOC finds merit, the EEOC may bring a claim of discrimination against the claimant's employer on the claimant's behalf in a trial court of appropriate jurisdiction. In the event that the EEOC does not find that there is any merit to the allegations or if the EEOC declines to take the case even if it finds the allegations have merit, it will issue a "Notice of Right to Sue," without which the claimant may not bring an independent claim against his or her employer in the trial courts. A claimant may then elect to bring a lawsuit against the offending employer in a court of appropriate jurisdiction.

In addition to federal law, state, city, and local ordinances may also apply to employment relationships. One example of federal/state overlap is workers compensation. While the DOL administers disability compensation to federal workers and their dependents, employees of private companies must go through their state compensation board, each of which has its own rules and regulations.⁸⁵ Additionally, some states have their own anti-discrimination statutes enforced by administrative bodies that may or may not work with the EEOC in investigating a charge of discrimination. For example, Texas maintains a Texas Workforce Commission – Civil Rights Division ("CRD") that oversees state employment discrimination, payday laws, child labor laws, and minimum wage requirements.⁸⁶ An employee may choose to dual-file a Charge of Discrimination with the CRD and the EEOC, or may file with just one of

⁸¹ *Jurisdictional Standards*, NATIONAL LABOR RELATIONS BOARD, <http://www.nlr.gov/rights-we-protect/jurisdictional-standards> (last visited December 2, 2015). Among those exempted are federal, state, and local governments, employers who employ only agricultural laborers, and employers subject to the Railway Labor Act. *Id.*

⁸² *See supra*, note 74.

⁸³ *The General Counsel*, NATIONAL LABOR RELATIONS BOARD, <https://www.nlr.gov/who-we-are/general-counsel/richard-f-griffin-jr> (last visited December 2, 2015).

⁸⁴ *Rules and Regulations*, NATIONAL LABOR RELATIONS BOARD, https://www.nlr.gov/sites/default/files/attachments/basic-page/node-1717/rules_and_regs_part_102.pdf (last visited December 2, 2015).

⁸⁵ *Workers Compensation*, DEPARTMENT OF LABOR, <https://www.dol.gov/general/topic/workcomp> (last visited May 23, 2016).

⁸⁶ *Employment Law: Discrimination, Wages & Child Labor*, TEXAS WORKFORCE COMMISSION, <http://www.twc.state.tx.us/businesses/employment-law-discrimination-wages-child-labor> (last visited May 23, 2016).

the organizations.⁸⁷ The CRD will then investigate and come to a conclusion based on the Texas anti-discrimination statutes.⁸⁸

B. Joint-Employer Issues

The franchising community is buzzing with anxiety over potential joint employer liability following the recent aggressive position taken by both the NLRB and the DOL against a wide range of businesses, including franchise systems. Under the joint employer doctrine of liability, an employee who is formally employed by one employer (the primary employer) may be deemed to be constructively employed by another employer (the secondary employer) if that secondary employer exercises sufficient control over the employee's terms and conditions of employment. Joint employers must comply with federal, state, and local labor and employment laws with respect to "jointly employed" employees. In other words, if a primary employer and secondary employer are held to be "joint employers" of the primary employer's employees, the secondary employer is directly liable for labor and employment law violations of the primary employer.

While once a one-off theory of liability under which business were implicated for the sins of another, the theory of joint employer liability has expanded to affect numerous industries and business structures under various federal statutes. Joint employer liability can be ascribed under the FLSA, FMLA, Title VII, ADA, ADEA, NLRA, and OSH Act, as well as various state and local statutes. Complicating matters more, the test or standard for determining when a company is acting as a joint employer liability may be different for each one of these statutes and in different jurisdictions. And, liability may be initially determined by an administrative body, and, then upon appeal of the decision to the appellate court in the jurisdiction, the court may apply or interpret the rule a completely different way than the administrative body.

The present theories of employer-employee relationships and joint employer liability originated from the common law theory of agency.⁸⁹ Simply stated, a person is an employee of an employer if "a person is employed to perform services in the affairs of another and who, with respect to the physical conduct in the performance of the services, is subject to the other's control or right to control."⁹⁰ Under the original common law theory of tort liability, an employer is responsible for the torts of his employee if the tort occurred as the result of conduct within the scope of the employment.⁹¹

Obviously, common law theory of agency extends beyond the purview of tort law. Most significantly, it has extended into and been modified by the various employment laws enacted over the last century in the United States.⁹² The problem today is that the terms "employee" and "employer" are not well-defined in the majority of the employment laws governing the employer-employee relationship, muddying the waters and instigating a significant number of lawsuits that hope to clarify the meaning of the terms.⁹³ Further complicating the matter, is the absence of a clear line between who can be categorized as an employee versus an independent contractor, or a temporary employee who is employed by another organization, in this employment relationship with the employer.⁹⁴ On the most basic level, a person is an employee when the employer exercises some level of control or reserves the right of control

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ Restatement (Second) of Agency, §§ 220 and 26 (2nd ed. 2010).

⁹⁰ *Id.* at § 220.

⁹¹ *See id.*

⁹² Mitchell H. Rubinstein, *Employees, Employers, and Quasi-Employers: An Analysis of Employees and Employers Who Operate in the Borderland Between an Employer and Employee Relationship*, 14:3 U. PA. J. BUS. L. 605, 612-14 (2012).

⁹³ *Id.*

⁹⁴ *Id.*

over the person in the activity performed in the interest of the employer.⁹⁵ The standard that establishes the employer-employee relationship varies by statute and is a fact-intensive determination. Consequently, a worker may be considered an employee under a certain statute utilizing one test, while not considered an employee under a different statute utilizing a different test.

The current position taken by the DOL on joint employer liability is based on the position taken by its Administrator, Dr. David Weil. He argues that changes in the structure of the economy and in employment relationships require changes in strategic enforcement of certain DOL statutes. Dr. Weil proposes that the employment structure has fundamentally changed—the basic relationship between the employer and employee has devolved because of the use of subcontracting, outsourcing, and franchising, which has led to “fissuring” of the employment models.

According to Dr. Weil, fissuring of the workplace has led to vulnerable employees, and he proposes regulatory and enforcement solutions to protect those vulnerable employees. In proposing new strategies, Dr. Weil examined a sampling of food and hotel franchise systems. He suggests that enforcement must focus on “workplaces where labor standards violations occur [franchisees] and also at the higher level of industry structure, where ‘lead firms’ [franchisors] play a key role in setting the competitive environment and employment conditions for employers at ‘lower levels’ [franchisees] of the industry structure.” Essentially, Dr. Weil advocates for increased and more efficient enforcement of existing employment laws and the creation of additional legislation to address the problems he identifies. He posits that existing workplace legislation should be reformed to broaden the responsibility of larger companies who engage in fissuring activities by arguing that if the company controls the quality, production, and delivery of services, then they should also bear the responsibility for employment issues. Dr. Weil’s stance is driving the current DOL policy making and aggressive enforcement strategies, particularly when it comes to enforcement of the FLSA, FMLA, and MSPA.

In parallel, the NLRB is driving its own changes to the definition of employer and employee. Before mid-2014, the NLRB consistently took the position that franchisor-franchisee relationships did not give rise to joint employer liability. This trend started to change with the NLRB’s General Counsel Richard Griffin’s amicus brief to the *Browning-Ferris*⁹⁶ case (which, incidentally, did not involve a franchise) in which he advocated for a new joint employer standard for franchise systems.⁹⁷

Keeping in line with this trend, on July 29, 2014, the General Counsel of the NLRB announced that it had investigated alleged violations of the NLRA by McDonald’s franchisees as a result of activities surrounding employee protests.⁹⁸ In issuing its complaints, the General Counsel announced that some alleged violations were merited while others were not. Notably, the NLRB named the franchisor, McDonald’s USA, LLC as a joint employer respondent in the 43 cases where the complaint was authorized.⁹⁹

On April 28, 2015, while *Browning-Ferris* was being considered, and amidst the McDonald’s controversy, the Office of the General Counsel issued an Advice Memorandum on whether Nutritionality, Inc., a franchisee, is a joint employer with Freshii Development, LLC, the franchisor of restaurants

⁹⁵ See *id.*; see also Restatement (Second) of Agency § 220.

⁹⁶ See *Browning-Ferris Industries of California, Inc. d/b/a BFI Newby Island Recyclery & FPR-II, LLC. d/b/a Leadpoint Business Services*, N.L.R.B. Case 32-RC-109684 (August 27, 2015).

⁹⁷ *Amicus Brief of the General Counsel*, NATIONAL LABOR RELATIONS BOARD (June 26, 2014), <http://apps.nlr.gov/link/document.aspx/09031d45817b1e83>.

⁹⁸ *NLRB Office of the General Counsel Authorizes Complaints against McDonald’s Franchisees and Determines McDonald’s, USA, LLC [sic] is a Joint Employer*, NATIONAL LABOR RELATIONS BOARD (July 29, 2014), <https://www.nlr.gov/news-outreach/news-story/nlr-office-general-counsel-authorizes-complaints-against-mcdonalds>.

⁹⁹ *Id.*

offering healthy meal options (“Freshii”) and/or its franchise development agent.¹⁰⁰ By way of background, Freshii grants franchisees, such as Nutritionality, the right to own and operate a Freshii fast-casual restaurant chain.¹⁰¹ Nutritionality operated a single Freshii store in Chicago and employs between five and nine employees.¹⁰² In summer of 2014, Nutritionality terminated one employee, and disciplined and terminated a second employee, for attempting to unionize at this location.¹⁰³ Upon a complaint being made to the NLRB, the regional NLRB office found merit for unfair labor practices against Nutritionality, but sought an advisory opinion on whether Freshii or its development agent should also be held liable under a joint employer theory of liability.

In this Advice Memorandum, the General Counsel advised that the Freshii franchise system did not create joint employer liability between the franchisor and franchisee under his June 26, 2014 amicus brief for *Browning-Ferris*.¹⁰⁴ Under the NLRB General Counsel’s proposal of reverting to the pre-1984 standard,¹⁰⁵ the Memorandum found that Freshii did not significantly influence the working conditions of Nutritionality’s employees, *i.e.*, it has no involvement in hiring, firing, disciplining, supervising, or setting wages.¹⁰⁶ Because Freshii does not directly or indirectly control or otherwise restrict the employees’ core terms and conditions of employment, meaningful collective bargaining between Nutritionality and any potential collective-bargaining representative of the employees could occur in Freshii’s absence.¹⁰⁷ Arguably, the Board’s finding that collective bargaining can occur without Freshii is the difference between this decision and the McDonald’s USA, LLC potential joint employer liability in the McDonald’s investigations.

Then, the NLRB issued its decision in *Browning-Ferris* on August 27, 2015.¹⁰⁸ Browning-Ferris (“BFI”) operated a recycling business that directly employed 60 employees.¹⁰⁹ It also used Leadpoint, a subcontractor, to provide an additional 150 staff members to sort recyclable materials from waste and to clean the facility.¹¹⁰ Under the services agreement between the two companies, the Leadpoint employees were to be screened, hired, disciplined, and supervised by Leadpoint but allowed BFI to involve itself in hiring, disciplining, scheduling, and setting wages of the employees. Notably, the agreement prevented Leadpoint from paying its employees more than BFI, required Leadpoint applicants to undergo drug testing and prohibited Leadpoint from hiring workers that BFI had already rejected, provided BFI the right to discontinue use of Leadpoint employees, and permitted BFI to control the productivity pave of Leadpoint employees and timing of their shifts.¹¹¹

¹⁰⁰ Advice Memorandum, NLRB Office of the General Counsel, *Nutritionality, Inc. d/b/a Freshii*, Cases'1 3-CA-134294, et al. (April 28, 2015)

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 1.

¹⁰⁵ “Under that standard, the Board finds joint employer status where, under the totality of the circumstances, including the way the separate entities have structured their commercial relationship, the putative joint employer wields sufficient influence over the working conditions of the other entity’s employees such that meaningful bargaining could not occur in its absence. This approach makes no distinction between direct, indirect and potential control over working conditions and results in a joint employer finding where “industrial realities” make an entity essential for meaningful bargaining.” *Id.* at 9.

¹⁰⁶ *Id.* at 10.

¹⁰⁷ *Id.*

¹⁰⁸ *Browning-Ferris Industries of California, Inc. d/b/a BFI Newby Island Recyclery & FPR-II, LLC. d/b/a Leadpoint Business Services*, N.L.R.B. Case 32-RC-109684 (August 27, 2015).

¹⁰⁹ *Id.* at 1.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 17-19.

In a landmark 3-2 decision, the Board stated that it was returning to a broader pre-1984 standard of the joint employer doctrine, thereby overturning the joint-employer standard that had been in place since 1984. The Board stated that two or more entities would be joint employers of an employee if: 1) they are both employers within the meaning of the common law; and 2) they share or codetermine those matters governing the essential terms and conditions of employment.¹¹² A change to this broader standard subject more business models, and even the franchise model, to joint employer liability. And, while the General Counsel recognizes that some franchise systems are not subject to joint employer liability (such as the Freshii franchise, discussed above), his prosecution of the McDonalds' system indicates that he believes that other franchise systems are indeed subject to joint employer liability.

Joint employer liability is an amorphous theory that changes with political trends, each federal agency's own agendas, and the interplay between the agency decision and the courts. Moreover, agency action and potential outcomes are difficult to predict due to the lack of a clear bright-line rule for what constitutes a joint employer. Therefore, businesses and franchise systems are left to weigh their risk and institute policies they can only hope lets them escape liability for the sins of another company should troublesome actions lead to a DOL or NLRB investigation.

8. REMEDIES

To protect the franchise system, a franchisor must enforce franchisee compliance with payment obligations, obligations to operate the business in accordance with the franchisor's standards and operating procedures, obligations to use the franchisor's trademarks only for authorized purposes and according to the franchisor's rules for trademark use, and obligations to comply with post-termination provisions such as confidentiality and covenants not to compete. Franchisor-initiated actions are generally brought when a franchisee fails to report sales and/or pay royalties, marketing fees, or other amounts due under the franchise agreement, for in-term defaults under the agreement, and to enforce post-term provisions (such as de-identification obligations and post term noncompete covenants) which survive termination of the contractual relationship.

Before initiating an action against a franchisee, a franchisor should first ensure that its own house is in order. If the franchisee or franchised business is located in a Franchise Registration and Disclosure State, was the franchise properly registered or exempted from registration at the time of the offer and sale? Was the franchisee properly disclosed? Was the franchise agreement properly executed, and were all necessary agreements signed (including personal guaranties and option agreements)? If the franchise was terminated or refused renewal, did termination or nonrenewal comply with applicable state relationship laws? Once these determinations have been made, the franchisor may choose to initiate legal action against the franchisee.

If it is determined that registration or disclosure violations occurred during the sales process, or violations of the state relationship laws occurred during the franchise term or in connection with ending the franchise relationship, the franchisee may have statutory claims against the franchisor, including claims for rescission and/or exemplary damages.

A. Collection of Money

i. Past Due Balances

Actions to collect royalties or other financial obligations are based in contract law. In most jurisdictions, a breach of contract claim has five elements: (i) a valid contract; (ii) plaintiff is a proper party to sue under the agreement; (iii) plaintiff performed or was excused from performing its contractual

¹¹² *Browning-Ferris Industries of California, Inc. d/b/a BFI Newby Island Recyclery & FPR-II, LLC. d/b/a Leadpoint Business Services*, N.L.R.B. Case 32-RC-109684 (August 27, 2015), at 15.

obligation; (iv) defendant breached the agreement; and (v) defendant's breach caused plaintiff injury¹¹³. In order to prove a valid contract exists, the franchisor will need to show that the parties were competent to enter a contract; the contract was for a legal purpose; there was mutual consent or an offer and acceptance; and legal consideration.

Consideration is sometimes referred to as a mutuality of obligation, but is more accurately defined as the bargained for exchange of promises which either bestows a benefit to the promisor or a loss to the promisee.¹¹⁴ Sometimes the adequacy of consideration is attacked in franchisor/franchisee disputes; however, the benefits the franchisee receives from the System or the protected territory the franchisee is granted under the franchise agreement is adequate consideration. It is possible to challenge the value of the territory granted or the products and services provided within the System, but generally, an argument that a franchise agreement is unenforceable for lack of consideration will fail.¹¹⁵

Next the amount of the past due balance must be determined. This is usually a straight-forward mathematical calculation based on the terms of the franchise agreement. If the franchise agreement requires the payment of royalties in the amount of 6% and advertising fund contributions in the amount of 2% of gross revenue, then the balance can be calculated accordingly. The parties sometimes disagree on the amount of the gross revenue where the franchisor has used estimates in the absence of reporting or where the franchisor claims intentional underreporting, but the calculation *method* is seldom in dispute.

Claims to collect in-term non-payment of royalties or other monies due under the agreement are generally not difficult claims for franchisor's to prosecute and prevail. Additionally, courts have awarded franchisors lost profits for periods of time when franchisees continue to operate using the franchisor's trademarks after termination or expiration of the franchise agreement.¹¹⁶

ii. *Lost Future Royalties*

Where a franchisor terminates a franchise agreement for cause, and then attempts to recover lost future profits (in the nature of lost future royalties) through the remaining term of the agreement (or sometimes the franchise agreement will contain a formula for calculating liquidated damages), the franchisor's right to relief is more uncertain and may depend on the specific facts of the case and the jurisdiction of the litigation. The legal issue centers on a proximate cause analysis and the doctrine of election of remedies. At common law, when a party breaches an agreement, the non-breaching party may elect to terminate the contract and be relieved of future performance, or may elect to honor the contract and sue for damages resulting from the breach. So where a franchisee breaches the franchise agreement (for example, by failing to pay royalties), and the franchisor terminates the franchise on account of the breach, should the franchisor be permitted to recover its profits through the remaining term of the franchise agreement?

There are two lines of authority in the franchise context. One line of cases, beginning with *Postal Instant Press, Inc. v. Sealy*,¹¹⁷ bars an award of lost future profits, and the other line of cases allows for recovery.

¹¹³ *Marquiz Acquisitions, Inc. v. Steadfast Ins.*, 409 S.W.3d 808, 813-14 (Tex. App.—Dallas 2013, no pet.) (element 1, 3-5); *Perry v. Breland*, 16 S.W.3d 182, 187 (Tex. App. —Eastland 2000, pet. denied) (element two).

¹¹⁴ *Texas Gas Utils. Co. v. Barrett*, 460 S.W.2d 409, 412 (Tex. 1970); *Ulico Cas. Co. v. Allied Pilots Ass'n*, 262 S.W.3d 773, 790-91 (Tex. 2008).

¹¹⁵ *Smoothie King Franchises, Inc. v. Southside Smoothie & Nutrition Ctr., Inc.*, 2012 U.S. Dist. LEXIS 67620, *24-27 (E.D. La. May 14, 2012).

¹¹⁶ See *Precision Tune Auto Care v. Pinole Auto Care*, 2001 U.S. Dist. LEXIS 24840, *10-11 (E.D. Va. Oct. 15, 2001); *Burger King Corp. v. Mason*, 855 F.2d 779 (11th Cir. 1988).

¹¹⁷ *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704 (Cal. App. 2d Dist. 1996).

iii. *The Sealy Analysis*

In *Postal Instant Press, Inc. v. Sealy*, the California Court of Appeals overturned an award of lost future royalties based on three principles.¹¹⁸ First, because the franchisor terminated the franchise agreement for failure to timely pay royalties, the court determined the proximate cause of the franchisor's damages derived from the franchisor's decision (and actions) to terminate the agreement and not from the franchisee's non-payment of royalties. According to the court's reasoning, the franchisee's conduct was the cause of the past due royalty obligations and the franchisor's termination of the franchise agreement was the conduct that stopped the on-going royalty obligation. Second, the Court found that absent a proximate cause issues, awarding lost future profits to a franchisor would result in unreasonable, unconscionable, and oppressive damages.¹¹⁹ The court cited to the Restatement (Second) of Contracts which provides a court the discretion to limit foreseeable damages, including lost profits, in the interest of justice to avoid a disproportionate award.¹²⁰ Third, the Court found that an award of lost future royalties was too speculative to merit an award of damages under contract law where, generally, lost profit type damages must be identifiable with reasonable certainty, not conjectural or speculative, and were within the contemplation of the parties when the contract was executed.¹²¹

Other courts subsequently followed *Sealy* or found similar reasons to bar an award for lost future royalties, such as deeming such an award as void for violating public policy or because the obligation to pay continuing royalty fees was not contemplated by the parties since it was not included in the contract.¹²² Cases interpreting Florida law similarly held that the franchisor's termination of the franchise agreement caused the loss of future product sales and royalty fees and not the prior defaults of the franchisee.¹²³

iv. *The Second Path*

It appeared from the various rulings across the country that courts were considering several issues when denying franchisor claims for lost future royalties, such as: (1) the type of damage analysis: lost profits vs. lost royalties; (2) the conduct giving rise to the claim: termination vs. abandonment; (3) contractual language: whether or not the obligation and damages were contemplated by the parties; (4) evidentiary matters: the quantum of evidence necessary to carry the burden for proving damages; and (5) other considerations: any duty of the franchisor to mitigate, avoiding awards that result in a windfall or double compensation for the same injury.

In light of the numerous cases where the franchisor's damage claims failed due to one or more of the five reasons stated above, franchisors began addressing these issues both proactively by changing the terms of their franchise agreements and through their management of the default process. Franchisors began to reform their contracts to include the continuing obligation to pay royalties throughout the term of the agreement even when the agreement is terminated, and to include liquidated damages provisions to assist with the evidentiary burden associated with overcoming arguments that the damages calculations were too speculative. The default section of franchise agreements began to include abandonment and other language that shifted the responsibility for terminating the agreement to the franchisee through the franchisee's conduct rather than on the franchisor. Franchisors began arguing that the franchisee terminated or abandoned the agreement in order to avoid summary judgment dismissals in favor of the franchisee. At trial, franchisors used expert witnesses to validate the calculation of damages providing

¹¹⁸ *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704 (Cal. App. 2d Dist. 1996).

¹¹⁹ *Id.* at 1713-14.

¹²⁰ Restatement 2d Contracts §351(3).

¹²¹ *Sealy*, 43 Cal. App. 4th 1704, footnote 5 at p. 1714; *Texas Instruments v. Teletron Energy Management*, 877 S.W.2d 276, 279 (Tex. 1994).

¹²² *Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC*, 2009 U.S. Dist. LEXIS 70920, (W.D.N.C. Aug. 7, 2009) (on appeal, the appellate court ruling that it was improper to preclude lost future royalties at summary judgment stage as a matter of law.).

¹²³ *Burger King v. Hinton*, 203 F.Supp.2d 1357, 1366 (S.D. Fla. 2002).

offsets for the franchisor's savings associated with not providing services to the franchisee's business, and to discount to present value in order to bolster the certainty of the damages claims and remove them from the realm of speculation or arguments of double recovery.

The tide began to turn for franchisors in the early 2000s when the Sixth Circuit upheld a franchisor's right to future royalties for the remaining nine years left in the term.¹²⁴ Then, relying on the *Speedy* case while refusing to follow *Sealy*, a Texas Court of Appeals, applying Georgia law, held that a terminated franchisee was liable for the franchisor's lost future profits for the remainder of the 25-year term of the franchise agreement when the franchisee de-identified its franchised business and continued operating the same type of child care business in the same location.¹²⁵ In this case, the court agreed that payment of royalties for 25-years was contemplated by the parties. Further, the franchisee's conduct caused the material breach and subsequent termination of the franchise agreement, and as a result, the franchisee was required to pay the franchisor's lost revenue, in the form of lost future royalties as damages.

Courts also began enforcing the liquidated damages provisions now being incorporated into franchise agreements.¹²⁶ Enforcement of liquidated damages provisions, which are commonly found in contracts outside the franchise industry, pose a different test. In most jurisdictions, a contractual liquidated damages provision is valid if: (1) the injury caused by the breach is difficult or impossible to estimate at the time of contracting; (2) the amount of liquidated damages is a reasonable forecast of just compensation; and (3) the clause is not a penalty and is not intended to be a penalty.¹²⁷

Over the last decade, franchisors have successfully recovered lost future royalty damages from franchisees by proactively planning for potential litigation.

B. In-Term Breaches

Essentially, all franchise agreements require franchisees to operate according to the franchisor's System while prohibiting the franchisee from owning or operating, directly or indirectly, any competitive business. Covenants not to compete typically extended past termination or expiration of the franchise agreement; however, post term covenants are more limited in terms of time and geography.

Because non-compliance can damage the brand and the integrity of the franchise system, it is important that the franchisor actively monitor the franchised businesses for System compliance. Deviations should be documented and promptly addressed, so that these variations don't become systemic or appear to operate as a waiver. Periodic inspections and uniformity of remedial action avoid the appearance of retaliation, and documentation may prove valuable if non-compliance continues to be a problem with any particular franchisee.

Franchisees typically are and should be prohibited from operating a competitive business during the franchise term. A franchisee should not be allowed to learn the System, benefit from the franchisor's expertise in the industry, profit from the franchisor's goodwill, and then use the knowledge to unfairly compete with the franchisor and other franchisees. In-term noncompete covenants are routinely enforced by the courts, even in states like California, where public policy prohibits enforcement of post term noncompete agreements.

¹²⁴ *Am. Speedy Printing Ctrs. v. AM Mktg., Inc.*, 69 Fed. Appx. 692, 699 (6th Cir. Mich. 2003)

¹²⁵ *Progressive Child Care Sys. v. Kids 'R' Kids Int'l, Inc.*, 2008 Tex. App. LEXIS 8416, (Tex. App.—Fort Worth Nov. 6, 2008).

¹²⁶ See *Radisson Hotels Int'l, Inc. v. Majestic Towers, Inc.*, 488 F. Supp. 2d 953 (C.D. Cal. 2007); *La Quinta Corp. v. Heartland Props., LLC*, 2008 U.S. Dist. LEXIS 53297, *4-5 (W.D. Ky. July 11, 2008); *Country Inns & Suites by Carlson, Inc. v. Interstate Props., LLC*, 2008 U.S. Dist. LEXIS 54265 (M.D. Fla. July 16, 2008); *Century 21 Real Estate LLC v. All Professional Realty, Inc.*, 889 F. Supp. 2d 1198, 1227-1231 (E.D. Cal. 2012).

¹²⁷ *FPL Energy, LLC v. TXU Portfolio Mgmt. Co.*, 426 S.W.3d 59, 69 (Tex. 2014); *S. Union Co. v. CSG Sys*, 2005 Tex. App. LEXIS 564, at *17 (Tex. App.—Austin, Jan. 27, 2005).

C. Post Termination Breaches

The most common post-termination breaches involve violations of the post-termination covenants not to compete, failure to de-identify the franchised location, and failure to assign phone numbers. Obviously a franchisor cannot allow a terminated or non-renewing franchisee to continue to operate using its trademark and trading on the franchisor's goodwill. Accordingly, the decision is often made to attempt to seek an injunction (frequently, a preliminary injunction) to enjoin the unauthorized use of the franchisor's trademarks¹²⁸ and to enforce compliance with the post term noncompete covenants. If a preliminary injunction issues, then the franchisee is enjoined from operating until there is a trial on the merits. Generally, the parties will be able to reach a settlement at this point. It is also important to note that if a franchisor fails to act, the doctrine of laches may prevent future enforcement which may also compromise the franchisor's leverage in settlement discussions.

So long as the covenants not to compete are reasonable in time and geographic restriction, post term covenants not to compete are enforceable in most jurisdictions.¹²⁹ In some jurisdictions, however, post term noncompete provisions in franchise agreements are not enforceable at all, and in most other states the court has the power to reform them so that they are no broader than necessary to protect a franchisor's legitimate business interest. Therefore, franchisors generally are successful in enforcing noncompete covenants and recovering damages for any breach.¹³⁰

9. CONCLUSION

Franchising is a highly regulated industry, and involves a complex business model that incorporates many types of relationships. As franchising parties, and as advisors who assist them, it is important to have a good understanding of the basics of this heavily-regulated business model and the laws that apply to the various aspects of the franchise relationship.

¹²⁸ *S & R Corp. v. Jiffy Lube Int', Inc.*, 968 F2d 371, 375 (3rd Cir. 1993).

¹²⁹ *Gallagher Healthcare Ins. Servs. v. Vogelsang*, 312 S.W.3d 640 (Tex. App.—Houston [1st Dist.] 2009).

¹³⁰ See *Armstrong v. Taco Time Int'l*, 30 Wn. App. 538 (Wash. Ct. App. 1981); *S & R Corp. v. Jiffy Lube Int', Inc.*, 968 F2d 371, 375 (3rd Cir. 1993).