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FREQUENTLY ASSERTED FRANCHISEE CAUSES OF ACTION AGAINST FRANCHISORS

This final section addresses the claims which franchisees frequently assert and the contractual provisions which may pose obstacles to the assertion of those claims, and suggests various strategies for dealing with those provisions. Franchisors seek to limit their potential exposure to franchisees in several ways, including:

A. Limiting the scope of written disclosures and representations in the offering circular (and attempting to curtail pre-sale representations outside of the circular).

B. Limiting the scope of the franchisor's express and implied contractual duties in the franchise agreement.

C. Imposing a variety of substantive and procedural barriers to litigation by the franchisee.

Franchisors justify these drafting strategies as protecting the "system", which provides little solace to an aggrieved franchisee who was essentially asked to "check his legal rights at the door" when signing the franchise agreement.

However, despite all of the clever draftsmanship, franchisees continue to prevail (in actual cases or at the bargaining table) when the facts are in the franchisee's favor. For franchisee counsel, the following protocol is useful in case evaluation:

1. Gather all facts and all documents that might possibly bear on the dispute, from the franchisee's initial contact, to the present.
2. Review the UFOC to determine whether there has been any violation in the registration and disclosure process.
3. Review all pre-sale representations to determine whether any other claim of fraud or misrepresentation is possible.
4. Review the Franchise Agreement to determine if the franchisee can state a claim for breach of contract, either under the agreement's express terms, or by going beyond the written agreement with legal duties that are implied in fact or law.
5. Determine whether any other statutory or common law claims are available.

6. Consider the franchisor's possible justifications for its actions and all of the franchisor's available defenses (and possible counterclaims).

A. Claims Arising In The Franchise Sales Process

1. Registration And Disclosure Violations

Consideration of potential claims in franchising logically begins with the issue of whether there were registration or disclosure violations. *See* Garner (Editor), *Franchise Desk Book* (Selected State Laws, Commentary and Annotations) (American Bar Association) (2001) (hereinafter "Desk Book") for a summary of state franchise laws.

(a). The Federal Trade Commission Rule

In turn, the subject of disclosure violations begins with the Federal Trade Commission Franchise Rule, 16 C.F.R. §436. In enacting the Franchise Rule, the FTC determined, that as a matter of law, certain disclosures must be made, accurately and completely, in the sales process, including, e.g.: (i) the exact nature of the investment in the franchise, with specific ranges of estimated expenditures; (ii) the recurring funds required to be paid by the franchisee to the franchisor or its affiliates, including required inventory purchases; (iii) the number of franchises and company-operations that were planned to be opened in the following year; and (iv) the history of any failed or closed franchises or company-owned stores. The current FTC Franchise Rule permits, but does not require, the provision of earnings claims. There are numerous ways that a franchisor that elects to make earnings claims may violate the Franchise Rule.[1] The FTC Franchise Rule does not regulate franchisor conduct beyond pre-sale disclosures. The FTC is in the process of amending the Franchise Rule, but the anticipated amendments are not expected to extend into the areas of franchise relationships or terminations (and are disappointing to franchisee advocates).

Federal courts hold that the Franchise Rule does not create a private remedy. Enforcement at the federal level is left to the FTC, and while FTC enforcement can be vigorous, FTC enforcement is not common. *See FTC v. Minuteman Press*, 53 F. Supp. 2d 248, 258 (S.D.N.Y. 1998) (a franchisor's issuance of false earnings claims in violation of the FTC Rule subjected the franchisor to liability under the FTC Act).

(b). State Law Claims Under Little FTC Acts

Most, if not all, states have enacted sweeping "consumer fraud" or "deceptive business practice acts, commonly referred to as "Little FTC Acts", which may provide a means for private litigants to enforce the FTC Franchise Rule. Franchisee standing is a threshold issue, which will vary from state to state, but franchisees will usually win this debate, as Little FTC Act standing is usually

[1] A franchisor might provide false earnings information, provide undocumented information, provide earnings claims outside the UFOC, or even fail to provide a UFOC.

conferred broadly.[2] Standing is sometimes conferred on all "businesses" or "borrowers;"[3] or on "consumers" or under a "consumer nexus" test when the franchise is purchased from the franchisor, or where the trade practices are addressed to the market generally or [which] otherwise implicate consumer protection concerns." (*Id.*)

The bridge between Franchise Rule violations and actionable claims under Little FTC Acts is found in the FTC Act, 15 U.S.C. §45. In *FTC v. Minuteman Press*, *supra*, a franchisor's conduct was a concurrent violation of both the Franchise Rule and Section 5(a) of the FTC Act, which prohibits "unfair or deceptive acts or practices in or affecting commerce."[4] The franchisor violated Section 5(a) by "making false gross sales and profitability claims to prospective… franchisees" which tend to bear directly on the economic viability of the transaction under consideration, [and which] are both likely to deceive and material."[5] This same conduct violated the Franchise Rule governing earnings claims, and significantly, the earnings claim violation was actionable by the FTC under Section 5(a) of the FTC Act.[6] Consistent with *Minuteman Press*, violations of

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2 *See Avery v. State Farm,* 2005 Ill. LEXIS 959 (2005), observing that Section 10a(a) of the Illinois Consumer Fraud Act authorizes private causes of action for practices proscribed by section 2. Section 10a(a) states, in pertinent part: "*any person* who suffers actual damage as a result of a violation of [the] act committed by any other person may bring an action against such person." 815 ILCS 505/10a(a).

3 *See Sullivan's Wholesale Drug Co., Inc. v. Farly's Pharmacy, Inc.*, 214 Ill. App. 3d 1073, 1082, 573 N.E.2d 1370, 1376 (5th Dist. 1991) (also construing the Illinois CFA); and *Scotsman Group v. Mid-America Distribs.*, 1994 U.S. Dist. LEXIS 4127 **14-20 (N.D. Ill. Apr. 5, 1994) (dealers or distributors seeking to invoke the Illinois CFA need not prove that they were "consumers" or that the defendants' practices had injured consumers generally). *See also People ex rel. Scott v. Cardet Int'l Inc.*, 24 Ill.App.3d 740, 321 N.E.2d 386, 391-92 (Ill. App. Ct. 1974); *Bixby Food Sys. Inc. v. McKay*, 985 F.Supp. 802, 807 (N.D. Ill. 1997); *cf. Peter v. Stone Park Enters.*, 1999 U.S. Dist. LEXIS 11385 *19 (N.D. Ill. July 22, 1999). *See also Kavky v. Herbalife Int'l of Am.*, 359 N.J. Super. 497; 820 A.2d 677 (N.J. Ct. App. 2003); *Morgan v. Air Brook Limousine, Inc.*, 510 A.2d 1197 (N.J. Super. Ct. Law Div. 1986); *Diesel Injection Service Co. v. Jacobs Vehicle Equip. Co.*, 2002 Conn. Super. LEXIS 1227 (Conn. Super. Ct. 2002); *Cf. Bailey Employment, Inc. v. Clifford Hahn*, 545 F. Supp. 62 (D. Conn. 1982). *See also Athlete's Foot Mktg. Assocs., Inc. v. Inner Reach Corp.*, Bus. Franchise Guide (CCH) ¶ 12,349 (N.D. Ga. 2003).

4 53 F. Supp. 2d 248 (S.D.N.Y. 1998).

5 *Id.* at 258.

6 *Id.* The court noted that the "Franchise Rule defines earnings claims to include any oral, written, or visual representations to a prospective franchisee which state specific actual or potential levels of sales, income, gross or net profits, or to make representations that state other facts that suggest such specific levels. 16 C.F.R. § 436.1(b), (c), (d); Final Interpretive Guides, 44 Fed. Reg. at 49,982." In addition, the rule requires a franchisor that elects to make earnings claims to prospective franchisees to "have written substantiating documentation on hand, see 16 C.F.R. § 436.1(b)(2), (c)(2), and to furnish

the FTC's Franchise Rule should constitute *per se* violations of state Little FTC Acts, as these violations bear directly upon the economic viability of the franchise investment. Improper earnings claims, for example, would arguably be grounds for a private statutory claim under the same circumstances in which the FTC is empowered to bring an enforcement action.

(c). State Franchise Act Claims For Registration & Disclosure Violations

Where available, franchisees usually invoke state franchise statutes as their primary effort to state an actionable claim. These laws are not uniform. Sixteen states have enacted registration and disclosure acts.[7] Two other states require pre-sale disclosure without registration.[8] State franchise acts may apply where the sale is made within the state, although the franchise is located elsewhere. For example, while the registration provisions of the Illinois Franchise Disclosure Act (IFDA) apply only to franchises in Illinois, the anti-fraud provisions apply whenever "an offer to sell or buy a franchise is made within this State and accepted within or outside of this State."[9]

Often, a threshold issue is to determine whether a business arrangement is a "franchise."[10] Most, but not all, states require the payment of consideration to the franchisor to create a franchise. (*Desk Book*, *supra*) In *To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc.*, the dealer's required payments for certain printed materials

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supporting 'Earnings Claim Document[s]' to those individuals to whom representations were made. Final Interpretative Guides, 44 Fed. Reg. at 49,966, 49,982."

7 The states that have enacted registration and disclosure statutes are: *Arkansas* (Ark. Code Ann. §§ 4-72-201 to -210 (2001); *California* (Cal. Corp. Code §§ 31100-31516 (2001)); *Delaware* (Del. Code Ann. tit. 6, §§ 2551-2556 (2000)); *Hawaii* (Haw. Rev. Stat. §§ 482E-1 to -12 (2000); *Illinois* (815 Ill. Comp. Stat. Ann. 705/1 to /44 (2001)); *Indiana* (Ind. Code Ann. §§ 23-2-2.5-1 to -51 (2000)); *Iowa* (Iowa Code §§ 523B.1 to .3 (2001)); *Maryland* (Md. Code Ann. [Bus. Reg.] §§ 14-201 to -233 (2001); *Minnesota* (Minn. Stat. §§ 80C.01 to - 30 (2000)); New York (N.Y. Gen. Bus. Law §§ 680-695 (2001)); New Jersey (N.J. Stat. §§ 56:10-1 to -29 (2001)); *North Dakota* (N.D. Cent. Code §§ 51-19-01 to -17 (2000)); *Oregon* (Ore. Rev. Stat. §§ 650.005 to 650.085 (1999)); *Rhode Island* (R.I. Gen. Laws §§ 19-28.1-1 to -34 (2001)); *South Dakota* (S.D. Codified Laws §§ 37-25A-1 to -87 (2001)); *Virginia* (Va. Code Ann. §§ 13.1-557 to -574 (2001)); *Washington* (Wash. Rev. Code §§ 19.100.010 to .940 (2001)); and *Wisconsin* (Wis. Stat. §§ 553.01 to .78 (2000)). *See also* Fla. Stat. § 559.802(1) (2000), which "exempts franchises from filing as long as the franchisor files notice with the proper authority that the franchisor is in substantial compliance with the FTC Rule and pays the required fee."

8 *See* Mich. Comp. Laws § 19.854(8) (2000); and Ohio Rev. Code Ann. § 1334.02 (Anderson 2001).

9 *See* Illinois Franchise Disclosure Act, 815 Ill. Comp. Stat. §§ 705/1, /5, /6 and /10.

10 *See* Miller, "*Unintentional Franchising*", St. Mary's Law Journal, Vol. 36, No. 2 (2005).

was an "indirect" franchise fee.[11] More recently, a national insurance company learned from a $2.3 million verdict that Connecticut requires only a prescribed marketing plan and the use of trademark to create a franchise.[12]

(d). Common Law Remedies For Disclosure Violations

Franchisees may assert common law misrepresentation for disclosure violations. *See Rodopoulos v. Sam Piki Enter.*, 570 So.2d 661 (Ala. 1990), where a franchisor's failure to comply with the FTC Franchise Rule on earnings claims was admissible to prove the franchisor's standard of care and its failure to adhere to that standard.

2. Fraud or Misrepresentation In The Franchise Sales Process

Beyond alleging a registration or disclosure violation, the franchisee might allege claims for misrepresentation in a variety of statutory and common law counts.

(a). Fraud Claims Under State Little FTC Acts

<u>The scope of actionable conduct under state Little FTC Acts is quite broad. For example, the Illinois Consumer Fraud & Deceptive Business Practices Act ("ICFA"), 815 Ill. Comp. Stat. § 505/1 et seq., provides in pertinent part that:</u>

> Unfair methods of competition and unfair or deceptive acts or practices, including but not limited to the use or employment of any deception, fraud, false pretense, false promise, misrepresentation or the concealment, suppression or omission of any material fact, with intent that others rely upon the concealment, suppression or omission of such material fact, … in the conduct of any trade or commerce are hereby declared unlawful whether any person has in fact been misled, deceived or damaged thereby. In construing this section consideration shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to Section 5 (a) of the Federal Trade Commission Act [15 U.S.C. § 45].

The Texas Deceptive Trade Practices Act (the "TDTPA"), provides a cause of action against parties that engage in false, misleading, and/or deceptive acts or practices, including *e.g.*, the misrepresentation of the characteristics or benefits of a "service"; the misrepresentation that "services" were of a particular standard, quality or grade when they were of another; the misrepresentation that an agreement "conferred or involved rights, remedies or obligations which it did not so confer or involve"; or a

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11 152 F.3d 658 (7th Cir. 1998).

12 Conn. Gen. Stat. § 42-133e(b). A Connecticut jury recently awarded $2.3 Million to an insurance agent, where the agency was found to be a franchise under the state law. *See Alex Charts v. Nationwide Mutual Insurance*.

failure to disclose information concerning goods and services which was known at the time of the transaction, with the intent of inducing the consumer into entering into the transaction, which the consumer would not have otherwise entered into; and failure to comply with filing and disclosure requirements established by the TDPTA, including those requirements of the Texas Business Opportunity Act.[13]

Even deception short of common law fraud, is arguably actionable under these types of statutes. In Illinois, the legislature's express directive for courts to consider both judicial and FTC "interpretations" of the FTC act, arguably creates a private cause of action for violations of the Section 5(a) of the FTC Act, and Franchise Rule violations.[14] This result should be the same under the broad provisions of any comparable Act.

Plaintiffs under a little FTC Act usually need not prove intentional fraud by the franchisor or its sales agents. As the court in *Minuteman Press* held, "[i]f erroneous information is being disseminated in the marketplace, the availability of injunctive relief does not turn on whether the person or entity making the false claims is acting fraudulently as distinct from recklessly or due to sheer ignorance. The effect on consumers is the same in any event."[15] The focus is on the effect on the consumer and not the intent of the seller, and even innocent deception would be actionable so long as there was intent to induce reliance (as opposed to intent to deceive).[16]

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[13] Texas Bus. Com. Code § 17.50(a)(1).

[14] In *Saunders v. Michigan Ave. Nat'l Bank*, 278 Ill. App. 3d 307, 662 N.E.2d 602 (1st Dist. 1996), the Illinois Appellate Court recognized the linkage to the FTC Act: "Illinois courts determine whether conduct [violates] the Consumer Fraud Act on a case-by-case basis. … In determining whether conduct [violates the ICFA], courts may rely upon interpretations of the Federal Trade Commission Act. 815 ILCS 505/2."

[15] 53 F. Supp. 2d at 260. Illinois follows the same rule, as the franchisor or sales agent need not require proof of actual reliance or intentional fraud when bringing a claim under the state Little FTC Act, the Illinois Consumer Fraud Act (ICFA). The Illinois Supreme Court has repeatedly held that reliance is not needed to establish a consumer fraud claim. "[W]e must hold that a complaining party is not required to establish reliance, either actual or reasonable, to state a claim under the Illinois Consumer Fraud Act. This is in line not only with the Illinois Supreme Court's statements regarding the absence of a reliance requirement, but also the liberal policy behind the Act."15 Additionally, it has long been held that a showing of intentional fraud is not required in Illinois as well. "[A]n intent to deceive is not essential to a finding of unfair or deceptive conduct under section 2 of the Consumer Fraud Act." *People ex rel. Hartigan v. Stianos*, 475 N.E.2d 1024, 1027 (Ill. App. Ct. 1985).

[16] *See Carl Sandburg Village Condo. Ass'n No.1 v. First Condo. Dev. Co.*, 557 N.E.2d 246 (Ill. App. Ct. 1990). *Minuteman Press*, 53 F. Supp. 2d at 260-63; *Martin v. Heinhold Commodities, Inc.*, 162 Ill.2d 33, 76 (1994) (citations omitted) ("the test [under the Illinois act] is the effect the [deceptive] conduct *might have* on the consumer") (emphasis added).

Consistent with *Minuteman Press*, Little FTC Act plaintiffs are generally not required to prove actual reliance.[17] Therefore, these claims are not defeated by disclaimers of reliance contained in the offering circular.[18] The usual test is whether a reasonable person would be likely be misled by the material misrepresentations or omissions. (*Id*.). <u>However, in order to recover damages, plaintiffs will usually may be required to prove proximate causation, which effectively requires proof of reliance in order to establish that "but for" the deception, the plaintiff would not have entered into the transaction ("transaction causation").[19] In certain states, such as Illinois, further proof of "loss causation" is also required. (*Id*.). The deception must relate to the financial loss to support a damages claim. (*Id*.) Fraudulent inducement based on false earnings claims is likely to meet a loss causation test, while fraudulent inducement regarding a non-financial matter, such as the experience level of the franchisor's officers, may not be sufficient for this purpose.</u>

(b). <u>**Fraud Claims Under State Franchising Acts**</u>

State franchising acts typically define and prohibit "fraudulent practices" In the franchise sales process. For example, the IFDA makes it unlawful to:

(a) employ any device, scheme or artifice to defraud.

(b) make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made in the light of the circumstances under which they are made, not misleading.

(c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

The degree of intent needed to state a fraud claim under state franchising laws varies among states and even within the statutes of some states, such as Indiana's, making generalization difficult.[20] Again using the Illinois Franchise Disclosure Act as an

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17 *See Siegel v. Levy Org. Dev. Co.*, 153 Ill. 2d 534, 542-43, 607 N.E.2d 194 (1992).

18 53 F. Supp. 2d at 262-63. *See also Athlete's Foot Mktg. Assoc., Inc. v. Inner Reach Corp.*, Bus. Franchise Guide (CCH) ¶ 12,349 (N.D. Ga. 2003) (where the UFOC recited that: "[franchisor] and [franchisee] expressly acknowledge that [franchisor] has made no representations, projections or earning claims to [franchisee] with regard to the performance of or sales by each Store. It is expressly agreed between the parties that results and performance of each Store are matter strictly within the control of the [franchisee].") (emphasis added). The court held that where the franchisor made earnings claims (despite the disclaimers), the disclaimers were violative of the California Unfair Trade Practices Act, which was a fundamental public policy of California. *Id.*

19 *See Martin v. Heinhold*, 163 Ill. 2d 33, 39-40, 643 N.E.2d 734 (1994).

20 *See Motor City Bagels L.L.C. v. American Bagel Co.*, 50 F. Supp. 2d 460, 468 (D. Md. 1999).

example, the Act's plain language indicates that while intent must be proven to establish "fraud" or "deceit" in subparagraphs (a) and (c), subparagraph (b) imposes strict liability for the "mak[ing] of any untrue statement of a material fact…" Scienter is not required.

Claims for promissory fraud are generally actionable under other state franchise acts, where the promises are made in bad faith and intent to deceive 9although proof requirements vary).[21] In contrast with Little FTC Acts, proof of actual and reasonable reliance is generally required to state a claim under the anti-fraud provisions of state franchising laws.[22] Thus, issues concerning integration and "no reliance" clauses permeate fraud claims brought under state franchising acts.

3. Common Law Claims

(a). Fraudulent Inducement

The elements of fraudulent misrepresentation are generally: (1) the making of a representation by defendant; (2) the representation was false; (3) the representation was material; (4) the defendant knew the representation was false; (5) defendant intended to deceive plaintiff; (6) plaintiff acted in reliance on the truth of the representation and was justified in relying on the representation; (7) the representation was a proximate cause of plaintiff's damages; and (8) the amount of damage.[23] In *Preferred RX, Inc. v. American Prescription Plan, Inc.*,[24] the Sixth Circuit explained a party's duty to disclose material facts. The court held:

> [A]n action for fraud and deceit is maintainable not only as a result of affirmative misrepresentations, but also for negative ones, such as a failure of a party to a transaction to fully disclose facts of a material nature where there exists a duty to speak...[A] party is under a duty to speak, and therefore liable for non-disclosure, if the party fails to exercise reasonable care to disclose a material fact which may justifiably induce another party to act or refrain from acting, and the non-disclosing party knows that the failure to disclose such information to the other party will render a prior statement or representation untrue or misleading.[25]

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21 *Healy v. Carlson Travel Network*, 227 F. Supp. 1080, 1092 (D. Minn. 2002). Proof of intent in cases of promissory fraud usually requires independent proof of a fraudulent scheme that goes beyond the mere making of the promise that was not kept. *See Houben v. Telular Corp.*, 231 F.3d 1066 (7th Cir. 2000).

22 *See e.g. Hardees v. Hardees Food System, Inc.*, 31 F.3d 573, 579 (7th Cir. 1994) (reasonable reliance required to state a fraud claim under the Indiana Franchise Act, Ind. Code § 23-2-2.5-1 et seq.).

23 *See Midwest Home Distrib., Inc. v. Domco Indus. Ltd.*, 585 N.W.2d 735 (Iowa 1998).

24 46 F.3d 535 (6th Cir. 1995).

25 *Preferred RX*, 46 F.2d at 546 (*quoting Miles v. McSwegin*, 388 N.E.2d 1367, 1369 (Ohio 1979)).

(b). Negligent Misrepresentation

Generally, a claim for negligent misrepresentation requires "(1) that defendant made a misrepresentation of a fast or existing material fact; (2) that defendant had no reasonable ground for believing the statement to be true; (3) that defendant intended to induce plaintiff's reliance on the misrepresentation; (4) that plaintiff was ignorant of the true facts and justifiably relied on the misrepresentation; and (5) that plaintiff was damaged as a result."[26]

In Illinois, a defendant is not liable unless it is engaged in the "business of supplying information." *See First Midwest Bank, N.A. v. Stewart Title Co.*, 2005 WL 119802 (1st Dist. 2005) (whether a party is in the business of supplying information depends "upon the nature of the information at issue and its relation to the kind of business being conducted… 'The critical question is whether the information is an important part of the product offered. [A] business[] will be deemed to be in the business of supplying information if the information furnished along with the non-informational goods or services is central to the business transaction.") (Citations omitted).

4. Remedies For Pre-Sale Claims

Franchisees that prevail on a claim arising in the pre-sale process must generally elect between damages or rescission. Non-profitable franchisees often seek recessionary remedies, while profitable franchisees are more likely to claim lost profit damages. Franchisees seeking to avoid a post-termination non-competition clause are more likely to pursue rescission (or antecedent material breach by the franchisor).

B. Post-Sale Claims

1. Post-Sale Fraud Claims

Franchisees may claim to be defrauded after they sign a franchise agreement. They may allege that the franchisor made overly optimistic projections in support of a bank loan, or to persuade the franchisee to remodel or otherwise increase its investment. The elements of misrepresentation, stated above, apply after the sale. State franchising acts do not provide remedies for post-sale fraud claims. However, post-sale fraud or misrepresentation is arguably actionable at common law or under a state Little FTC Act. In *Davis v. McDonald's Corp.*, the court held that a franchisor's post-sale statements about the future impact of additional stores in the area might constitute fraud if it had superior knowledge of the underlying facts.[27]

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26 *Maltz v. Union Carbide Chems. & Plastics Co.*, 992 F. Supp. 286 (S.D.N.Y. 1998) (applying California law).

27 *Davis v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 11,387 (1998).

2. Post-Sale Statutory Protection

If available, the state franchise act must be examined to determine whether the franchisee is afforded any post-sale protection in connection with events such as transfers and renewals, terminations, territorial encroachment, discrimination, and retaliation.[28] Here, there is no substitute for researching the applicable state statute.

(a). Economic Discrimination Claims

Claims of economic discrimination among franchisees are potentially powerful claims on the right facts. In *Canada Dry Corp. v. Nehi Beverage Co., Inc.*, the Seventh Circuit held that under the Indiana franchise act, a franchisee could defend against termination if the franchisor had discriminated engaged in "arbitrary disparate treatment among similarly situated individuals or entities" (i.e., other franchisees).[29] In *General Aviation, Inc. v. Cessna Aircraft Co.*, the Sixth Circuit held that the anti-discrimination provisions of the Michigan franchise act required a franchisor to offer renewal to its franchisees on the same terms that were offered to similarly-situated franchisees.[30] Discrimination issues may also be challenged under the implied covenant of good faith and fair dealing.

(b). "Good Cause" For Termination

"Good cause" for termination is the most important post-sale statutory protection. Failure to pay royalties is the most obvious example of "good cause", and a franchisee that does not pay royalties will probably not be able to stop a termination. However, that franchisee may nonetheless have a damages claim if the franchisor's conduct was a cause of the franchisee's inability to pay royalties. In *Interim Health Care of Northern Illinois v. Interim Health Care*, the Seventh Circuit reversed a summary judgment for the franchisor on a claim that the franchisor breached the implied covenant of good faith and fair dealing in invoking the termination clause after the franchisor had substantially damaged the franchisee by failing to refer national account patients to the franchisee.[31] "Good cause" for termination was not a complete defense to the lack of good faith.

(c). Termination "Strategery"

In examining a notice of termination, or notice of default preceding a termination, the franchisee's counsel must determine if the alleged violations are curable (under the agreement or a state statute); and if the franchisee has a factual defense. For

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28 The Iowa Franchise Investment Act is probably the broadest relationship statute, as it addresses "relationship" problems such as transfer, termination, non-renewal, and also protects the franchisee from territorial encroachment resulting from the franchisor's subsequent sales. *See* Iowa Code §§ 523B.1 to .3 (2001).

29 723 F.2d 512 (7th Cir. 1984), citing Ind. Code § 23-2-2.7-2(5).

30 13 F.3d 178 (6th Cir. 1994), construing Mich. Comp. Laws, § 445.1527.

31 225 F.3d 876 (7th Cir. 2000).

terminations that might be defensible, in fact or law, the franchisee might seek an injunction against termination, in order to avoid the prospect of Lanham Act liability if the franchisee remains open after the date of termination declared by the franchisor. The disadvantage in taking this approach is a shifting of the burden of proof at the preliminary injunction stage, but the prospects of trademark infringement liability often compel the franchisee to assume that burden. Where a choice of forum battle is anticipated, "filing first" becomes more attractive for that reason as well.

Most often, the best strategy for a franchisee facing termination is to negotiate a period of time in which the franchise can be sold to preserve equity. To the extent that the franchisee can allege colorable defenses or counterclaims, the franchisee has obviously increased its leverage for this negotiation. The franchisee might also consider the prospect of surrendering the location, but reserving damages claims (or counterclaims). The most dangerous outcome, to be avoided at all costs, is to remain open post-termination without the protection of an injunction, thus risking trademark liability.

3. Claims For Breach of Contract

The most common post-sale claim is for breach of contract, including claims for breach of the express contractual term as well as for the implied covenant of good faith and fair dealing. In virtually every state, the implied covenant of good faith and fair dealing is implied into every contract as an aid to the interpretation of the parties' agreement, but not as an independent source of contractual duties.[32] The implied covenant imposes a duty of "good faith" and "fair dealing" in the performance of discretionary duties, or the exercise of discretionary rights, under the agreement. The key is whether the franchisor is "given wide discretion", leaving the franchisee to "hope that the discretion is exercised fairly" and "reasonably, and with proper motive", and not "arbitrarily, capriciously or in a manner inconsistent with the reasonable expectations of the parties."[33] This principle assures that parties do not try to take advantage of each other in a way that could not have been contemplated at the time that the contract was drafted or to do anything that would destroy the other party's right to receive the benefit of the contract."[34] The duty of good faith may also be invoked where there is some "gap" in the agreement, resulting from the fact that the drafters were not able to delineate every possible contingency that could arise over the term of the agreement.[35]

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[32] *See Martindale v. Lake Shore Nat'l Bank*, 15 Ill.2d 272, 286, 154 N.E.2d 683 (1958); and *Zeidler v. A&W Rests., Inc.*, 301 F.3d 572, 575 (7th Cir. 2002) ("'Bad faith' is a term of art in contract law; it refers to one party's manipulation of contractual terms in order to take commercial advantage of another party").

[33] *Dayan v. McDonald's Corp.*, 125 Ill. App. 3d 972, 990, 466 N.E.2d 958 (1st Dist. 1984).

[34] *Voyles v. Sandia Mortgage Co.*, 196 Ill.2d 288, 296, 751 N.E.2d 1126 (2001).

[35] *See Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookie, Ltd.*, 970 F.2d. 273, 280 (7th Cir. 1992) ("Good faith is … the duty to avoid taking advantage of

(a). Other Ways For Franchisees To Expand The Contract

As franchisee advocate Michael Dady has written, a contract arguably consists of all of the parties' various expressions of interest, not just the written agreement; and oral agreements that supersede the written agreement are enforceable.[36] Other ways for franchisees to attempt to expand a franchisor's duties include:

- Parol Evidence, which can be admitted to explain or clarify ambiguous writings in all jurisdictions.[37] If the language used in a contract is "reasonably susceptible of more than one meaning," it is ambiguous, and parol evidence may be introduced.[38]

- Custom and Practice, Course of Dealing. Evidence of the custom and practice in the industry with respect to franchise terminations and the course of dealing between the particular franchisor and franchisee is commonly admissible to assist the fact-finder in determining the agreement's terms.[39]

- Oral Modification. Contracts may also be modified, usually by oral agreements, after they have been entered into. In fact, contracts are sometimes subject to oral modification even where the written agreement provides that it can only be modified in writing. Courts allow agreements to be modified orally or by actual performance if such modification is done in good faith.[40]

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gaps in [a franchise agreement] in order to exploit the vulnerabilities that arise in performance"); *see also*, Fox and Su, *Franchise Regulation: Solutions In Search Of Problems*, 20 Okla. City U. L. Rev. 241, n. 17 (1995) ("A [franchise agreement] is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance").

36 Caruso & Dady, citing *Darrell Dunafon v. Taco Bell Corp.*, Bus. Franchise Guide ¶ 10,919 (W.D. Mo. 1996). See also *Lindsey v. Jewels By Park Lane, Inc.*, 265 F.3d 1087; 2000 WL 254336.

37 *See e.g.*, *ICC Leasing Corp. v. Midwestern Mach. Co.*, 257 N.W.2d 551, 554 (Minn. 1977).

38 *See e.g.*, *Blattner v. Forster*, 332 N.W.2d. 316, 319 (Minn. 1982).

39 *See* U.C.C. § 2-202; and *Anderson Tractor Sales v. Fiat Tractor North Am. Operations*, No. 14Y1990034594 (A.A.A. 1996).

40 *See* U.C.C. § 2-209; and *Kelly-Stehney & Assocs., Inc. v. MacDonald's Indus. Prods., Inc.*, 658 N.W. 2d 494 (Mich. Ct. App. 2003).

- Promissory or equitable estoppel, which may also prevent a franchisor from invoking a clause in its written contract where the franchisor has, by its conduct, led its franchisee to believe it would not rely on the clause against that franchisee.[41]

- Recoupment, which may imply a minimum term to an at-will agreement (the length of time in which the franchisee can reasonably be expected to recoup its investment)[42] "has traditionally been confined to the recovery of preliminary expenses incurred in setting up a distribution system, such as sums expended for initial promotion and renting a facility."

- Unjust Enrichment: Typically, to satisfy a claim for unjust enrichment, a party must demonstrate the following three elements: (1) a benefit conferred upon one party by the other; (2) an appreciation or knowledge by the receiving party of the benefit; and (3) the acceptance or retention by the receiving party of the benefit under such circumstances as to make it inequitable for the receiving party to retain the benefit without the payment of its value.[43]

(b). Contract Clauses That Give Franchisees Trouble

i. Provisions That Expressly Negate A Claimed Legal Right

The most damaging clauses for franchisees are those that expressly negate a right that would otherwise exist by implication, *e.g.* a clause that expressly negates any territorial protection and which limits a franchise to the exact location (and which, in the case of a food franchise, would literally allow the franchisor to sell the exact product from a kiosk on the street in front of the franchised location, at half price)![44] These clauses are often the result of court decisions that were seen as expanding franchisee protection.[45] Recently, franchisor attorneys have advocated the total abolition of good faith and fair dealing through expansive disclaimers. *See* Schumacher, *Exercise of*

41 *See Central Microfilm Serv. Corp. v. Basic/Four Corp.*, 688 F.2d 1206 (8th Cir. 1982).

42 *See e.g.*, *Italian & French Wine Co. v. Negociants U.S.A., Inc.*, 842 F. Supp. 693 (W.D.N.Y 1993).

43 *Sensormatic Sec. Corp. v. Sensormatic Elecs. Corp.*, 249 F. Supp. 2d 703, 708 (D. Md. 2003); *see also Joan Hansen & Co. v. Everlast World's Boxing Headquarters Corp.*, 744 N.Y.S.2d 384 (N.Y. App. Div. 2002).

44 *Scheck v. Burger King Corp.*, 798 F. Supp. 692 (S.D. Fla. 1992) and *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999).

45 *See* Heller, "*Interim Health Care: The 7th Circuit applies The Implied Covenant*" (ABA 2000) (recommending that "the decision should prompt franchisors to review the language of their franchise agreements and redraft those provisions that a court may later conclude vest discretion in the franchisor.").

Discretion – Laws Affecting A Franchisor's Exercise of Discretion and Avoiding Claims In The Exercise Of Discretion (IFA 2005). These proposals would literally, and by design, license a franchisor to behave unreasonably, and to act contrary to the parties' reasonable expectations at the time of contracting. Whether the courts will accept those proposals remains to be seen. Absent a standard of care by which to measure the adequacy of a franchisor's discretionary performance, the franchisor's promise is wholly illusory. *See Chodos v. West Publishing Co., Inc.*, 292 F.3d 992, 996-97 (9th Cir. 2002) (the obligation of good faith and fair dealing renders discretionary promises real and prevents the voiding of contracts for lack of mutuality).[46]

ii. Integration And "No Reliance" Clauses

It remains unsettled whether a provision that the written agreement is "complete" will bar a fraud claim. The Seventh Circuit case has held that if a contract was procured by fraud, an integration clause reciting that the written agreement was complete would not preclude a fraud claim arising from the parties' discussions before the contract was signed; the integration clause "*would go down the drain with the contract of which it was a part.*"[47] The court explained that parties seeking to avoid fraud claims could still protect themselves by specifically providing that there was "no reliance" upon any oral or written representations not included in the final agreement.[48] Particularly problematic, however, is the argument that a "no reliance on prior representations" clause somehow precludes reliance on representations made in the Offering Circular. That application of an integration clause would arguably violate public policy, since franchisors provide Offering Circulars to comply with the FTC Franchise Rule and applicable state laws. "No waiver" clauses in state franchising acts, where applicable, arguably void these attempts.[49]

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46 Closely related are clauses asserting that the agreement is complete as written and that there are no "implied agreements." Franchisors argue in litigation that a "no implied agreements" clause should be interpreted as negating the implied covenant of good faith and fair dealing in its entirety. That assertion arguably has no merit. Since the implied covenant of good faith and fair dealing is not typically viewed as an independent source of contract-in-fact duties, but rather is a contract-in-law aid in interpreting the existing agreement, the covenant's existence should not be affected by a clause stating that there are "no [independent] implied agreements."

47 *Vigortone AG Prods., Inc. v. AG Prods., Inc.*, 316 F.3d 641 (7th Cir. 2002) (*citing Olympia Hotels Corp. v. Johnson Wax Dev. Corp.*, 908 F.2d 1363, 1371 (7th Cir. 1990)).

48 *See e.g.*, *Healy v. Carlson Travel Network Assocs.*, 227 F. Supp. 2d 1080, 1094 (D. Minn. 2002), *citing Commercial Props, Inv., Inc. v. Quality Inns Int'l, Inc.*, 938 F.2d 870 (8th Cir. 1991).

49 As discussed above with respect to Little FTC Acts, franchisees might also turn to state consumer fraud or deceptive business practice laws to avoid the potential application of integration clauses in general, and as applied to UFOC disclosures in particular.

For contract claims, integration clauses are commonly enforced, leaving a party seeking to avoid its application to try to establish that the franchise agreement was incomplete (which is rare), ambiguous, or that the proposed additional term is separate from the subject matter of the agreement containing the integration clause.[50]

iii. Choice-Of-Law Provisions

Franchisors use choice-of-law clauses in an attempt to control the substantive law that will govern the parties' agreement. Courts review these clauses under a four-part test (or a close variation): (1) Did the parties agree to the choice of law in advance? (2) Are the contacts of the parties evenly divided between the chosen state and the plaintiff's state? (3) Are the parties of relatively equal bargaining strength? (4) Is the application of the chosen law repugnant to the public policy of the forum state?[51]

Serious problems arise when franchisors seek to use choice-of-law clauses to circumvent state franchising acts. With both the proliferation of state laws regulating the termination or substantial alteration of franchise relationships and the wide disparity in the nature and amount of regulation, enforceable choice-of-law provisions may dramatically affect the rights of those on both sides of the franchise relationship. Historically, state statutes regulating the conduct of parties to a franchise agreement have been viewed by courts as embodying the fundamental public policy of the state, and, as such, in the past, courts have consistently held that these statutes prevailed over conflicting language in the agreements between the parties.[52] Certain courts, however, have disregarded these statutory protections.[53]

Other problems may occur if a choice-of-law clause provides for the law of the state where the franchisor has its headquarters or principal place of business, but if the franchisor then relocates after the agreement is signed. In that situation, courts must determine whether the parties' rights were fixed at the time the contract was signed, or whether the choice of law floats with the franchisor.

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50 *See Miniasian v. Standard Chtd. Bank*, 109 F.3d 1212, 1215 (7th Cir. 1997) (if an integration clause is to have any application, the "subject matter" of the alleged false promises must be fully integrated into "an unambiguous contract provision").

51 *See Modern Computer Sys. v. Modern Banking Sys.*, 871 F.2d 734 (8th Cir. 1989). *See also TeleSave Merchandising Co. v. Consumers Distrib. Co.*, 814 F.2d 1120 (6th Cir. 1987).

52 *See Luis Rosario, Inc. v. Amana Refrigeration*, 733 F.2d 172, 173 (1st Cir. 1984); *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979); *Cutter v. Scott & Fetzer Co.*, 510 F. Supp. 905 (E.D. Wis. 1981); *33 Flavors, Inc. v. Bresler's 33 Flavors*, 475 F. Supp. 217, 227 n.29 (D. Del. 1979).

53 *See* Caruso & Dady for further discussion of this point.

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Franchisees may use choice-of-law provisions offensively. For example, a California statute provides that non-compete clauses that would restrain a person from engaging in a "lawful profession, trade or business of any kind" are void.[54]

iv. Forum Selection Clauses

Forum selection clauses that would require a franchisee to litigate outside its home state are often void under state franchising acts.[55] Presumably, franchisees are protected in the registration process from approval of franchise agreements that would purport to require litigation in another state, in violation of a state law.[56] Franchisees are often well advised to be the "first to file" in their home state.

v. Jury-Trial Waivers

In federal cases, a contractual agreement can operate to waive the right to a jury trial, but, consistent with the status of jury trials as a constitutional right, such agreements are strictly and narrowly construed. Four factors courts use to consider contractual jury-trial waivers are: (1) the relative bargaining power of the parties; (2) the extent to which the party opposing the waiver understood that provision; (3) the extent to which the provision was negotiated; and (4) the conspicuousness of the provision. Courts place the burden of establishing these factors on the party seeking to enforce a waiver provision. Franchisees can argue against these provisions with success.[57]

vi. Damage Limitations And Exclusions

The agreement might provide for limitations on the right of either party to seek punitive damages from the other. Arguably, these provisions should be given no effect, since punitive damages are rarely (if ever) available in contract actions, and if the claim is based on fraudulent inducement, then damage limitations should be stricken as part of the fraud. There is, however, no broad rule striking down these clauses.[58]

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[54] Cal. Bus. & Prof. Code § 16600. *See Budget Rent A Car Corp. v. G.M. Truck Rental*, 2003 U.S. Dist. LEXIS 11323 (N.D. Ill. June 26, 2003).

[55] *See e.g.*, 815 Ill. Comp. Stat. § 705/4.

[56] Item 17 of a UFOC requires disclosure of choice of law and choice of forum provisions in an agreement.

[57] *See MZ Ventures v. Mitsubishi Motor Sales of Am., Inc.*, 1999 U.S. Dist. LEXIS 14421 (C.D. Cal. August 30, 1999) (holding that franchisor failed to establish the effectiveness of a jury trial waiver).

[58] *See Gannon v. Circuit City Stores*, 262 F.3d 677, 681-82 (8th Cir. 2001) (observing that the district court had refused to enforce a waiver of punitive damages in an employee's dispute resolution agreement, where the employee alleged the intentional tort of sexual

Similarly, there is no broad rule to strike down the exclusion of consequential damages or lost profits. The argument may be, however, that if the combined effect is to deprive the franchisee of any effective remedy, the agreement is unconscionable.

vii. Waiving The Right To Bring A Class Action

Federal courts permit contractual waivers of the right to seek class-wide relief.[59]

viii. Shortened Limitations Periods

These clauses are usually upheld, even in the Ninth Circuit (although it remains possible for the authors to conceive of provisions that would be so short as to arguably become unconscionable).[60] Moreover, fraudulent concealment and/or the discovery rule should continue to apply even where the franchisor has imposed a shortened period.

C. RICO Claims

The federal Racketeering Influenced & Corrupt Organizations Act, 18 U.S.C. § 1961 *et seq.*, provides a comprehensive remedy for serious fraud claims, complete with treble damages and attorneys' fees. Detailed discussion of RICO is beyond the scope of this paper. However, for franchising:

- The most important predicate acts are mail fraud or wire fraud. (18 U.S.C. § 1341 and 18 U.S.C. § 1343).
- The pattern of racketeering activity may be present where the alleged violations are system-wide.
- Franchisors can be "persons" that violate the RICO statute in relationship to an "enterprise", which can be the franchise system, or some portion of that system (as an association-in-fact). *See Lee v. General Nutrition Cos., Inc.*, where the franchisee stated a RICO claim under Section 1962(a),

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harassment, but noting that the employer did not appeal the issue, and there was a lack of precedent on the issue).

59 *See Arnold v. Goldstar Fin. Sys., Inc.*, 2002 U.S. Dist. LEXIS 15564 (N.D. Ill. August 20, 2002) (rejecting the contention that an arbitration agreement was void because it would have required the prospective plaintiff to waive its right to file a class action under a federal consumer protection law). For a discussion of class actions in franchising, *see Broussard v. Meineke Discount Mufflers*, 155 F.3d 331 (4th Cir. 1998), where the court of appeals overturned a verdict for a combined class of current and ex-franchisees, finding that the two sub-classes had distinct interests in the survival of the system.

60 *See Soltani v. W. & S. Life Ins. Co.*, 258 F.3d 1038, 1042 (9th Cir. 2001).

alleging that the franchisor engaged in a fraudulent scheme to drive GNC franchisees out of business and to retake the stores.[61]

D. Anti-Competitive Conduct

1. Antitrust Claims

Exhaustive antitrust discussion is beyond the scope of this paper. However, successful antitrust claims by franchisees are not common, since franchisors usually do not have sufficient market power for their conduct to be deemed anti-competitive under the Rule of Reason (which governs vertical non-price restraints).[62]

2. Robinson-Patman Act Claims

Price discrimination claims under the Robinson-Patman Act, 15 U.S.C. § 13, remain viable for franchisees. This Act comes into play when franchisees purchase goods from the franchisor or from third-parties that the franchisor may designate.[63] The Supreme Court's 2005 decision in the *Volvo* dealers' case is beyond the scope of this paper. The difficulty in proving price discrimination is built into § 13(b) of the Act, which contains three express affirmative defenses, including "due allowance" for cost differentials, "changing market conditions", and "meeting the competition." Two cases in which franchisees stated viable claims are noted below.[64]

3. Contract Challenges To Anti-Competitive Conduct

Anti-competitive conduct by a franchisor may breach a duty of good faith and fair dealing, even if it is not possible to state an antitrust claim. In *Matthis v. Exxon Corp.*, fifty-four (54) franchised gasoline dealers alleged that their franchisor had attempted to drive them out of business by imposing a low price setting, where "price" had been an open term of the contract that had been left to Exxon's discretion, and where Exxon allegedly intended to replace them with lower price jobbers.[65] Only the contract claims survived to trial. Examining the franchise agreement to mount challenges to the

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61 2001 U.S. Dist. LEXIS 24739 *7 (C.D. Cal. November 21, 2001).

62 *See* B. Bruckman and H. Hillman, *Problems of Dual Distribution Systems*, ABA Forum on Franchising (October 2002) (separate papers). *See also Maris Distrib. Co. v. Anheuser-Busch, Inc.*, 302 F.3d 1207 (11th Cir. 2002), for an illustration of the difficulty of establishing actionable Sherman Act claims under the rule of reason.

63 Third-party supplier cases may involve claims of illegal brokerage payments in violation of 15 U.S.C. § 13(c).

64 *Schwartz v. Sun Co.*, 276 F.3d 900, 903-04 (6th Cir. 2002); and *Inomed Labs LLC v. Aza Corp.*, Bus. Franchise Guide (CCH) ¶ 12,465 (S.D.N.Y. 2002). .

65 302 F.3d 448 (5th Cir. 2002).

arbitrary exercise of discretion has particular relevance in the context of dual distribution.

E. Civil Rights Claims

California provides statutory protection to minorities from discrimination in franchising.[66] At the federal level, racial minorities (but not women or other minorities) are protected from discrimination in franchising by a Reconstruction era law, 42 U.S.C. § 1981, which provides that "all persons" shall have the same right as "white persons" to "make and enforce contracts." Civil rights claims turn on "direct" or "indirect" proof of discriminatory intent — *i.e.*, that the color of the plaintiff's skin caused the adverse action and keep the franchisor's stated reasons for its actions were phony.[67] The Seventh Circuit has held that plaintiffs may present "a mosaic of evidence which, taken together, would permit a jury to infer discriminatory intent."[68] *See also Home Repair, Inc. v. Paul W. Davis Sys., Inc.,* where a "mosaic" of proof included evidence of suspicious timing, inconsistent behavior, racist statements and/or evidence of "racial steering" of minority franchisees to minority communities.[69]

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66 Cal. Civil Code, §51.8 and 84.

67 *Troupe v. May Dept. Stores Co.*, 20 F.3d 734, 736 (7th Cir. 1994).

68 *Id.*; and *Kennedy v. Schoenberg, Fisher & Newman, Ltd.*, 140 F.3d 716, 724-25 (7th Cir. 1998).

69 2000 U.S. Dist. LEXIS 929 (N.D. Ill. Jan. 31, 2000).