FRANCHISEE LITIGATION PERSPECTIVE

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I. WELCOME TO THE FUTURE

This program started as an opportunity for a couple veteran franchisee trial lawyers to share tricks of the trade with a high-power franchisor lawyer standing at the ready to challenge us. We'll do that, but let's also preview issues and arguments on the horizon.

II. INHERENT CONFLICTS OF INTEREST

Franchisees like to think they have unity of purpose with the franchisor to grow the brand and make money. Too few franchisees understand that franchising creates a classic adversarial relationship leaving franchisees vulnerable. Problems arise when franchisors see increased profits for themselves at the franchisees' expense. The lure of short-term profit should never be underestimated since "in the long run we are all dead" as the late economist John Maynard Keynes once explained.[1]

Problems begin in the sales process when franchisors (too often aided by lawyers):

- Narrowly construe disclosure obligations, causing materially misleading FDDs that inflate or distort financial performance representations, hide franchise failures, understate costs, *etc.*

- Abuse franchise agreement "no-reliance" clauses seeking immunity from the consequences of deception in the franchise sales process.

[1] http://www.thecommentator.com/article/3689/john_maynard_keynes_in_the_long_run

Franchise agreements invite future train wrecks when the franchisor strives to circumvent the implied covenant of good faith and fair dealing. Law Professor Gillian Hadfield nailed this problem in a 1990 Law Review article explaining how franchisees are near-completely dependent on the franchisor's wisdom and honesty.[2] Franchisors emboldened by one-sided franchise agreements may succumb to the temptation to:

- Modify system standards to impose sweeping concept change without demonstrating ROI or imposing costs or obligations never agreed to.[3]

- Inspect and grade franchised locations dishonestly.

- Pursue shareholder value over franchisee equity, profiting from mandated product purchases, opening encroaching new units, *etc.*

- Engage in deception during the franchise term, *e.g*. dangling the opportunity to renew or expand then saying "no" for pretextual reasons.

- Exercise excessive control over franchised units risking joint employer liability.

- Usurp local goodwill by claiming ownership of franchisee customer lists – a practice facilitated by data mining.

- Engage in conduct that would have *per se* violated the Sherman Act before *Continental T. V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977).

- Impose overbearing dispute resolution clauses.

- Impose liquidated damages clauses seeking to profit from franchise failure.[4]

- Use arbitration to keep bad practices secret.[5]

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[2] *See* Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts* 42 STAN. L. REV. 927-992 (1990).

[3] ROI means "return on investment." Franchisees investing their time in addition to their dollars seek ROI greater than what they might earn in passive investments.

[4] In a recent arbitration, the Arbitrator concluded a franchisor's damage claims asserted against former area developers in a declining system were "*disproportionate, unreasonable, unconscionable and grossly oppressive*." (emphasis added).

[5] Rejecting the same franchisor's view that results in arbitration are secret, this author made it a point to discuss the case (naming the franchisor but not its attorney) on Blue MauMau

- Impose non-disclosure and non-disparagement clauses on departing franchisees (and employees) to keep their bad practices secret.

- Manipulate franchisee advisory councils.

- Marginalize independent franchisee associations.

- Retaliate against franchisees who speak out in dissent.

But to what end? Your speakers today respectfully submit that franchising is not or should not be like Big Pharma, whereby some casualties and resulting verdicts are assumed as the cost of doing business.

III. TRIAGE

In any new representation of an existing franchisee or dealer, there are cascading concerns (beyond whether the client will be a good fit and the representation makes economic sense). Before diving into the facts of the potential case, we strive to:

1. Understand the brand: Start-up or mature; growing or declining, *etc.*?

2. Understand the potential client: Sophisticated in business, or not?

3. Does the potential client have a defined business goal, starting with: Stay in? Get out?

IV. REPRESENTING INDEPENDENT FRANCHISEE ASSOCIATIONS

Similar triage is necessary to properly represent an independent association, with the caveat that association counsel must be vigilant to avoid conflicts of interest in also representing individual franchisees in the same system.

A. Support the brand

Never forget the association's purpose is to help build equity for its members, which most often means supporting the brand and "reminding" the franchisor its long-term success depends on franchisee success.

-https://www.bluemaumau.org/blog/2017/12/11/arbitrator-rejects-tilted-kilts-damage-claim-disproportionate-unreasonable

B. The Hippocratic Oath applies

The nature of the franchise system will have a substantial effect on your advice to the association on strategy and tactics. Where a brand has substantial value to its franchisees, the utmost care must be taken not to injure that brand. The temptation to speak to the media should be resisted. Legal action, by the assertion of associational standing or supporting test cases, should be a last resort. Hopefully it will be enough that the franchisor knows the association has that capability and adjusts its stance towards its franchisees. The highest value of the proverbial "big stick" is to never have to swing it.

But there are exceptions to every rule ...

C. Protect association members

The franchisor must know the association will protect its members from retaliation and will not tolerate efforts at divide and conquer.

V. CIVIL RIGHTS IN FRANCHISING

Any lawyer representing a minority franchisee, at any stage of the relationship, must have a working familiarity with 42 U.S.C. §1981, an important federal civil rights law enacted by Congress in 1866 at the end of the Civil War.

Section 1981 does not receive the attention given to "Section 1983" which is used to challenge deprivations of civil rights done under color of state law. Section 1981 was enacted to give the newly freed African American slaves many of the rights "enjoyed by white citizens" including the important right to "make and enforce contracts." In 1991, Congress amended Section 1981 to clarify that "to make and enforce contracts" includes "the making, performance, modification, and termination of contracts, and the *enjoyment* of *all benefits*, *privileges*, terms, and conditions of the contractual *relationship.*" (emphasis added). This statutory language was practically written with franchising in mind and, for minority franchisees, Section 1981 solves the problem created by the fact that most franchise agreements confer only limited express rights on the franchisee. For example, under Section 1981(b), franchisors may not steer minority franchisees to inferior locations or discriminate against them in any other aspect of the relationship, whether part of the written contract or not.

VI. FRAUD AND DISCLOSURE CLAIMS ARISING IN THE SALES PROCESS

Fraud includes:

> Anything calculated to deceive, whether it be a single act or combination of circumstances, whether the suppression of truth or the suggestion of what is false, whether it be by direct falsehood or by innuendo, by speech or by silence, by word of mouth or by look or gesture.[6]

The fraud analysis begins with a thorough review of the FDD followed by a comparison of the FDD to all other known or suspected facts even if arguably barred by limitations because that evidence might still be admissible in court. *See Brinkley–Obu v. Hughes Training, Inc.,* 36 F.3d 336, 346 (4th Cir.1994)("Statutes of limitations do not operate as an evidentiary bar controlling the evidence admissible at the trial of a timely-filed cause of action.")[7]

Catching a franchisor in an outright lie in an FDD can happen and when it does, most lawyers will know what to do. Far more common, the claim will be that an FDD was materially misleading even though no bald-faced lie is likely to be proven.

A. State Franchising Acts

Recognizing federal law creates no private cause of action for violations of the FTC Franchise Rule, franchisees do best in states like Illinois that have enacted specific franchisee protection acts derived from Rule 10b-5, the primary anti-fraud weapon in the U.S. securities laws, meaning it is "more than reasonable to look to traditional Rule 10b–5 principles" in construing these anti-fraud provisions. *See Bonfield v. AAMCO Transmissions, Inc.*, 708 F. Supp. 867, 875–76 (N.D. Ill. 1989), construing the Illinois Franchise Disclosure Act (815 ILCS 705/1 *et seq*.)

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[6] *Bundesen v. Lewis*, 291 Ill. App. 83, 97, 9 N.E.2d 327, 334 (1937).

[7] *See also, Kalia v. St. Cloud State Univ.*, 539 N.W.2d 828, 833 (Minn. Ct. App. 1995) (statute of limitation "bars only *claims* for violations that fall outside its applicable period … [but] does not bar evidence relevant to a timely filed claim, especially otherwise admissible evidence that would assist a fact-finder in ascertaining the truth" [and/or] "where it is offered to establish an element of actionable conduct such as malice." (citations omitted). And, if you are arbitrating, remember there is persuasive (and sometimes controlling) authority that "arbitration is not an 'action' subject to state statutes of limitations" and "state statutes of limitations may not apply to arbitrations absent the parties' agreement." *Broom v. Morgan Stanley DW Inc.*, 169 Wash. 2d 231, 244, 236 P.3d 182, 188 (2010).

For example, the (IFDA) differentiates between Section 5 "prohibited practices" including failing to deliver a properly registered, required disclosure statement "meeting the requirements of this act" and containing no "untrue statement of a material fact" and not "omit[ting] any …material fact." 815 Ill. Comp. Stat. Ann. 705/5; and Section 6 "fraudulent practices":

(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 statements made, in the light of the circumstances under which they are made, not misleading; or
(c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

815 Ill. Comp. Stat. Ann. 705/6.

B. Little FTC Acts

Fraudulent omission is also actionable under most "Little FTC Acts." *See e.g.* Illinois Consumer Fraud & Deceptive Business Practices Act, 815 Ill. Comp. Stat. Ann. 505/1 et seq., which is also analyzed by reference to Rule10b-5. *See Martin v. Heinold Commodities, Inc.*, 163 Ill. 2d 33, 643 N.E.2d 734 (1994).[8] Determining if franchisees are protected by a consumer fraud or deceptive practice act in the particular jurisdiction is an important inquiry.[9] Absent statutory language excluding franchisees, or a recent definitive statement by the highest court in the state so holding, we would consider filing

[8] "'Little FTC Acts' refers generally to the consumer protection or deceptive trade practices legislation adopted in one form or another by 49 states – some, but not all of which are modeled after the FTC Act." *See Toward Greater Equality in Business Transactions: A Proposal to Extend the Little FTC Acts to Small Businesses*, 96 Harv. L. Rev. 1621, 1640 (1983). For a fifty state survey, *see* http://www.nclc.org/images/pdf/udap/udap-report.pdf.

[9] Without limitation, states in which franchisees have "Little FTC Act" standing include: Connecticut (*Bailey Employment System, Inc. v. Hahn,* 545 *F.Supp.* 62 (D.Conn.1982), aff'd without op. 723 *F.*2d 895 (2 Cir.1983); Florida (*KC Leisure, Inc. v. Haber*, 972 So. 2d 1069, 1071 (Fla. Dist. Ct. App. 2008; Georgia (*Athlete's Foot Marketing Assocs., Inc. v. Inner Reach Corp.)*, Bus. Franchise Guide (CCH) ¶ 12, 349 (N.D. Ga. 2003); Illinois (*People ex rel. Scott v. Cardet Int'l, Inc.*, 24 Ill. App. 3d 740, 744, 321 N.E.2d 386, 390 (1974)); New Jersey (*Morgan v. Air Brook Limousine, Inc.*, 211 N.J. Super. 84, 100, 510 A.2d 1197, 1205 (Law. Div. 1986)); Ohio (Ohio Rev. Code Ann. § 1345.01-13 expressly includes franchises); and Texas (*Century 21 Real Estate Corp. v. Hometown Real Estate Co.*, 890 S.W.2d 118 (Tex. App. 1994). This list is not exhaustive.

a Little FTC Act claim despite older authority suggesting or holding franchisees are not covered because the franchise sale was not viewed as a consumer transaction.

C. Common Law

Fraudulent omission is actionable at common law, which imposes a duty to disclose where an omitted material fact: (1) is known only to the franchisor and is beyond the reach of any buyer exercising due diligence;[10] (2) the franchisor actively conceals the material fact;[11] or (3) without disclosing additional facts, the representations made (including those in the FDD) are merely "half-truths."[12] As one court put it:

> [E]ven though one is under no obligation to speak as to a matter, if he undertakes to do so, either voluntarily or in response to inquiry, he is bound not only to state the truth but also not to suppress or conceal any facts within his knowledge which will materially qualify those stated; if he speaks at all, he must make a full and fair disclosure. So it is that if a franchisee raises a question the franchisor must avoid half-truths.[13]

D. The FTC Franchise Rule does not permit fraud by omission

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[10] *See Forest Pres. Dist. of Cook Cnty. v. Christopher*, 321 Ill. App. 91, 52 N.E.2d 313, 319-20 (Ill. App. 1st Dist. 1943) (when "the other remains silent when it is within his power to prevent the expenditure of money under a delusion . . . to permit one to take advantage of the mistake of another would be revolting to every sentiment of justice." The court further stated, "there are times ... when it becomes the duty of a person to speak, in order that the party he is dealing with may be placed on equal footing with him, and when a failure to state a fact is equivalent to a fraudulent concealment, and amounts to [an] affirmative falsehood.").

[11] "Mere silence in a transaction does not amount to fraud." *Hirsch v. Feuer*, 299 Ill. App. 3d 1076, 702 N.E.2d 265, 273 (Ill. App. 1st Dist. 1998). However, silence accompanied by deceptive conduct or suppression of material fact, can give rise to concealment and "it is then the duty of the party which has concealed information to speak." *Id.*

[12] *W.W. Vincent & Co. v. First Colony Life Ins. Co.*, 351 Ill. App. 3d 752, 814 N.E.2d 960, 969 (Ill. App. 1st Dist. 2004) ("A statement which is technically true may nevertheless be fraudulent where it omits qualifying material since a 'half-truth' is sometimes more misleading than an outright lie."); *see also The Clearing Corp. v. Fin. And Energy Exch. Ltd.*, 09 CV 5383, 2010 WL 2836717, at *2-5 (N.D. Ill. July 16, 2010) (plaintiff sufficiently alleged a duty to disclose where he alleged facts to show that the defendant's acts contributed to the plaintiff's misapprehension of a material fact and the defendant intentionally failed to correct plaintiff's misapprehension).

[13] *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1313 (5th Cir. 1977).

Courts should reject these myths:

- The FTC Franchise Rule ties their hands by restricting what they may disclose.

- An FDD is not actionable if it is "literally true."

The correct position is that the FTC Franchise Rule establishes a minimal level of disclosure but does not limit disclosure to what is expressly "required" by the Rule (or by a non-preempted state law). The Rule allows franchisors to disclose information "required or permitted" by the FTC Franchise Rule or applicable state law, without delineating or placing limits on what is "required" or "permitted."[14]

There is no "Thou Shall Not Disclose" rule where the effect of non-disclosure would be materially misleading. Since the statutory and/or common law of every state prohibits fraud by omission, the correct view must be that while the FTC Franchise Rule limits disclosure to enumerated categories, it does not (and must not be interpreted as) precluding the disclosure of facts to avoid fraud by omission, *i.e.* to avoid the FDD being materially misleading. An FDD is actionable under state laws modelled after Rule 10b-5 where the franchisor "omit[s] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading." (815 Ill. Comp. Stat. Ann. 705/6).

E. Recent federal court holding rejecting "literal truth" defense

Must a franchisor disclose that in the most recent year, company-owned units lost money where that fact is not apparent from Item 19 Financial Performance Representations or the attached audited financial statements (that might come from a parent company)?

In *Dissette v. Pie Five Pizza Company*, a franchisor moved to dismiss a franchisee's complaint that the FDD was materially misleading by omission in multiple respects, to which the franchisor argued "*Plaintiffs do not allege that any fact in these FDDs is actually untrue.*"[15] That statement was true but the motion to dismiss was denied. In response to the franchisee's allegation that Pie Five and RAVE failed to disclose information regarding their financial condition*, i.e.* that company stores were losing money and the franchisor was in financial distress or decline, the franchisor and its corporate parent argued its FDD disclosed extensive financial information in Item 19 and in the audited financial statements and there was "no allegation that any of the

[14] *See* Statement of Basis and Purpose, page 201, quoting Section 4.36.6(d) of the Rule

[15] 16-CV-11389, Dkt. #15, at 1, fn. 3 (emphasis added).

information provided is actually false" and "nor does [the parent company's SEC filings] contradict any identified prior disclosure." [16]

For the franchisee, we argued that the although the franchisor's parent reported a consolidated loss ("in ways no one could decipher"), the disclosure did not reveal: (i) company-owned Pie Five units were losing money; and (ii) the corporate parent was in "financial decline or distress, meaning it could not support the Pie Five franchise program and would instead become a drain on this franchise program." The District Court denied the motion to dismiss, holding that whether "company-owned Pie Five units were running losses" was material because "there's a substantial likelihood a reasonable investor would have viewed the information as having significantly altered the total mix of available information" and denied the defendant's motion to dismiss.[17] The Court added that the FDD did not "directly contradict" the misleading impression formed by the plaintiff, and the claim would proceed because it was "plausible" that the FDD was misleading.

The pivotal moment came in impromptu oral argument in the District Court, when counsel posed a rhetorical question: *Would the Court allow the offeror of securities to argue it can make an initial public offering materially misleading to investors? And if not, then how could a franchisor be allowed to make that argument?*

F. Are there limits on disclosure?

Franchisors complain there is no limit to claimed omissions, but the test of materiality is "[whether] a buyer would have acted differently knowing the information, or if it concerned the type of information upon which a buyer would be expected to rely in making a decision regarding the purchase of the [franchise]."[18]

Returning to state statutes modelled after Rule10b-5 in the federal securities laws: *Why is the buyer of a franchise entitled to disclosure less than the buyer of securities?* A recent American Bar Association primer on federal securities litigation defines "materiality" exactly as defined by the District Court in *Pie Five* (above):

> Generally, information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. Where disclosure of information would have a

[16] *Id.*, at 4.

[17] *Id.*, Dkt. 39, at 5.

[18] *Wernikoff v. Health Care Serv. Corp.*, 877 N.E.2d 11, 16 (Ill. App. 1st Dist. 2007).

substantial effect on the price or perceived value of a corporation's securities, that information is material.[19]

The same authors explain that "[a]ssessing materiality is typically a fact-specific inquiry" and that "[m]aterial information … can relate to any aspect of a corporation's business" including "*contemplated, proposed or current business plans or operations*." *Id.* (emphasis added).[20] Factors potentially material in a securities purchase could be equally material to a franchise purchase or renewal; and this materiality will only increase as private equity buys more franchise systems, becoming franchisors;[21] and increasingly invest in franchised units.[22] Franchisees have no less stake in their franchise systems and, as a matter of law, should receive the same level of disclosure.

1. Hypothetical #1

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[19] *See C. Loewenson, Jr. and R. Smithline, Insider Trading,* American Bar Association (2017), Chapter 2, *Elements of Insider Trading*, by G. Harris, at 13-14.

[20] Additional examples from the same authors include:

- Contemplated, proposed, or current corporate transactions, mergers, acquisitions, purchases or sales of assets, or financial restructuring;
- Unpublished financial reports, projections, earnings, losses, or other financial information;
- Pending or new research and development, products, patents, or inventions;
- Changes in the issuer's debit, liquidity, or credit standing;
- Changes in the issuer's important suppliers or customers;
- Changes in the issuer's senior management;
- Future dividend payments, stock splits, or issuance or redemption of securities;
- Major litigation, investigations, regulatory proceedings, or violations of state or federal laws.

[21] *See* J. Mazzero, *Private Equity Is Buying More Franchise Systems*,Forbes, (Jan. 14, 2019), *available at* https://www.forbes.com/sites/joycemazero/2019/01/14/private-equity-is-buying-more-franchise-systems-here-are-the-key-legal-issues-they-are-looking-at/#57d9fa881b95.

[22] C. Modell and N. DeCarlo (Speakers) and S. Hagedorn (Moderator), *Attracting, and Negotiating With, Private Equity Owned Franchisees*, IFA's 45th Legal Symposium (2012), *available at* https://www.franchise.org/sites/default/files/ek-pdfs/html_page/PE-Owned-Franchisees_0.pdf.

A publicly-traded franchisor unveils significant brand changes in unit design, menu, operations *etc.* The franchisor "persuades" nearly all franchisees to accept these changes and incur substantial debt to fund them. The franchisor touts the claimed unanimous enthusiasm of its franchisees and enjoys a higher stock price. But the brand makeover was rushed, without ordinary due diligence and without confident return on investment (ROI) projections. *This is not disclosed to existing or prospective franchisees or to stock purchasers.* Meanwhile, key corporate officers profit from the enhanced stock prices through their executive compensation plans.

To the extent shareholders can prove the franchisor misrepresented the likely success of its brand makeover plan, the shareholders would likely have viable securities fraud claims. That key officers profit from inflated stock values and money raised by this deception is likely admissible as proof of scienter (though probably insufficient to prove scienter if standing alone. *See Sec. & Exch. Comm'n v. Blackburn*, 156 F. Supp. 3d 778, 791 (E.D. La. 2015); and *Novak v. Kosaks*, 2016 F.3d 300, 307-08) (2d Cir. 2000).[23]

Do new or renewing franchise buyers have comparable fraud and disclosure violation claims? If not, why not?

Do existing franchisees, induced to incur substantial debt during their franchise relationships, have claims too? If not, why not?

2. Hypothetical #2

Item 19 FPR's do not disclose identifiable traits that determine whether an individual franchisee is likely to be a "top tier" or bottom-tier performer, such as:

- Regional variation across the country
- Certain markets consistently substandard
- Under-capitalized franchisees consistently under-perform
- Units in higher crime areas consistently under-perform

[23] In *Novak*, the Second Circuit held that "[m]otives that are generally possessed by most corporate directors and officers do not suffice; instead, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from the fraud;" and held further that this requirement was generally met when corporate insiders were alleged to have misrepresented to the public facts about the corporation's performance or prospects in order to keep the stock price artificially high while they sold their own shares at a profit." *Id.* providing examples *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 185 (2d Cir. 1999); *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir.1985).

- Units owned by persons of color consistently under-perform

Is there a disclosure violation? Must the discrepancies be statistically significant?

3. Hypothetical #3

A franchise agreement expressly negates a contractual right to acquire more units or to renew the franchise upon expiration. But the franchisor has an established course of dealing whereby franchisees can earn the right to expand or be renewed, subject always to the franchisor's reservation of the contractual right to change the requirements or even to say "no" for any reason or no reason. This course of dealing is essential for the brand, which depends on franchisee's being faithful to system standards and appropriately reinvesting throughout the term.

Should the franchisor be required to disclose its policies that constitute a course of dealing? Should a franchisee that relies on the course of dealing have any remedy if the franchisor denies expandability or renewal?

G. Overcoming Contractual Disclaimers

1. A proposed "Rule of Silence"

There is a short answer in the debate whether a franchisor can immunize itself from liability for false statements made outside the FDD – *e.g*., oral statements at discovery day -- by the aggressive use of "no reliance" disclaimers: *If franchisors wish to be immunized from liability for anything said in conversation with a prospective franchisee or in written sales materials outside the FDD, then franchisors should be barred from any communication with a prospective franchisee outside the FDD itself.*

Under this proposed rule there would be no discovery day and no franchise sales persons. Franchisees would receive their FDD, conduct whatever independent due diligence they wish, and decide. Ridiculous? Franchisee lawyers respectfully submit it is more ridiculous to allow franchise sales personnel to engage in sales talk but require the franchisee to acknowledge and agree he or she will not rely on anything said.

Most franchise lawyers know the courts have split on these questions. Good cases for franchisees include *Hanley v. Doctors Exp. Franchising, LLC*, 2013 WL 690521, at *27 (D. Md. Feb. 25, 2013), citing *Randall v. Lady of America Franchise Corp.,* 532 F.Supp.2d 1071 (D.Minn.2007). In other cases, the franchisors won, but those defeats occurred because the franchisee had a weak fraud claim to begin with or the franchisee missed opportunities to make better arguments.

2. The FTC Franchise Rule does not create a "license to lie"

Franchisors misstate the FTC Franchise Rule when they cite the rule at 16 C.F.R. § 436.9(h) barring franchisors from "disclaim[ing] or requir[ing] a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments" that the Rule supposedly permits every other type of disclaimer they can think of. That argument overlooks the FTC's Statement of Basis and Purpose which explains that franchisors may include integration clauses[24] and disclaimers for *unauthorized* statements by salespersons, along with statements made by other franchisees, or in franchise advertising and marketing materials, or unattributed statements in the trade press and third-party representations.[25] The distinction between *authorized* and *unauthorized* representations is vital and follows general laws of agency whereby a principal is liable for misstatements by an agency only where the agent has actual authority, or is cloaked with apparent authority, or where the principal ratifies the agent's statements. *There is no valid reason to grant franchisors blanket immunity when they commit misrepresentation especially not when the franchisee seeks clarification of questions raised by the FDD.* For example:

- An FDD discloses that ten (10) units failed last year; that eight (8) franchisees sued for fraud and that some stores earned far less than the system-wide average. Upon reading this information a prospective franchise buyer asks the franchisor to explain these failures. At discovery day the franchisor claims, "the problem was the failed franchisees did not follow our system" and asserts that "no one who actually follows our system has ever failed."

- Another FDD discloses a pizza franchisee must buy the pizza sauce from the franchisor's distribution arm or an approved supplier and the franchisor may derive revenue based on franchisee purchases. At discovery day the franchisor denies a request by the franchisee to see a price list, explaining "the past is no guarantee of the future" and "we would not want to mislead you" but "don't worry, with the size of our system, we have tremendous buying power which gives our franchisees a huge advantage."

[24] Integration clauses address questions of contract interpretation and do not bar fraud claims.

[25] 72 Fed. Reg. 15, 444 (Mar. 30, 2007), at 253.

In both hypotheticals the franchisees believed what they were told, but what they were told turned out to be false. There was no "system" to follow to protect the new franchisee from failing. The pizza franchisee later discovered she could buy identical sauce for less somewhere else. Are the "out of FDD" statements not sufficiently tied to statements made in the FTC as purported clarifications, as opposed to outright contradictions, which concededly would be more problematic for a franchisee?[26]

As always, the ruling on the effect of the disclaimer may turn on the severity of the misrepresentations, the circumstances in which they were made and the exact language of the disclaimer.[27] As the district court stated in *Hanley*:

> The disclaimer cannot change the historical facts; if the dishonest franchisor made misrepresentations, then he made misrepresentations, no matter what the franchise agreement says.[28]

3. Disclaimers create questions of fact

When courts correctly reject the argument that a disclaimer is a complete bar, the disclaimer will likely have evidentiary significance permitting a defendant to challenge the franchisee's claimed reliance.[29] More often than not, this is the proper resolution of the disclaimer issue – and as question of fact the franchisee can prevail. Questions to the franchisee along these lines should be considered:

Q. "Sir, when you signed the franchise agreement did you understand that you were giving them the right to lie to you about X?

Q. Or to keep you in the dark about Y?

C. If you knew the truth about X or Y would you have bought the franchise anyway?"

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[26] In *Ellering v. Sellstate Realty Systems Network, Inc.*, the issue was framed as whether the claimed misrepresentation directly contradict the language of the contract or the FDD, including but not limited to the language of the disclaimer? 801 F. Supp. 2d at 844-45.

[27] *See Napcor Corp. v. JP Morgan Chase Bank, NA*, 406 Ill App 3d 146, 938 N.E.2d 1181, 1184 (Ill. App. 2d Dist. 2010) (not allowing a general disclaimer of "no representations" to negate proof of reliance on a specific misrepresentation).

[28] *Hanley,* 2013 WL 690521 at *28.

[29] *See Long John Silver's, Inc. v. Nickleson*, No. 3:11-CV-93-H, 2013 WL 557258 (W.D. Ky. Feb. 12, 2013); and *Hanley* 2013 WL 690521.

4. Side-stepping disclaimers with parol evidence

It is worthwhile to include a contract claim based on the implied covenant of good faith and fair dealing alongside your fraud claim, reserving the right to elect remedies. Where good faith and fair dealing is invoked "to allow redress for the bad faith performance of an agreement even when the defendant has not breached any express term" or "to permit inquiry into a party's exercise of discretion expressly granted by a contract's terms" the court should allow the franchisee to introduce evidence that might otherwise be barred by the integration clause or a no reliance clause:

> Because the covenant of good faith and fair dealing is implied by operation of law, the view that the parol evidence rule somehow inhibits plaintiffs' claim is erroneous. … To determine what is considered a good faith performance, the court must consider the expectations of the parties and the purposes for which the contract was made. It would be difficult, if not impossible, to make that determination without considering evidence outside the written memorialization of the parties' agreement. Therefore, in determining whether a breach of the covenant has occurred, a court must allow for parol evidence …

Seidenberg v. Summit Bank, 348 N.J. Super. 243, 258–59, 791 A.2d 1068, 1076-7 (App. Div. 2002).

H. Rule 9(b) Particularity

Some courts exclude claims for fraud by omission from the stringent particularity requirements of Fed.R.Civ.P. 9(b) given "the practical matter that omissions cannot be described in terms of the time, place, and contents of the misrepresentation or the identity of the person making the misrepresentation." *Flynn v. Everything Yogurt*, CIV. A. HAR92-3421, 1993 WL 454355, at *9 (D. Md. Sept. 14, 1993) (citation omitted).

I. Reasonable Reliance

There is case law holding that reliance is not an element of a fraudulent omission claim, and that reliance is presumed from materiality. *See Press v. Chem. Inv. Servs. Corp.*, 988 F. Supp. 375, 384 (S.D. N.Y. 1997) *aff'd*, 166 F.3d 529 (2d Cir. 1999).

Relatedly there is authority that reliance is not required in statutory fraud claims (discussed below);[30] but that authority is not uniform.

J. Benefit of the bargain damages for fraud

Franchisees might seek "benefit of the bargain" damages for fraud including lost future profits where the franchisor deceptively projected future financial performance. See *Roboserve, Inc. v. Kato Kagaku Co.*, 78 F.3d 266, 274 (7th Cir. 1996) citing Restatement (Second) of Torts § 549 (1977) ("the recipient of a fraudulent misrepresentation in a business transaction is also entitled to recover additional damages sufficient to give him the benefit of his contract with the maker, if these damages are proved with reasonable certainty."); *but see, Barrett v. Huff*, 6 A.D.3d 1164, 1167, 776 N.Y.S.2d 678, 681 (2004) (benefit of bargain damages not recoverable in New York).

K. Transaction Causation vs. Loss Causation

The Illinois Supreme Court in *Martin v. Heinold Commodities, Inc.*, borrowed from federal court decisions construing Rule 10-b-5, holding that to recover damages for violating the Illinois Little FTC Act, a plaintiff:

> "must show two types of causation: (1) transaction causation; and (2) loss causation. … Transaction causation has been defined as meaning that "the investor would not have engaged in the transaction had the other party made truthful statements at the time required." … Loss causation, on the other hand, has been defined as meaning "that the investor would not have suffered a loss if the facts were what he believed them to be." … In this regard, loss causation is analogous to proximate cause. It has thus been noted:

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[30] *See* Tim A. Thomas, Annotation, *When is it unnecessary to show direct reliance on misrepresentation or omission in civil securities fraud actions under § 10(b) of Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b))* and *see* Rule 10b-5 (17 CFR § 240.10b-5), 93 A.L.R. Fed. 444 (originally published in 1989). *See also Bonfield v. AAMCO Transmissions, Inc.*, 708 F. Supp. 867, 875-76 (N.D. Ill. 1989) acknowledging the link between the antifraud franchise laws and Rule 10(b)-5); *Chicago Male Medical Clinic, LLC v. Ultimate Management, Inc.*, No. 12 C 05542, 2012 WL 6755104, at *3 (N.D.Ill. Dec. 28, 2012), citing *Promios v. Fair Automotive Repair, Inc.*, 808 F.2d 1273, 1276 (7th Cir. 1987) (same)); *Enservco, Inc. v. Indiana Securities Div.*, 623 N.E.2d 416-421-22 (Ind. 1993) (same); *Continental Basketball Ass'n., Inc. v. Ellenstein Enterprises, Inc.*, 640 N.E.2d 705, 707 (Ind. App. 1 Dist. 1994)(same).

"The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss."

163 Ill. 2d 33, 60, 643 N.E.2d 734, 747 (1994).

L. Lost profit claims for the lost opportunity to acquire a franchise

There is substantial and uncontradicted authority that a disappointed buyer might recover lost profits for a franchise that never opened. *See Wilbern v. Culver Franchising Sys., Inc.*, No. 13 C 3269, 2015 WL 5722825, at *31 (N.D. Ill. Sept. 29, 2015) ("In the franchise context … courts have held that historical data from franchise operations can be a proper yardstick for losses sustained by a potential franchisee who was prevented from going into the franchise business by the wrongful conduct of the defendant".) Proof comes from favorable Item 19 financial performance representations showing that most units in the same brand (and same region) are reasonably likely to generate strong revenues, coupled with favorable Item 20 data showing continuity and growth, and supplemented by unit level profitability data obtained in discovery.[31]

The challenge for these clients is to establish liability. The usual issue is whether a prospective purchaser had an enforceable contract or facts strong enough to invoke promissory estoppel as in the classic decision in *Hoffman v. Red Owl Stores, Inc.*, 26 Wis. 2d 683, 694, 133 N.W.2d 267, 273 (1965), adopting Sec. 90 of Restatement, 1 Contracts ("A promise which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee and which does induce such action of forbearance is binding if injustice can be avoided only by enforcement of the promise.")[32] Or, an existing franchisee might challenge a franchisor's decision it is not eligible for expansion invoking the implied covenant good faith and fair dealing. Or a minority franchisee might validly state a claim for the denial of civil rights under the Civil Rights Act of 1870 (42 U.S.C. Section 1981) if denied the right to purchase a franchise on the same terms as "white citizens."

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[31] The same court held that "reasonable certainty" to prove lost profits is generally the preponderance of evidence standard.

[32] But where a franchisor does not approve a sale by an existing franchisee, most courts hold the disappointed buyer cannot sue the franchisor because the buyer is not in privity with the franchisor and the courts usually reject claims of tortious interference on the grounds a franchisor cannot "interfere" in its own prospective contract. See *Home Repair, Inc. v. Paul W. Davis Sys., Inc.*, No. 98 C 4074, 1998 WL 721099, at *5 (N.D. Ill. Oct. 9, 1998). This rule is not absolute.

M. Emotional distress damages for fraud

There is a split of authority whether emotional distress damages are recoverable when caused by fraud. *See Kilduff v. Adams, Inc.*, 219 Conn. 314, 324, 593 A.2d 478, 484 (1991) (surveying cases).

VII. RELATIONSHIP ISSUES

"Relationship issues" arising during the franchise relationship (after the sales process and before terminations or post-termination controversies) are most likely to generate system-wide controversy and spur activity by independent franchisee associations. These cases are driven by the facts: Franchisees are most likely to prevail when there is proof the franchisor's conduct was not merely unreasonable but outrageous and where there is evidence of selfish motive. There is no exact formula.

Absent a state law governing the relationship issue, and there are few that do, franchisees might challenge perceived abusive conduct during the relationship under"

- Contract law including the implied covenant of good faith and fair dealing.
- Little FTC Acts, which are not limited in scope to franchise sales.
- Common law fraud, in more limited circumstances; and
- Antitrust law, but much less so since *Continental T. V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977).

VIII. GOOD FAITH AND FAIR DEALING

Most relationship cases are litigated under the much-maligned implied covenant which strives to regulate discretionary contract performance:

> [A] covenant of good faith and fair dealing is implied in every contract absent express disavowal… Problems relating to good faith performance are most common where one party to an agreement is given wide discretion, and the other party must hope the discretion is exercised fairly. … *When one party to a contract is vested with contractual discretion, it must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously or in a manner inconsistent with the reasonable expectations of the parties.*

Interim Health Care of N. Illinois, Inc. v. Interim Health Care, Inc., 225 F.3d 876, 884 (7th Cir. 2000) (emphasis added).

In *Interim*, the Seventh Circuit refused to find an implied territorial restriction on dual distribution competition, then reached almost the same desired result by finding the implied covenant restricted the franchisor's ability to withhold referrals of account leads to the franchisee, accounting for most of the damages at issue:

> We do not think that in allowing or initiating cross-border servicing of patients Interim–National violated the duty of good faith because the terms of the contract permitted this activity. But the contract is far less conclusive on the subject of referring account leads—the parties agree that Interim–National may decide to withhold some account leads, but the contract is vague about which leads it may withhold, and what justifies withholding. Interim–National had wide discretion, and its exercise of that discretion was governed by a duty of good faith.

Id. at 884.

A. The *Restatement* is persuasive

Beyond researching state law, franchisees invoking good faith and fair dealing should cite to the Restatement (Second) of Contracts § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement") and to cases in the particular jurisdiction citing the Restatement with approval. The Restatement comments provide broad definitions allowing franchisees to craft good faith & fair dealing arguments tailored to almost any fact pattern in which the franchise agreement is structured to allow franchisors to exercise discretion or even "sole discretion:"[33]

<u>Comment (a) to Restatement (Second) Section 205</u>:

> *a. Meanings of "good faith."* Good faith is defined in Uniform Commercial Code § 1-201(19) as "honesty in fact in the conduct or transaction concerned." "In the case of a merchant" Uniform Commercial Code § 2-103(1)(b) provides that good faith means "honesty in fact and the

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[33] *See also Charlotte Broad., LLC v. Davis Broad. of Atlanta, L.L.C.*, 2015 WL 3863245, at *7 (Del. Super. June 10, 2015) ("The implied covenant particularly applies where the contract permits a party to exercise sole discretion."), *aff'd sub nom. Davis Broad. of Atlanta, L.L.C. v. Charlotte Broad., LLC*, 134 A.3d 759 (Del. 2016); *CC Fin. LLC v. Wireless Props., LLC*, 2012 WL 4862337, at *5 n.53 (Del. Ch. Oct. 1, 2012) ("A contract which grants one party sole discretion with respect to a material aspect of the agreement may, through the implied covenant of good faith and fair dealing, require that the exercise of discretion be in good faith.")

observance of reasonable commercial standards of fair dealing in the trade." The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. *Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness.* The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.

Comment (d) to Restatement (Second) Section 205:

d. Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

B. Establish the franchisee's "justified expectations"

Because good faith and fair dealing seeks to protect the parties' "justified expectations" it is imperative to win the debate on what "expectations" were justified. This means presenting parol evidence of the parties' negotiations. *Seidenberg v. Summit Bank*, 348 N.J. Super. 243, 258–59, 791 A.2d 1068, 1076-7 (App. Div. 2002).[34]

C. Subjective bad faith is important

Courts disagree whether a breach of the implied covenant requires subjective bad faith. *See Fleetwood v. Stanley Steamer Int'l*, 446 F. App'x 868 (9th Cir. 2011) ("'actual dishonesty' or actions outside accepted commercial practices required to show

[34] Be careful, because the franchisees' claimed expectations cannot be in direct contradiction of an express contract term. *See Cook v. Little Caesar Enterprises, Inc.*, 210 F.3d 653, 657 (6th Cir. 2000) ("Cook could not employ the implied covenant of good faith and fair dealing to override the express term of the franchise agreements which allowed Little Caesar Enterprises to license franchises outside of Cook's one-mile exclusive territories.")

bad faith" – suggesting that either subjective or objective bad faith can carry the day); *see also In re Sizzler Restaurants Int'l, Inc.*, 225 B.R. 466, 474 (Bankr. C.D. Cal. 1998), also framing the required proof as an alternative between objective and subjective bad faith:

> The inquiry into Sizzler's decision-making process is not an inquiry that looks to results, but more appropriately should examine the actual decision-making process to determine whether it was legitimate, i.e., honest ***or*** within accepted commercial practices. This court declines to second-guess the result reached, as long as the decision-making process was honest ***or*** was within accepted commercial practices.

These cases suggest that "commercial negligence" alone could establish a breach of the implied covenant, but most courts require dishonesty or other subjective bad faith before allowing a franchisee to challenge a franchisor's decision-making as lacking diligence or failing to meet industry standards of reasonableness. *See Svela v. Union Oil Co. of California,* 807 F.2d 1494, 1501 (9th Cir.1987) (court cannot second-guess franchisor's economic decisions *if made in good faith*) (emphasis added); *Agad, supra,* 941 F.Supp. at 1222 (implied covenant of good faith and fair dealing cannot be used to second-guess franchisor's *legitimate* business decisions) (emphasis added).[35]

D. Dual distribution

Franchisors engaged in dual distribution risk being held in breach of the implied covenant where they favor company-owned units. *Interim*, 225 F.3d at 884 (franchisor routing of national account leads to company-owned outlet instead of to franchisee created triable question of fact); *see also Bryman v. El Pollo Loco, Inc.* (2018).[36]

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[35] *See also Clark v. America's Favorite Chicken Co.,* 110 F.3d 295, 297–99 (5th Cir.1997) (no breach of the implied covenant despite fact franchisor's national marketing strategy and concept made individual franchisee less competitive and resulted in loss of business); *see also Vaughn v. General Foods Corp.,* 797 F.2d 1403, 1413 (7th Cir.1986) (no protection against dissatisfaction of franchisee with the degree of success it achieved as a result of franchisor's attempts to create a viable franchise system). Missing from these decisions was subjective bad faith.

[36] As reported by *Franchise Times*:

"The jury found that El Pollo Loco Inc. was encroaching on the Brymans' territory by building company-owned restaurants in the same area, in Lancaster, California, and not giving the Brymans the right of first refusal to run the company-owned stores. Those stores siphoned revenue from the Brymans' location."

IX. FRAUD DURING THE FRANCHISE RELATIONSHIP

Claims for fraud in franchising typically arise in the franchise sales process, but possible fraud during the relationship should not be overlooked. Whenever a franchisee contends the franchisor acted in bad faith, the alleged bad faith will probably contain an element of fraud presuming the franchisor was pretending to act in good faith and did not voluntarily reveal its bad motives or other grounds to find bad faith. This raises the possibility a franchisee can establish fraud, overcoming the franchisor's possible success negating the implied covenant.

For example, in both *Chang v. McDonald's Corp*., 105 F.3d 664 (9th Cir. 1996), and *Zuckerman v. McDonald's Corp*., 35 F. Supp. 2d 135, 136 (D. Mass. 1999), the courts rejected claims that McDonald's breached the implied covenant by refusing to renew franchise agreements (a practice called "rewrite" in that system) because the franchise agreement unambiguously stated there is no contractual right to renew. That McDonald's does offer rewrite to many (most?) of its franchisees and has articulated written policies stating when a franchisee might be eligible for rewrite did not override the express contract language negating a right to renew. It would seem, therefore, that McDonald's found the perfect legal formula for allowing a franchisor to make a discretionary decision (to rewrite or not) with no opportunity by the franchisee to argue the denial is a breach of contract. That is McDonald's intent, to preserve the ability to say "no rewrite" free from challenge except in the minority of states offering statutory protection against non-renewal.

But in *Darling v. McDonald's Corp*., 2006 WL 164986, (Cal. Ct. App. Jan. 24, 2006), the franchisee proved McDonald's committed fraud in leading a multi-unit franchisee to believe it would rewrite her most profitable restaurant as it approached end of term while secretly planning to not rewrite that restaurant as part of a larger plan to drive her out of the system. In reliance on fraud, the franchisee invested substantial sums to improve her restaurant(s) to stay eligible for the rewrite she believed she had been promised. Darling won a substantial verdict against McDonald's ($6.5 million compensatory damages and $10 million punitive) when a jury found McDonald's guilty of fraud. *Darling* is an outlier, but it identifies a winning path for franchisees deceived into believing the franchisor will make a favorable decision.

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https://www.franchisetimes.com/news/May-2018/El-Pollo-Loco-Verdict-Makes-New-Law-Attorney-Says/

A. Little FTC Act Claims during Relationship

Too often overlooked, in states where franchisees have standing under the Little FTC Act, those statutes can protect franchisees from bad faith, predatory or "unfair" conduct that may, or may not, breach the franchise agreement. "The concept of unfairness is even broader than the concept of deceptiveness, and it applies to various abusive business practices that are not necessarily deceptive." *Tucker v. Sierra Builders*, 180 S.W.3d 109, 116–17 (Tenn. Ct. App. 2005). From this Tennessee appellate court construing that state's Little FTC Act:

> In the 1994 legislation reauthorizing the Federal Trade Commission, Congress undertook to codify the Commission's policy statement on unfairness by stating that an act or practice should not be deemed unfair "unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition." 15 U.S.C.A. § 45(n). Following the mandate of Tenn. Code Ann. § 47–18–115, we will use this description of unfairness to guide our interpretation of Tenn. Code Ann. § 47–18–104(a).

In *Century 21 Real Estate Corp. v. Hometown Real Estate Co.*, 890 S.W.2d 118, 127 (Tex. App. 1994), writ denied (Sept. 14, 1995), a Texas appellate court affirmed a franchisor's statutory liability for committing a deceptive trade practice by engaging in an "unconscionable action or course of action" [defined as] an act or practice that, to a person's detriment, takes advantage of the person's lack of knowledge, ability, experience, or capacity to a grossly unfair degree, or that results in a gross disparity between the value received and consideration paid, in a transaction involving the transfer of consideration. …" The court held Century 21 committed a deceptive trade practice because it violated its established "*unwritten policy*" was to not allow the opening of a nearby competing agency if the existing franchisee had sufficient market share.[37] Course of dealing has consequences.[38]

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[37] In *Century 21 v. Hometown*, the franchisor waived its contention the franchisee lacked as a "consumer" under the Texas DPTA. *Id.* at 124. Subsequent "Texas courts have held that a franchise may be a good or service under the DTPA." *Carroll v. Farooqi*, 486 B.R. 718, 726 (N.D. Tex. 2013).

[38] *But see Abraham v. WPX Prod. Prods., LLC*, 184 F. Supp. 3d 1150, 1208 (D.N.M. 2016): ("even if the language of the contract appears to be clear and unambiguous, "a court

As decisions on expandability, renewal or termination are typically made based on, or substantially influenced by franchisor inspection and grading of the franchisee's units, we are likely to see increased challenges to franchisor grading under Little FTC Acts. *See Dayan v. McDonald's Corp.*, 125 Ill. App. 3d 972, 998, 466 N.E.2d 958, 977 (1984), where the franchisor established good cause for terminating a franchisee by refuting the franchisee's contention "he was in substantial compliance with QSC standards and that McDonald's had manufactured a case against him in order to recapture the Paris market." If that proof had gone the other way, and the franchisee proved McDonald's had unfairly applied QSC or deceptively claimed the franchisee failed to meet QSC, and then used the claimed QSC failure to terminate, deny expandability, or deny rewrite, a similar Little FTC Act claim would arguably be sustainable.

X. THE ANTITRUST GAP

Once upon a time, franchisees enjoyed substantial protection under Section 1 of the Sherman Act, 15 U.S.C. §1, from unlawful restraints of trade such as abusive tying arrangements, where as a condition of buying the franchise, franchisees must buy necessary supplies from the franchisor or its designated suppliers on unfavorable terms.

That changed when the Supreme Court in *Continental T. V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977), held that in most Section 1 cases, a restraint of trade (such as a tying arrangement) is not unlawful unless the franchisor has "market power" "to force a purchaser to do something that he would not do in a competitive market" -- "the ability of a single seller to raise price and restrict output" … [and holds that market power] is ordinarily inferred from the seller's possession of a predominant share of the market." *Eastman Kodak Co. v. Image Tech. Servs., Inc.*, 504 U.S. 451, 464, 112 S. Ct. 2072, 2080–81, 119 L. Ed. 2d 265 (1992) (citations omitted).

The wisdom of the Supreme Court's antitrust jurisprudence in an era where companies "too big to fail" have caused tremendous damage to our economy is beyond our scope. But the concern shared by franchisee lawyers is obvious: The Supreme Court asks if the franchisor has the "power" to injure the end consumers making them pay higher prices or "do without" ignoring franchisees caught in the middle. Franchisees take the bullet when franchisors engage in conduct formerly condemned as *per se* antitrust violations but have no antitrust remedy precisely because they cannot

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may hear evidence of the circumstances surrounding the making of the contract and of any relevant usage of trade, course of dealing, and course of performance," in order to decide whether the meaning of a term or expression contained in the agreement is actually unclear.")

sufficiently raise prices to end consumers. The Supreme Court sees no injury to competition when franchisees take the bullet, but that view leaves franchisees at the mercy of franchisors, whose incentive is to squeeze franchisee margins, stopping just short of where *all* franchisees are driven out of business.

From Dr. Eric Forister, an experienced economist that has testified on antitrust issues for this author and who adds this commentary:[39]

There is a view sometimes espoused that antitrust should only be concerned with harm to end-consumers. From an economic perspective, this view has a blind spot when it comes to market power arising from franchise agreements. Franchise agreements often include terms that give the franchisor market power over their franchisees. This is true even if the franchisor lacks market power in a more broadly defined upstream market. At the same time, a franchisee may operate in a retail market that is very competitive, where they would not be able to pass through small but significant cost increases that are not market-wide. In such a situation, the franchisor could use its market power to raise prices to a franchisee without causing price increases (i.e., harm) to end consumers.

This situation creates a potential economic inefficiency. If franchisees don't have adequate protection against the franchisor exercising its market power, then this will deter franchisee investment (e.g., in new franchise locations). This effect could be broadly felt across the retail marketplace. Although franchisors have an incentive to ensure a level of franchisee investment that maximizes franchisor profits, this may not align with the level of investment that would occur absent the franchisor's exercise of market power.

Applying antitrust law to franchises is not inconsistent with the goal of protecting consumers and protecting competition. Franchisees are the customers, not competitors, of the franchisor. If the downstream market is competitive then the middle-men (franchisees) get squeezed when the upstream supplier (franchisor) exercises the market power they have in the upstream market. The lack of downstream market power nixes all the

[39] *See* https://www.econone.com/staff-member/eric-forister/.
Dr. Forister is with EconOne in Los Angeles.

examples of consumer harm that readily come to mind, because the franchisee can't lower quality or raise prices.

One could talk about the economic inefficiency this situation creates. If franchisees don't have adequate protection against the franchisor exercising its market power, then this will deter investment in new franchise locations. This would be broadly felt across the retail marketplace. This is simply be a blind spot in terms of antitrust policy.

The franchisee is a customer of the franchisor. On a related note, antitrust law is intended to protect competition and not competitors. Applying antitrust law to franchises would be consistent with this, because the franchisee is not a competitor of the franchisor.

Dr. Eric Forister, PhD.

One day franchisees will find the right facts to establish that systematic weakening of most franchisees in a brand harms competition hopefully persuading the Supreme Court to review its position. Until then, absent protection under the antitrust laws, franchisees may challenge anti-competitive conduct as a breach of the implied covenant of good faith and fair dealing (foregoing the potential for treble damages);[40] or as violations of Little FTC Acts that protect against unfair or deceptive conduct (as opposed to protecting competition, the focus of the antitrust laws). There is little precedent, but Little FTC Act claims alleging both "unfair or unconscionable" and "fraud or deception" theories of liability have been pled as additional counts in major pending antitrust cases.[41] Franchisees must win the argument that "harm to competition" and "antitrust injury" are not required elements of a Little FTC Act claim.

XI. ROBINSON-PATMAN MISCONSTRUED

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[40] *See Matthis v. Exxon Corp.,* 302 F.3d 448 (5th Cir. 2002), where fifty-four (54) franchised gasoline dealers alleged the franchisor attempted to drive them out of business by taking away their margins, intending to replace them with lower price jobbers. The franchisees abandoned claims under the Sherman and Clayton Acts, and the Petroleum Marketing Practices Act, and went to trial on a common law claim that the franchisor had breached a duty of good faith, imposed by the Texas Uniform Commercial Code, in setting price, which was an "open term." The dealers won their contract claim and the verdict was affirmed.

[41] *See Sergeants Benevolent Ass'n Health & Welfare Fund v. Actavis, plc,* No. 15 CIV. 6549 (CM), 2018 WL 7197233, at *35–36 (S.D.N.Y. Dec. 26, 2018) and *In re Packaged Seafood Prod. Antitrust Litig.*, 242 F. Supp. 3d 1033, 1072 (S.D. Cal. 2017).

The Robinson-Patman Act ("RPA"), 15 U.S.C. §13(a) expresses "Congressional intent to protect individual competitors, not just market competition, from the effects of price discrimination." *Chroma Lighting v. GTE Products Corp.*, 111 F.3d 653, 657-8 (9th Cir. 1997); *see also, Williams v. Duke Energy International, Inc.*, 681 F.3d 788, 799 (6th Cir. 2012).[42] But despite clear Congressional intent, the RPA inspires seemingly endless hostility inspiring judges and arbitrators to invent novel ways to reject claims that ought to be meritorious.[43] In *Volvo Trucks N. Am., Inc. v. Reeder-Simco GMC, Inc.*, 546 U.S. 164, 180–81, 126 S. Ct. 860, 872, 163 L. Ed. 2d 663 (2006), the Supreme Court confirmed that "a permissible inference of competitive injury may arise from evidence that a favored competitor received a significant price reduction over a substantial period of time." *Id.,* 546 U.S. at 177, 126 S. Ct. at 870, citing *FTC v. Morton Salt Co.,* 334 U.S. 37, 49–51, 68 S.Ct. 822, 92 L.Ed. 1196 (1948) etc. Significantly, the "*Morton Salt"* inference re-affirmed in *Volvo* does not require a franchisee or dealer to prove that the franchisor has "market power" or there is *actual injury* to end consumers – and this is a very substantial distinction from the Supreme Court's view of most "restraint of trade" cases under Section 2 of the Sherman Act since *GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549.

But then the *Volvo* Court stated: "we continue to construe the Act 'consistently with broader policies of the antitrust laws' [and] 'we would resist interpretation geared more to the protection of existing *competitors* than to the stimulation of *competition*.'" *Volvo,* 546 U.S. at 181, 126 S. Ct. at 873.

We respectfully submit no one, not even the Supreme Court, can have it both ways. Either the RPA as enacted in 1936 was a "small business protection law" (and it was) or it wasn't. Whether franchisees and dealers should enjoy legislative and

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[42] "The RPA was enacted in response to the comparative competitive advantage of large purchasers, who could induce advertising allowances, rebates, and special services from sellers due to their size. Small independent stores were at a "hopeless competitive disadvantage" compared to large stores and thus the RPA was enacted "to eliminate these inequities." *Id.,* citing *FTC. v. Simplicity Pattern Co*., 360 U.S. 55, 69 (1959)."

[43] To succeed on a RPA secondary line claim, a franchisee or dealer alleging price discrimination most prove that: (1) at least one sale at issue crossed state lines; (2) each sale was for the use or resale in the United States; (3) the products sold were physical items; (4) the sales were made by Company about the same time; (5) the products sold were of like grade and quality; (6) Company "discriminate[d] in price between purchasers of commodities of like grade and quality" (the threshold Robinson-Patman inquiry. 15 U.S.C. §13(a); (7) there is a reasonable possibility that the discriminatory pricing caused harm to competition; and (8) the dealer was injured. *See Model Jury Instructions in Civil Antitrust Cases*, American Bar Association, 2016 Ed., Ch. 5, Section A.2. (electronic publication version).

regulatory protection remains vital today. Advocates for franchisees must convince courts (starting with the U.S. Supreme Court in its antitrust and RPA jurisprudence), FTC regulators, and legislatures that franchisees continue to need (and deserve) protection from abusive practices. *Or if not, is the franchise business model sustainable?*

XII. THE EMPLOYER vs. CONTRACTOR DEBATE

That the Ninth Circuit has reversed the district court and reinstated the claim by 7-Eleven franchisees that 7-Eleven misclassified them as independent contractors rather than employees in violation of the Fair Labor Standards Act and the California Labor Code is beyond our scope. *Haitayan v. 7-Eleven, Inc.,* No. 18-55462, 2019 WL 968927, at *1 (9th Cir. Feb. 27, 2019). For our purposes:

- No franchisee should want to be an employee instead of a business owner in a contract relationship with the franchisor.
- This lawsuit is born out of desperation, that the franchisees perceive the relationship is so far out of balance this drastic remedy must be pursued.
- All franchisees in every brand must root for the 7-Eleven franchisees to succeed not because any franchisee wants to be an employee but because this case may lead to broader relationship throughout franchising and spur the enactment of further legislative and regulatory protections.

XIII. CONCLUSION

Regardless of which side of this great debate you find yourself, remember we are all very privileged to practice in an area with so many good lawyers with the opportunity to make many good friends across the country.

Thank you for your kind attention.