Franchise Law in the United States

Babette Märzheuser-Wood
Brian Baggott

I. Introduction

A. Role of the United States in the Global Franchising Industry

As the population of the United States swelled to over 320 million people in 2015[1], it remains a leader in the global franchising industry. Franchising and distribution continue to make up a large part of the United States economy. According to *The Franchise Times*, the top 200 largest franchise systems on its rankings had total annual sales in 2013 of $590 billion.[2] Among these systems are the likes of McDonald's, Kentucky Fried Chicken, 7-Eleven, Subway, Burger King, Pizza Hut, and Hertz. While these systems dominate the franchise landscape within the United States, they are part of the United States' larger franchise industry, which is estimated to consist of over 2,500 franchisors and, in 2014, nearly 770,000 franchise establishments. This size and breadth places the franchise industry as one of the United States' largest consumers and purchasers of commodities, sellers of other brand-name products, and employers.

The franchise industry within the United States shows no signs of slowing down. Since the recession years of 2007-2008, the franchise industry in the United States has continued to grow in a number of economic categories. In its recent Franchise Business Economic Outlook for 2015, the International Franchise Association (IFA), one of the leading franchise industry's trade associations, noted the consistent growth of the franchise industry since 2011 and projected that the growth of the output of franchise businesses would accelerate to 5.4% in 2015 and that the franchise sector's gross domestic product would increase by 5.1% and exceed the growth of the United States' gross domestic product.[3] As recently as February 2015, the United States reportedly added 29,000 franchise jobs across various industries.[4]

The growth of the United States franchise industry is not just limited to domestic growth. Recently, the top United States franchises have focused on expanding to international markets. According to *The Franchise Times*, for every one unit that the largest United States franchise systems added domestically in 2013, they added four locations internationally, and, in 2012, the average United States franchise system had approximately 36% of its locations outside the United States.[5] This international growth is spurred by a number of factors, including more emerging markets, reduced barriers to entry, increased private-equity ownership of United States franchises, and increased spending power of foreign populations.

Within the United States, the franchise industry is represented publicly by a variety of trade associations and publications, with the IFA being one of the leading associations made up of franchisors, franchisees, and suppliers.

---

[1] *See* http://census.gov/newsroom/press-releases/2014/cb14-tps90.html.
[2] *See* http://www.franchisetimes.com/Resources/Top-200/.
[3] *See* *http://emarket.franchise.org/FranchiseBizOutlook2015.pdf.*
[4] *See* http://www.adpemploymentreport.com/2015/February/NFR/NFR-February-2015.aspx.
[5] *See* http://www.franchisetimes.com/Resources/Top-200/.

The IFA and other groups actively promote the industry and its goals and focus on promoting and opposing certain franchise-related legislation, minimizing government control and regulation, and fostering collaboration between franchisors and their franchisees.

B. Federal v. State Dichotomy

Because the United States is a federalist government, the franchise industry is subject to two sets of laws: the United States federal law and individual state laws. At the federal level, the primary regulations on franchising are promulgated by the Federal Trade Commission (FTC) and are commonly known as the FTC Franchise Rule (FTC Rule).[6] By virtue of the Supremacy Clause in the United States Constitution, the FTC Rule, which is focused primarily on disclosure of material facts, applies in each of the 50 states, the District of Columbia, and all U.S. territories. In addition to the FTC Rule, 24 states have their own franchise disclosure and relationship laws.[7]

This dichotomy requires a franchisor, whether domestic or foreign, to verify its compliance with both sets of laws when evaluaying whether to operate in the United States and a particular state. For the most part, the individual states' laws impose additional obligations beyond the federal laws. Therefore, compliance with a state law generally means a franchisor is also complying with federal law. Differences exist, however, so a franchisor contemplating operations in the United States should evaluate all aspects of the applicable state law and the federal law.

II. What Constitutes a Franchise under U.S. Law

A. Importance of distinction between franchise and other types of business

To determine which United States laws apply, a putative franchisor must first determine whether its proposed business arrangement does in fact constitute a franchise under state and federal law. The question is important because being a franchise means that the business arrangement is subject to various disclosure and possibly registration obligations and contains restrictions on the ability to terminate or non-renew the relationship with putative franchisees. At the same time, a business seeking to avoid these obligations and restrictions must be wary of the common elements of a franchise and ensure that they do not exist in the proposed business arrangement. It is not unheard of for a party in the United States who thought it was operating as something far removed from a franchise to discover that it in fact is considered a franchise under federal or state law.

B. Elements of a Franchise Generally

Although the FTC Rule and various states' law include a definition of a franchise, they each generally share a combination of elements that exist in any franchise. What parties label their business arrangement is irrelevant. If the substance of the arrangement includes the majority of the following elements, then it is a franchise regardless of how it is labeled.

1. Right to Offer, Sell, or Distribute

A fundamental element of a franchise relationship is that the franchisee possesses the right to offer, sell, or distribute the franchisor's goods or services. This is the essence of a business relationship in which one party operates under the other party's brand and image, using its goodwill and reputation to market particular goods and services. If a party to an agreement does not have the right to offer, sell, or distribute the others' goods and services, then no franchise relationship exists. This element is more or less a test of independence. Employees, contractors, and general agents typically do not have the right to offer, sell, or distribute their principal's good or services independent of their status as an employee, contractor, or agent. As such, they are not franchisees. But when a separate corporation is formed with independent ownership and clear corporate separation, and it is granted by agreement the power to offer, sell, or distribute, on its own, the other party's goods or services, then a franchise relationship most likely exists.

---

[6] 16 C.F.R. § 436.1, *et seq.*

[7] Ark. Code Ann. §§ 4-72-201, *et seq.*; Cal. Corp. Code § 31005; Haw. Rev. Stat. § 482E-2; Conn. Gen. Stat. § 42-133e; 6 Del. Code Ann. §§ 2551, *et seq.*; Fla. Stat. §§ 817.416, *et seq.*; 815 ILCS 705/1, *et seq.*; Ind. Code § 23-2-2.5-1, *et seq.*; Iowa Code §§ 523H.1, *et seq.*, 537A.10, *et seq.*; Md. Code Ann. § 14-201, *et seq.*; MCLS § 445.1501, *et seq.*; Minn. Stat. § 80C.01, *et seq.*; Miss. Code Ann. § 75-24-51, *et seq.*; Mo. Rev. Stat. §§ 407.400, *et seq.*; Neb. Rev. Stat. §§ 87-401, *et seq.*; N.J. Stat. Ann. §§ 56:10-1, *et seq.*; N.Y. Gen. Bus. Laws § 681(3); N.D. Cent. Code §§ 51-19-01, *et seq.*; Or. Rev. Stat. § 650.005(4); R.I. Gen. Laws § 19-28-3(c); S.D. Codified Laws § 37-5B-1, *et seq.*; Va. Code Ann. § 13.1-559(b); Wash. Rev. Code § 19.100.010(4); Wis. Stat. § 553.03(4).

2. Substantial Association with Trademark and Other Intellectual Property

Under the FTC Rule and nearly every state law, the definition of a franchise requires there to be a substantial association between the franchisee's business and the franchisor's trademark or other intellectual property. The "substantial association" factor does differ between some states, but the involvement of a franchisor's trademark, its prominence in the business, and the license of it to a franchisee all compel the conclusion of a "substantial association." The key factors to determining whether a substantial association exists include the actual use of the trademark by the putative franchisee, the putative franchisee's investment in the business, and its expenditures on advertising and use of the trademarks. If a litmus test of sorts does exist, it is whether the putative franchisee is authorized to use the franchisor's trademarks in the operation of the business.

3. Payment of a Fee

Another common element of a franchise is the payment of a franchise fee, which generally is defined as a fee or charge that a franchisee must pay or agrees to pay in exchange for the right to enter into a franchise agreement. The traditional franchise fee generally takes the form of an upfront payment or ongoing royalty payments, but many other type of payments can qualify as franchise fee and, once again, the labeling of the payment as something other than a franchisee fees does not matter. For example, several states' laws specifically note the types of payments that will be considered franchise fees, including initial capital investment fees, fees to a franchisor based on the amount of goods or products a franchisee purchases from the franchisor, fees or charges based on a percentage of gross or net sales, and training fees. Mandatory purchases from a franchisor have also been deemed to be franchise fees. At the same time, many statutes have *de minimis* exceptions for fees or specifically exempt certain payments from being considered a franchisee fee. The most commonly exempted type of payment is a payment for goods for resale if the purchaser pays a bona fide wholesale price and the purchase is not required to purchase more than an amount that a reasonable businessperson would for his or her inventory.

4. Marketing Plan or System

California and many states require as a third element of a franchise that a franchisor prescribe a marketing plan or system in substantial part. This element actually has two components: (1) whether the franchisor maintains a marketing plan or system; and (2) if it does, whether the plan or system is prescribed in substantial part by the franchisor.

No bright-line test exists for either component, and both require consideration of a variety of factors. For instance, the relevant factors include whether a franchisor maintains a marketing plan or system; whether a franchisor made representations about such a plan to a franchisee; whether uniform prices or pricing plans are used; whether specific and uniform marketing material, practices, techniques, and merchandizing devices are used; whether a franchisee must purchase goods or services from sources approved and designated by the franchisor; the existence of written and standardized operating plans, brand standards, and training materials. In short, the more restrictions placed on a franchisee as it relates to marketing and promotions, the more likely it is that a marketing plan or system exists.

The next question, though, is whether the franchisor prescribes the marketing plan or system in substantial part on the franchisor. This, too, is not an easy question as the term "prescribe" often falls somewhere in between require and merely a suggestion and depends on how much control the franchisor has over the daily operation of the franchisor's business, especially aspects of its related to marketing and sales. Some states have clarified by statute that "prescribed in substantial part" can be satisfied simply though suggestions related to the marketing plan and system. But, for the most part, the issue boils down to the degree of control exercised by the franchisor when it comes to marketing; restrictions on a franchisee's ability to offer goods and services not approved by the franchisor; active involvement by the franchisor in marketing and promotions; and what level of approval, if any, a franchisor has on promotional and advertising materials.

5. Community of Interest

A host of states requires under their statutes that for a franchise to exist there must be a "community of interest" between the franchisor and the franchisee as it relates to the franchisee's business. Put simply, this test analyzes how closely tied the franchisee and its business is to the franchisor in terms of investments, control, financial contributions, and operations. Interdependence between the franchisee and the franchisor and some aspect of exclusivity are hallmarks of a community of interest. Factors that courts consider in analyzing whether a community of interest exists include the length of time the parties have been involved with each other; the extent and nature of their obligations; the relative amount of time and revenue attributable to the franchisor's products or services; the percentage of revenues received from the franchisor's products and services; any territorial grant; the use of the licensor's trademarks by the putative franchisee; the investment in inventory, facilities, and goodwill; the proportion of the putative franchisee's personnel that work on this part of the business; advertising expenditures for the putative franchisor's products or services; and the extent of any supplemental services.

C. Differences between a Franchise and Business Opportunity

A business arrangement very similar to a franchise—and regulated just as much—is what is known as a business opportunity. Just like the FTC Rule governing franchises, the FTC (and various states) also regulate business opportunities through the FTC Business Opportunity Rule. Under the FTC Business Opportunity Rule defines a "business opportunity" as a commercial arrangement in which (1) the seller solicits a prospective purchaser to enter into a new business; (2) the prospective purchaser makes a required payment; and (3) the seller represents to the prospective purchaser that the seller will: (a) provide locations for the use or operation of equipment, displays, vending machines, or similar devices, owned, leased, controlled or paid for by the purchaser; or (b) provide outlets, accounts, or customers, including, among other things, internet outlets, accounts, or customers for the purchaser's goods or services; or (c) buy back any or all of the goods or services that the purchaser makes, produces, fabricates, grows, breeds, modifies, or provides. The key distinctions between a franchise and a business opportunity are that there generally is no requirement to operate under a common brand or marketing system, no ongoing fees, and usually a lack of ongoing support from the seller. Practically, nearly all franchises fall outside the FTC Business Opportunity Rule and state counterparts so long as they comply with the FTC Rule and maintain a federally registered trademark.

III. Regulation of Franchising in the United States at the Federal Level

A. Required Disclosures under the FTC Rule

In addition to defining a franchise, the FTC Rule imposes various disclosure requirements in connection with a franchisor's offering a franchise for sale. The required disclosure is commonly known as a franchise disclosure document (FDD) and it must contain 23 specific items of information about the offered franchise and must be provided to any prospective franchisee. The type of information that must be addressed in a FDD includes basic information about the franchising company itself, the franchisor's litigation and bankruptcy history, the initial fees for the franchise and whether they are refundable, other fees and payment required from the franchisee, any obligation of the franchisee to purchase goods, services, or equipment from the franchisor or a designated third party, the parties' respective obligations, and pertinent information regarding the franchisor's trademarks and intellectual property. The FTC Rule requires franchisors to provide a FDD to prospective franchisees at least 14-calendar days before any agreement is signed or any consideration is paid. An earlier deadline applies "on reasonable request" from a prospective franchisee, but the FTC has interpreted this to apply only when "the parties have taken steps to begin the sales process."[8]

The FTC Rule is purely a disclosure rule; it does not require registration or prior approval before offering a franchise for sale, nor does the FTC regulate the franchise relationship generally or assess the completeness or accuracy of disclosure documents. The FTC Rule was promulgated to guard against uninformed purchases of a franchise and is designed to create a minimum level of disclosure for all franchise offerings. Its focus is on the disclosure of information that is "material" to the offered sale, which is determined by whether "a reasonable prospective franchisee would consider the information as influencing the decision to purchase."[9] While it applies on a nationwide basis, the FTC Rule acts as a floor and does not preempt state laws that do not conflict with the FTC Rule. In the event that a state law requires additional disclosures beyond the FTC Rule, a franchisee must comply with the state law.

In addition to requiring a FDD, the FTC Rule also regulates disclosure of the franchise agreement. First, the franchise agreement must be attached as an exhibit to the initial FDD. If no substantive changes are made to the agreement following submission with the FDD, then the FTC Rule does not require any additional disclosures. But, if a franchisor unilaterally and materially alters the franchise agreement after submitting it with the FDD, then the FTC Rule mandates a supplemental disclosure process. Upon disclosure of the revised franchise agreement, a seven-day waiting period must run before the franchise agreement is signed or consideration is paid. However, two exceptions to this seven-day waiting period exist. No waiting period is required when (1) the only changes to the franchise agreement are non-substantive, "fill-in-the-blank" changes or (2) the franchisee initiates negotiations that lead to the changes.

In addition to the general disclosure requirements—both as to the FDD and the franchise agreement—the FTC Rule lists several prohibited acts that are deemed to be unfair and deceptive. One of the most heavily litigated prohibited acts is a franchisee's dissemination of "financial performance representations" to prospective franchisees that do not

[8] 16 C.F.R. § 436.9(e); Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p.21 (May 2008).

have a reasonable basis and written substantiation and are inconsistent with the representations made in the FDD.[10] This prohibited act is designed to guard against franchisors making inaccurate statements to prospective franchisees about potential revenue and profits from operating a franchise in an attempt to entice the franchisee to purchase a franchise.

B. Exemptions from the FTC Rule

The FTC Rule is intended to apply to prospective sales of a franchise, by written agreement and in exchange for material consideration, to unsophisticated, independent prospective franchisees. Accordingly, the FTC Rule contains seven exemptions for circumstances that do not match this scenario. First, the FTC Rule and its disclosure obligations do not apply where the required payment before or until six months after commencing operations is less than $500.[11] Second, "fractional franchises" are also exempted from the FTC Rule. A "fractional franchise" addresses situations where a business operates multiple franchises and is defined as franchisee where (1) it or any of its officers or directors, or the officers or directors of a parent or affiliate, has more than two years of experience in the same type of business and (2) the parties have a reasonable basis to anticipate that the sales from the relationship will *not* exceed 20% of the franchisor's total dollar volume in sales during the first year.[12] Third, the FTC Rule exempts situations where a retailer licenses or permits a seller to conduct business from the retailer's premises and where the seller does not purchase good or services from the retailer or any person whom it requires the seller to do business.[13] This exemption is known as the leased departments exemption. Fourth, relationships that are covered by the Petroleum Marketing Practices Act are not subject to the FTC Rule.[14]

Fifth, the FTC Rule contains an exemption aimed at sophisticated investors. Under this exemption, none of the standard disclosures is required if the prospective franchisee's investment totals at least $1,084,900 and the franchisee signs an acknowledgement verifying the grounds for the exemption.[15] The initial investment excludes any financing received from the franchisor or its affiliate and the cost of unimproved land. This exemption also applies to a franchisee that has been in business for at least five years and has a net worth of at least $5,424,500.[16] No written acknowledgment is required in this circumstance.

Sixth, when the prospective franchisee is a recent former director, offer, or manager of the franchisor, the FTC Rule's disclosure obligations do not apply. Under this exemption, one or more of the purchasers of at least a 50% ownership interest in the franchise must have been, for two years, an officer, director, general partner, individual with management responsibility for the offer and sale of franchisor's franchises, or an owner of at least a 25% interest in the franchisor. The franchisee must have most recently held one of the above titles or positions within 60 days before the sale of the franchise.

Finally, in the rare instance where the franchise relationship is purely an oral relationship, the FTC Rule has no application.[17]

C. The FTC's Enforcement Powers

The FTC Rule does not provide franchisees with a private cause of action for violations. Instead, the FTC is charged with prosecuting violations of the FTC Rule. Generally, to establish a violation, the FTC must prove that (1) there was a representation, omission, or practice; (2) the representation, omission, or practice was likely to mislead consumers acting reasonably under the circumstances; and (3) the representation, omission, or practice was material. The FTC's chief method of enforcement is through cease-and-desist orders through which it can direct franchisors to cease the violating conduct. It may also enforce the FTC Rule through agency proceedings in court. Civil penalties up to $10,000 may be assessed for violations of the FTC Rule and upon a showing that the defendant violated the FTC Rule with actual knowledge or knowledge fairly implied on the basis of objective circumstances.

---

[10] 16 C.F.R. § 436.9(c).
[11] 16 C.F.R. § 436.8(a)(1).
[12] 16 C.F.R. § 436.1(g), 436.8(a)(2).
[13] 16 C.F.R. § 436.8(a)(3).
[14] 16 C.F.R. § 436.8(a)(4).
[15] 16 C.F.R. § 436.8(a)(5)(i).
[16] 16 C.F.R. § 436.8(a)(5)(ii).
[17] 16 C.F.R. § 436.8(a)(7).

D. Practical Effects of the FTC Rule on Franchise Agreements

In light of the 23 categories of information that must be addressed in a FDD under the FTC Rule, franchise agreements in the United States for the most part specifically address the topics that are part of a FDD. For example, as a result of a FDD requiring a franchisor to address issues such as territorial limitations, restrictions on purchasing supplies and inventory, default and termination rights and procedures, and trademarks, a franchise agreement generally includes corresponding provisions addressing the prospective franchisee's right, obligations, and limitations. As a result, a franchise agreement in the United States will commonly require a franchisee to purchase supplies from designated sources, clearly define the franchisee's territory and the franchisor's rights to develop in or around that territory, a franchisee's obligations upon termination, and the limits of the franchisee's right to use the franchisor's trademarks.

IV. Regulation of Franchising in the United States at the State Level

A. Key Distinction: Registration Requirements

As noted above, the FTC Rule simply requires certain pre-sale disclosures. The state laws go one step further and require not only disclosure but registration as well. Fourteen states maintain laws requiring registration of a franchise offering before the offer or sale of a franchise.[18] Michigan, Wisconsin, South Dakota, and Hawaii simply require registration through the filing of a disclosure document and the registration is effective as of the date of the application and filing is made. The remaining states require a franchisor to obtain approval of a disclosure document from the state, and the state may request or require changes to the document before approving it. If the disclosure document is insufficient or a state requires changes to it, a state will issue a "stop order" suspending the registration process until the deficiency is correct or the necessary change is made. The registration process in every state generally requires a franchise to pay a fee and submit an application for registration. In most states, the registration of the offering becomes effective with a certain period of time (generally 15-30 days), if there are no deficiencies or requests for changes.

Once an offering is registered, it is generally effective for one year and must be renewed on an annual basis. Material changes to the information contained in the disclosure document also require a franchisor to update their franchise registrations in the relevant states(s). Material changes are generally those that a prospective franchisee would reasonably want to know before purchasing a franchise.

B. Exemptions from State Law Requirements

Like with the FTC Rule, the state statutes requiring disclosure and registration also provide exemptions for certain types of franchises and transactions. Many of these exemptions are similar to the ones under the FTC Rule. For example, nine states' franchise statutes exempt from registration requirements franchisors with significant net worth and experience in the franchised business,[19] and several states exempt offers of sales in particular business like the sale of petroleum products. Other common exemptions under the states' statutes include sales by and between franchisees, limited offers of one or two franchises, and qualified sales to existing franchisees.

C. State Franchise Relationship Laws

In addition to state disclosure and registration requirements, at least 18 states also have enacted statutes governing substantive aspects of the franchise relationship beyond the offering and sale of a franchise.[20] These laws address, among other things, termination and non-renewal, encroachment, a franchisee's right to associate with others, covenants not to compete, discrimination, and control over advertising. Because the statutes were enacted to correct perceived unequal bargaining power between a franchisor and a franchisee, they often place restrictions on

---

[18] Cal. Corp. Code § 31005; Haw. Rev. Stat. § 482E-3(c); 815 ILCS 705/3; Ind. Code § 23-2-2.5-1; Md. Code Ann. § 14-201(e); Minn. Stat. § 80C.1; M.S.A. § 19.854(7a); MCLS § 445.1507a; N.Y. Gen. Bus. Laws § 681(3); N.D. Cent. Code § 51-19-02.5a; R.I. Gen. Laws § 19-28.1-3(7); S.D. Codified Laws Ann. § 37-5A-1; Va. Code Ann. $ 13.1-559(A); Wash. Rev. Code § 19100.010(4); Wis. Stat. § 553.03(4).

[19] Cal. Corp. Code § 31101; Ind. Code § 23-2-2.5-3; COMAR § 02.02.08.1; N.Y. Gen. Bus. Law §§ 684(2), 684(3)(a); N.D. Cent. Code § 51-19-04.1; R.I. Gen. Laws § 19-28.1-6; S.D. Codified Laws Ann. § 37-5A-12; Wash. Rev. Code § 19.100.030(4)(a)-(b)(i); Wis. Stat. § 553.22.

[20] Ark. Code Ann. § 4-72-202(7); Cal. Bus. & Prof. Code § 20020; Conn. Gen. Stat. § 2-133f; 6 Del. Code Ann. § 2552; Haw. Rev. Stat. § 482E-6(2)(H); 815 ILCS 707/19-20; Ind. Code § 23-2-2.7-1; Iowa Code §§523H.1-17, 537A.10; MCLS § 445.1527; Minn. Stat. § 80C.14(3)(b); Miss. Code Ann. § 75-24-53; Mo. Rev. Stat. §§ 407.405, 407.410(2); Neb. Stat. § 87-404; N.J. Stat. Ann. § 56:10-5; Va. Stat. § 13.1-564; Wash. Stat. § 19.100.180(2)(j); Wis. Stat. §§ 135.01-07.

the parties' freedom of contract and restrict rights a franchisor would otherwise have. For instance, many states' statutes impose a "good cause" requirement for a termination and define exactly what qualifies as good cause.

V. Key Areas of Law Relevant to Franchising

A. Trademark and Intellectual Property Law

One of the bedrock aspects of franchise law in the United States is the franchisee's license to operate its business under the franchisor's brand and utilize its trademarks and other intellectual property in the operation of the business. A franchise system is nearly always grounded in distinctive and recognizable trademarks and symbols that distinguish the system from competing or similar systems. The United States' trademark laws allow a franchisor to register and preserve its trademarks, license them to a franchisee, and, if necessary, take appropriate steps to enforce its rights in the trademarks. Because a franchisor's trademarks are tied to the franchise system, a franchisor must exercise control over the manner in which the trademarks are used in order to protect the franchise system's name, goodwill, and reputation and competitive position.

Once a trademark is registered through the United States Patent and Trademark Office, a certificate of registration is issued that creates a rebuttable presumption that the registrant is the owner of the trademark and that the trademark is valid and that the registrant has the exclusive right to use the mark. That exclusivity is crucial as it allows the holder to license the mark and to pursue enforcement of the mark through litigation and claims of trademark infringement and unfair competition. The principal United States law governing trademark infringement is the Lanham Act.

Because the use of trademarks are so embedded in the franchise relationship, it plays a prominent role in franchise litigation. In the usual scenario involving termination or non-renewal of a franchisee, very often a franchisee who continues to operate a franchise beyond the date of termination or non-renewal will generally always face a claim of trademark infringement and unfair competition under the Lanham Act from the franchisor. The claim generally focuses on the franchisee's lack of authority to use the trademark in light of the termination or non-renewal, the confusion that the unauthorized use causes among the general public, and the potential harm to the value of the trademark based on the holder's lack of control over the trademark's use or the franchisee's substandard performance or operations. If it is determined that the franchisee improperly operated the franchise, either because the termination was proper or the non-renewal was justified, then it could face substantial liability on a trademark infringement claim for actual and treble damages. Injunctive relief is also available for trademark infringement.

B. Contract Law

The franchise relationship is predicated on an agreement in which the franchisor allows a franchisee to operate a business under the franchisor's brand, use its trademarks, and, in exchange, remit payment to the franchisor. Naturally, this agreement is embodied in a written contract between the parties, which serves as the primary source for the parties' rights and obligations, as supplemented by any applicable state law. Thus, common-law principles of contract formation and interpretation fundamentally impact the franchise relationship. This is especially true where a provision in a franchise agreement is ambiguous, which may require a court to determine the parties' intent, or where a provision entitles one party to exercise its discretion, which may require a court to assess whether the party with the discretion acted unreasonably. By and large, these issues are treated uniformly among the states.

Just as important as the contractual principles governing franchise relationship are the quasi-contractual, or equitable, principles that follow contract law. Franchise agreements in the United States are generally highly detailed contracts that attempt to address all material provisions impacting the parties' relationship. This comprehensive approach, however, does not eliminate consideration of equitable principles like promissory estoppel, which protects a party who relies on a another party's representation or promise even though it may not be enforceable under contract law. Very often in the United States, franchisors who use even the most-detailed franchise agreements find themselves facing a claim from a franchisee for promissory estoppel based on alleged oral representations or promises that are not addressed within the written franchise agreement. Under such claims, a franchisee must provide evidence of a clear and unambiguous promise, that the franchisor should have expected the franchisee to rely on the promise, and the franchisee justified and detrimental relied on the promise. At first, it may seem that a claim for promissory-estoppel renders the parties' franchise agreement pointless, but, in reality, promissory-estoppel claims are difficult to establish when a comprehensive and detailed franchise agreement exists. In those circumstances, the franchise agreement often addresses the very subject matter of the alleged promise, which bars a promissory-estoppel claim, or contains provisions disclaiming reliance on any oral representation that, combined with the information provided in a FDD, make it difficult for a franchisee to establish reasonable reliance.

Another equitable principle that is prevalent in franchise relationships is the notion that parties to a written contract have an implied duty of good faith and fair dealing toward one another. This implied covenant is recognized in nearly every state and generally requires parties to treat one another honestly, reasonably, and with good faith in the performance of a contract. It is raised most often in disputes between franchisors and franchisees regarding terminations, transfers, and renewals, areas in which franchisors typically hold substantial discretion under a franchise agreement. Like with promissory estoppel, this implied covenant of good faith and fair dealing may seem open-ended and likely to supplant the parties' written agreement. But it does have significant limitations. In some states, a franchisor cannot assert a claim for breach of the implied covenant unless it can also point to a breach of an express provision in a franchise agreement. In most states, too, the implied covenant cannot contradict the express provisions in a written franchise agreement. Some states also limit its application to circumstances where a franchisor, under the franchise agreement, possessed the discretion to act, i.e., provisions requiring the franchisor's satisfaction or approval.

Despite these and other equitable principles that supplement contract law within the United States, the trend and general recommendation is to utilize detailed and comprehensive written franchise agreements. Doing so eliminates uncertainty and ambiguity and generally limits the application of the equitable principles.

C. Employment Law

One of the most active areas of law in the United States recently has been labor and employment law, including the increase of wage-and-hour lawsuits, particularly collective- and class-action lawsuits, challenging employers' pay and classification practices and general working conditions. At the same time, for decades the United States has maintained statutes prohibiting employers from engaging in unlawful discrimination based on multiple protected categories. More recently, states have passed their own anti-discrimination laws, many of which provide greater protections than federal law, and there has been a increase in legislation designed to protect whistleblowers and those who come forward with reports of illegal or improper activities. This confluence of developments has increased the potential for liability among employers in the United States. Many of the United States' and states' employment law allow for the recovery of actual and compensatory damages, punitive damages, and attorneys' fees.

Under the traditional franchise model, this increased liability would only be a concern for franchisors in terms of their own corporate entities and operations. The individual franchisees stood separately and were responsible for their own employees. However, this model has come under closer scrutiny in the United States recently, creating the very real potential that a franchisor could be deemed a "joint employer" with its franchisees and, thus, subject to employment-related claims from franchisees' employees. This issue ultimately turns on how much control, and what type of control, a franchisor exercises over its franchisees. The nature of the franchise relationship naturally means the franchisor must have some control, especially as to matters related to brand protection, trademarks, and general operating standards. Courts in the United States have recognized that control in these areas is expected and does not mean a franchisor should be considered a joint employer. But when a franchisor's control extends beyond the traditional franchise issues and crosses into control of a franchisee's day-to-day operations, especially on issues like hiring, termination, scheduling, employee conduct, then the distinction between the franchisor and the franchisee becomes blurred and courts have concluded that a franchise is in fact a joint-employer.

D. Antitrust Law

The nature of the franchise relationship on its face lends itself to conflict with the United States' antitrust laws. The antitrust laws are designed to protect competition and prevent collusion among competitors and others on prices, supply, and other economic factors. However, a franchise relationship naturally involves the sale of products or services from franchisors to franchisees and then to end-users and involves uniformity on prices and products and franchisees' mandatory purchases from a franchisor. In the normal context, these restraints, i.e., tying, exclusivity requirements, etc., would conflict with the antitrust laws' goals of free competition. However, the reality is that these arrangements rarely expose franchisors and franchisees to antitrust violations either because the restraints are fully disclosed through a FDD, are viewed as reasonable in light of the nature of the relationship and industry, or are minimized by franchisors' lack of market power.

E. Restrictive Covenants

Closely related to the role of antitrust laws in the franchising industry is the prominence of restrictive covenants in franchise agreements. Franchise agreements commonly include restrictive covenants limiting a franchisee's ability to compete with a franchisor through the operation of an identical or similar business. These provisions apply during the term of the franchise agreement and, many times, for a period of time after the agreement is terminated or expires, generally for a period ranging from six months to two years.

Because these covenants limit competition by their express terms, they constitute a restraint on trade and are potentially unenforceable. However, because the restrictive covenants are often designed to protect a franchisor's interests in its system, trade secrets, trademarks, and good will, they are widely enforced in the United States so long as they are otherwise reasonable in their geographic and temporal limitations and narrowly tailored to protect the applicable interests. The broader a restrictive covenant is in the type of competition that is prohibited, the geographic scope of the restriction, and the length of the restriction, the more likely it is that it will be deemed unenforceable or scaled back. Similarly, restrictive covenants that extend beyond the term of a franchise agreement will also draw closer scrutiny because, at that point, a franchisor's interests in the restrictive covenant are not as compelling and the covenant likely poses an increased hardship on the franchisee.

When a franchisee violates a restrictive covenant, the applicable franchise agreement typically entitles the franchisor to terminate the agreement for a material breach. For violations of post-term restrictive covenants, a franchisor generally turns to litigation and on an expedited basis through a motion for a temporary restraining order or preliminary injunction requiring the franchisee to comply with the covenant. Because injunctive relief is viewed as extraordinary remedy, a franchisor bears the burden of making a showing that it will suffer irreparable harm if an injunction is not granted. Irreparable harm means harm that cannot be remedied by money damages. Generally, damage to goodwill and competitive position, improper use of trade secrets, and loss of control of one trademarks and brand constitutes irreparable harm.

F. Termination and Renewal Rights under State Franchise Laws

A frequent topic of franchise litigation in the United States concerns a franchisor's termination or non-renewal of a franchise. The first source for a franchisor's rights regarding termination and non-renewal is, of course, the franchise agreement, which typically sets forth the grounds and process for termination, including any notice or cure rights a franchisee may have, and the rights, if any, for renewal or extensions of the franchise. The second source for a franchisor's rights, or, more appropriately, the limitations on those rights, is any applicable state franchise relationship law. Approximately 16 states have enacted statutes impacting a franchisor's right to terminate or non-renew a franchise.[21]

As for termination rights, a franchise agreement typically enumerates the categories of conduct or violations of the franchise agreement that will entitle a franchisor to terminate. Some relate to very specific actions, like under-reporting of revenue or sales, while others are catch-all provisions aimed at general and consistent failures to comply with the franchise agreement. Many times, a franchise agreement will separate the grounds for termination between those that a franchisee is entitled to cure within a certain amount of time after receiving notice from the franchisor and those where no cure rights exist. The incurable grounds generally include actions that either reflect malfeasance and bad faith on the part of the franchisee or that fundamentally impact the franchise relationship or status of the franchisee. If after termination a franchisee continue to operate the franchise and use the franchisor's trademarks, the franchisor may sue for trademark infringement.

For those states the have franchise laws that address termination, the primary restriction in the statutes is a requirement that a franchisor have "good cause" to terminate the franchise. This requirement is designed to protect a franchisor from arbitrary and capricious terminations that result in a franchisee losing its investment in the business. Like with franchise agreements, the state statutes have enumerated categories of conduct that qualify as good cause and generally always include a franchisee's failure to comply substantially with the material terms of the franchise agreement. These statutes also often mandate a minimum notice period and opportunity to cure before termination may become effective. Wrongful termination under these state statutes can have more severe consequences for a franchisor than wrongful termination under a franchise agreement, as it may entitle the franchisee to recover specific categories of damages and/or attorneys' fees.

As for non-renewal situations, under common law and absent anything to the contrary in a franchise agreement, a franchise agreement expires automatically at the expiration date identified in the agreement. There is no automatic right of renewal generally. But most states that limit a franchisor's ability to terminate a franchise agreement also limit or regulate its power to refuse to renew a franchise agreement. The statutes vary widely on this issue, but they can result in a franchisor having to renew with a franchisee if the franchisor failed to adhere to the statutory requirements. In some states, non-renewal is treated the same as termination, meaning a franchisor must

[21] Ark. Code Ann. § 4-72-202(7); Cal. Bus. & Prof. Code § 20020; Conn. Gen. Stat. § 42-133f; 6 Del. Code Ann. § 2552; Haw. Rev. Stat. § 482E-6(2)(H); 705 ILCS 19; Ind. Code § 23-2-2.7-1; Iowa Code §§ 523H.7, 537A.10; MCLS ST § 445.1527; Miss. Code. Ann. § 75-24-53; Mo. Rev. Stat. §§ 407.405, 407.410(2); Minn. Stat. § 80C.14(3)(b); Neb. Stat. § 87-404; N.J. Stat. § 56:10-5; VA Stat. § 13.1-564; Wash. Stat. § 19.100.180(2)(j); Wis. Stat. §§ 135.01-07.

give the franchisee notice and have good cause for the non-renewal. Other states simply have a lengthy notice period for non-renewals. Still others mandate a *quid pro quo* exchange for non-renewals: in order to non-renew, a franchisor must release the franchisee from a non-competition provision, repurchase the franchisee's inventory, or permit the franchisee to sell to a qualified purchaser. These restrictions on terminations and non-renewals reinforce the need for franchisors considering entering into a new state to research and become educated about the state's laws.

G. Litigation and Alternative Dispute Resolution

Besides the substantive areas of law discussed above, litigation of franchise disputes in the United States raises a number of procedural considerations to take into account. This is due in part to the detailed and comprehensive nature of franchise agreements in the United States, which leave little to chance and address issues such as where a dispute will be litigated, the process for litigation for resolving disputes, and the remedies available to either party. For the most part, courts will respect the parties' agreement on these issues.

A common provision in any commercial contract in the United States, and especially in the franchise agreements, is a provision designating how the parties may go about resolving a dispute. In the absence of a provision stating otherwise, the parties to a franchise agreement are free to litigate their disputes between one another in court. However, a franchisor and franchisee frequently agree to other dispute-resolution processes, including private arbitration before an individual or an arbitration organization the like American Arbitration Association. Because arbitration is thought to be private, quicker, less expensive, and not subject to appeal, it\ is frequently chosen as an exclusive dispute-resolution process between franchisors and franchisees. Such agreements are regularly enforced based on the federal government's pro-arbitration policy as expressed in the Federal Arbitration Act.

As an alternative to arbitration, which results in a binding decision, some franchisors and franchisees agree to pre-suit mediation as a means of dispute resolution. Generally, the parties agree to mediate a dispute before turning to litigation. These provisions, too, are enforceable. In reality, even if they are not, or they do not exist at all, parties to litigation inevitably end up mediating most disputes because it is generally required by court order or rule. Like with arbitration, parties to a franchise agreement are free to agree on the specifics of mediation, e.g., allocation of mediation costs, type or mediator (private, former judge, etc.), and the location for the mediation.

In addition to the *means* of dispute resolution, parties to a franchise agreement may generally agree to the *forum* for litigation of any disputes and to the law that will govern. In states without franchise laws or franchise laws that are silent on forum-selection clauses, such provisions will almost always be enforced following a recent United States Supreme Court re-affirming the validity of forum-selection clauses in contracts.[22] However, some states' franchise laws prohibit forum-selection clauses and, despite the Supreme Court's decision, may still bar such provisions.[23]

Finally, parties to a franchise agreement may generally agree to limit or re-affirm the remedies available to them in the event of a dispute or litigation. This may include an express acknowledgement of a party's right to injunctive relief for particular types of breaches, a bar on consequential or incidental damages, or a provision entitling a party to reasonable attorneys' fees and costs if it prevails in litigation. Absent such a provision, a franchisor or a franchisee is entitled to the full range of remedies under any applicable statute or under common law. However, under the "American Rule," attorneys fees are generally not recoverable unless they are provided for in a contractual provision or by statute.

VI. Recent Key Cases & Developing Issues in U.S. Franchising Law

A. Joint Employer Claims

Perhaps the biggest recent development in United States franchise law is the issue of joint employer liability among franchisors and their franchisees. This issue has been brought to the forefront due to the National Labor Relations Board's (NLRB) issuance of complaints against McDonald's Corporationn claiming McDonald's is a joint employer of workers at its franchisees. The NLRB is charged with enforcing the National Labor Relations Act (NLRA), which protects employees' rights to engage in concerted activity regarding wages and working conditions, including unionizing. The NLRB's complaints are tied to recent protests in the United States by fast-food employees regarding their wages and working conditions, and the complaints allege that McDonald's, as a joint employer with its

---

[22] *Atlantic Marine Const. Co., Inc. v. U.S. Dist. Ct. for West. Dist. Of Tex.*, 134 S. Ct. 568 (2013).
[23] *Frango Grille USA, Inc. v. Pepe's Franchising Ltd.*, No. 14-2086, 2014 WL 7892164 (C.D. Cal. July 21, 2014).

franchisees, is responsible for franchisee's discriminatory discipline, reductions in hours, discharges, and other coercive conduct aimed at the protesting employees' concerted activities.

The NLRB's complaints are remarkable given the absence of any evidence of McDonald's direct involvement in the challenged actions, i.e., discipline decisions, discharges, etc. There appears to be no dispute on this issue. However, the NLRB nevertheless contends that McDonald's is a joint employer because, through its franchise relationship and use of tools, resources and technology, McDonald's "engages in sufficient control over its franchisees' operations, beyond protection of the brand, to make it a joint employer with its franchisees." If the NLRB is successful, it would represent a seismic shift in the legal landscape for franchisors, and create significant exposure to franchisors under the NLRA.

One of the chief concerns with the NLRB's recent position is that, if successful, it will have a carryover effect beyond the NLRA and expose franchisors to liability under a host of employment laws based on their franchisees' actions. In essence, the fear is that the separation between franchisors and franchisees as employers that has existed for decades will disappear entirely. At least for now, courts facing joint employer theories similar to the NLRB's have rejected them. In *Patterson v. Domino's Pizza, LLC*, for example, the court held that Domino's was not the plaintiff's employer for purposes of a sexual harassment claim because it had no right or duty to control employment or personnel matters for the franchisee.[24] Similarly, in *Vann v. Massage Envy Franchising, LLC*, a California federal court rejected the plaintiff's claim that a franchisor was responsible for the franchisee's alleged wage-and-hour violations, finding that there was no evidence that the franchisor controlled the employees' work schedules.[25]

B. Proposed Legislation Designed to Protect Franchisees

States are increasingly considering or passing legislation designed to increase the protections afforded to franchisees. This legislation is often controversial and subject to highly publicized debate given the competing interests involved and the lobbying efforts by the interested parties.

California serves as a good example. In 2014, two bills were introduced in the legislature aimed at amending the California Franchise Investment Law and California Franchise Relations Act. The proposed amendments were substantial and included:

A requirement that the parties to a franchise relationship deal with each other in "good faith" in the performance and enforcement of the franchise agreement;

Increased remedies to franchisees, including injunctive relief, restitution damages, and attorneys' fees;

A requirement mandating that terminations be conducted "in accordance with the current terms and standards established by the franchisor then equally applicable to all franchisees . . . and is not arbitrary"; and

A provision limiting a franchisor's ability to terminate a franchise to situations where the franchisee "substantially and materially breached the franchise agreement."

Critics of these proposed provisions labeled them as radical changes in the current state of franchise law and framed them as having the potential to substantially harm California's economy. However, one of the bills received enough support that it made its way through the California legislature and likely would have passed but for the September 2014 veto by the California Governor. That the bill made it that far and had a groundswell of support by franchisees and other legislators means that it or other variations of it are likely to appear again in California or other states.

---

[24] 60 Cal. 4th 474, 333 P.3d 723 (2014).
[25] No. 13-2221, 2015 WL 74139 (S.D. Cal. Jan. 6, 2015).

Authors

Babette Märzheuser-Wood
Partner, London
D +44 20 7246 7053
babette.mwood@dentons.com

Brian Baggott
Counsel, Kansas City
D +1 816 460 2654
brian.baggott@dentons.com