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Franchise Update

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FRANCHISE UPDATE

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I. INTRODUCTION

THIS Article provides an update of judicial and legislative developments of franchise law in Texas and the Fifth Circuit during the Survey period. Relevant case law and legislative efforts from around the country regarding Federal Trade Commission rules, decisions, and prosecutions that impact franchise businesses are also included.

II. THE FRANCHISE RELATIONSHIP

A franchise relationship consists of three elements: (1) a significant association between the franchisee's business and the franchisor's trademarks; (2) payment of a franchise fee; and (3) the franchisor's right to exercise significant control over, or provide significant assistance to, the franchisee in the operation of its business.¹

A. ENCROACHMENT/GOOD FAITH AND FAIR DEALING

A franchisor's approval of a new franchisee located sufficiently close to an existing franchise as to draw business away from the existing franchise is often termed an "encroachment."² Another form of encroachment may be claimed when a corporation owns multiple brands that compete against each other. When two or more of these brands operate in the

1. Several attempts have been made in recent years to apply franchise laws to distributorships. For the most part, distributorships have been considered to be outside the scope of franchise laws. But in *Gentis v. Safeguard Bus. Sys., Inc.*, 71 Cal. Rptr. 2d 122, 129 (Cal. Ct. App. Jan. 20, 1998), a California appellate court concluded that a manufacturer of record-keeping systems and office products was a franchisor and that its distributors were franchisees. The court used the California Franchise Investment Law definition of a franchise, focusing specifically on the words "offer" and "distribute" to determine that the distributors did offer goods for sale. *See id.* at 126-27. The court's apparent expansion of the franchise definition is tempered, because neither party disputed the trial court's finding that the distributors operated under a marketing plan prescribed in substantial part by the manufacturer, that the operation of the business pursuant to that system was substantially associated with the manufacturer's trademark, and that the manufacturer was required to pay a franchise fee.

2. For a thorough discussion of encroachment, see Deborah S. Coldwell & John F. Dienelt, *Gerrymandering: When is Expansion Encroachment?* Business, Law & System Politics in the Encroachment Debate, (Oct. 16-18, 1996) (unpublished ABA Annual Program, "Franchise Elections," Vol. 2) (on file with author).

same vicinity, a dissatisfied franchisee may attempt to assert an encroachment claim.

Although franchise encroachment cases often include allegations of a breach of the implied covenant of good faith and fair dealing, courts have seemingly narrowed the use of the doctrine. Such cases suggest that the doctrine of good faith and fair dealing could not be used to override express contractual provisions authorizing the conduct or action of which the franchisee was complaining.³

Perhaps the most recognized case involving the implied duty of good faith and fair dealing in the encroachment context is *Scheck v. Burger King Corp.*⁴ Recently, however, the central issue surrounding the current uncertainty in encroachment law is whether, or when, a court should imply the covenant of good faith and fair dealing to a franchise agreement.⁵ Although express language in a franchise agreement will prevent the application of the covenant of good faith and fair dealing, *Carvel Corp. v. Baker*⁶ acknowledges the possibility that express language may not provide complete protection against a court's application of the implied covenant of good faith and fair dealing. Carvel, the franchisor, entered into a franchise agreement that reserved trademark rights to it. After a conflict arose under this first form franchise agreement, Carvel modified the reservation clause. The court, holding that Carvel's two individual contract clauses conflicted, analyzed the contract as a whole.⁷ The court concluded that interpreting the first agreement was a fact question for the jury.⁸ Therefore, Carvel's motion for summary judgment was denied.

While good faith and fair dealing continues to receive significant attention in the area of encroachment, the doctrine has also been invoked in cases involving allegations of a franchisor's inequitable or inappropriate conduct. For example, in *America's Favorite Chicken Co. v. Cajun Enterprises, Inc.*,⁹ the Fifth Circuit rejected a franchisee's claim that the franchisor breached the franchise agreement by failing to: (1) allocate advertising funds to its local market, and (2) provide continuous advisory

3. For example, see *Clark v. America's Favorite Chicken Co.*, 110 F.3d 295 (5th Cir. 1997) (holding that any competition created by the franchisor did not breach the covenant of good faith and fair dealing because, in the franchise agreement, the franchisor specifically reserved the right to establish competing businesses in the franchise agreement). See also, *Burger King Corp. v. Weaver*, Bus. Franchise Guide (CCH) & 10,762 (S.D. Fla. Sept. 19, 1995).

4. 756 F. Supp. 543 (S.D. Fla. 1991), *on rehearing*, 798 F. Supp. 692 (S.D. Fla. 1992).

5. See *Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396, 1403 (11th Cir. 1998) (demonstrating the importance of precise and particular franchise drafting as a means to avoid a court's implication of the covenant of good faith and fair dealing. The *Camp Creek* court distinguished two situations: (1) when the parties include contract language on the issue of competing franchises, the implied covenant cannot alter the express terms; and (2) when there is no such language, the franchisor may not, in bad faith, capitalize on the franchisee.).

6. 1997 U.S. Dist. LEXIS 17609 (D.Conn. July 22, 1997). Bus. Franchise Guide (CCH) ¶ 11,208, at 29,680.

7. See *id.* at *18-19.

8. See *id.* at *21.

9. 130 F.3d 180, 181-82 (5th Cir. 1997).

assistance. The court reasoned that there could be no violation of the franchise agreement because the agreement gave the franchisor sole discretion over advertising placement and because the franchisor would make ongoing assistance available if it deemed appropriate.¹⁰ The court also concluded that the franchisee could not assert a good faith and fair dealing claim for failing to provide ongoing assistance.¹¹ Louisiana law, which requires the franchisee to show an intentional, malicious failure to perform in order to prove breach of the implied covenant of good faith and fair dealing, governed the franchise agreement.¹² The franchisee failed to meet this burden.

B. FIDUCIARY DUTY

*Crim Truck & Tractor v. Navistar International*¹³ is the seminal Texas case addressing the existence of a fiduciary duty between a franchisor and franchisee. In *Crim Truck*, the Texas Supreme Court affirmed the appellate court's reversal of a jury verdict finding a fiduciary relationship between a franchisor and franchisee, because the court found no evidence of a confidential or fiduciary relationship between Navistar (formerly International Harvester) and the Crim family who had operated a Navistar franchise since 1943.¹⁴ Any evidence of confidence, trust, and reliance over the parties' forty-two-year relationship was not evidence of a relationship that required Navistar to put the Crims' interests before its own, because:

this argument clashes with the rule that a party to a contract is free to pursue its own interests, even if it results in a breach of that contract, without incurring tort liability. The fact that one businessman trusts another, and relies upon his promise to perform a contract, does not rise to a confidential relationship. Every contract includes an element of confidence and trust that each party will faithfully perform his obligation under the contract.¹⁵

Thus, under Texas law, neither a franchisor/franchisee nor a supplier/distributor relationship will be considered the type of formal relationship that automatically creates a fiduciary duty.¹⁶

In *ARA Automotive Group*,¹⁷ an automotive parts distributor asserted a fiduciary duty claim against an automotive parts manufacturer. The distributor claimed that its long-term, close relationship with the manufacturer, along with the manufacturer's possession of allegedly "confidential" information about the distributor's business, created a fi-

10. See *id.* at 182.

11. See *id.*

12. See *id.*

13. 823 S.W.2d 591 (Tex. 1992).

14. See *id.* at 592.

15. *Id.* at 594-95.

16. See *id.* at 594; see also *Adolph Coors Co. v. Rodriguez*, 780 S.W.2d 477, 481 (Tex. App.—Corpus Christi 1989, writ denied); *ARA Automotive Group v. Central Garage, Inc.*, 124 F.3d 720, 723 (5th Cir. 1997).

17. 124 F.3d at 720.

duciary relationship. The Fifth Circuit refused to recognize a fiduciary relationship because: (1) neither party expressly agreed to put the other's interests ahead of its own; (2) the written agreements between the parties expressly provided for each party's obligations; (3) there was no agreement to share profits or losses; and (4) the manufacturer exercised no control over the distributor.¹⁸

C. TERMINATION AND NON-RENEWAL

Wrongful termination cases depend largely upon which party wins the race to the courthouse. When a franchisee faces an impending termination, the franchisee may file suit first in an effort to preserve the franchise by injunctive relief and to assert damage claims against the franchisor. Four common issues arise in franchise termination litigation: (1) whether the franchisor's termination was proper; (2) whether the franchisor violated disclosure requirements; (3) whether the franchisor made fraudulent representations; and (4) whether the franchisor failed to provide services in accordance with the franchise agreement.

A franchisor or distributor may seek to treat the franchisee's breach of contract as a "constructive termination" (or "de facto termination") by claiming that the breach effectively terminates the contract. A claim of constructive termination was unsuccessful in *Ward's Equipment, Inc. v. New Holland North America, Inc.*¹⁹ The manufacturer informed the plaintiff, a farm equipment dealer, that it would not consent to any sale or assignment of the plaintiff's dealership, because the manufacturer's current market plan did not require a dealership at the dealer's location. The manufacturer then began supplying a competitor fifteen miles away while continuing to supply the dealer and honor its agreement. The dealer sued the manufacturer, claiming breach of contract, wrongful termination, encroachment, promissory estoppel, and breach of the implied covenant of good faith and fair dealing. The court affirmed all of the judgments from which the dealer appealed.²⁰ The wrongful termination claim failed because there was no termination; the manufacturer continued to supply the original dealer and the competitive dealer.²¹ The breach of contract claim failed because the contract authorized the manufacturer's conduct.²² The promissory estoppel claim failed because Virginia law did not recognize the doctrine's application in this fact scenario.²³ Finally, the claims of good faith and fair dealing failed because the implied covenant could not be used to override express contractual terms.²⁴

18. See *id.* at 726-27.

19. 493 S.E.2d 516, 519 (Va. 1997).

20. See *id.* at 521.

21. See *id.* at 519-20.

22. See *id.* at 519.

23. See *id.* at 520.

24. See *id.* See also *Dunafon v. Taco Bell Corp.*, No. 93-4490-CV-C-9, 1996 U.S. Dist. LEXIS 22026, at *23, Bus. Franchise Guide (CCH) ¶ 11,239, at 29,854 (W.D. Mo. Sept. 2,

It is unusual for a franchisee to obtain a preliminary injunction against termination of a franchise primarily because an adequate damage remedy exists for wrongful termination. But in *Rothman v. Re/Max of New York, Inc.*²⁵ the court granted a franchisee's request for a preliminary injunction despite the franchisor's failure to pay royalties. The preliminary injunction prevented the franchisor from terminating the franchise before the parties completed arbitration. The franchisee established that there was a reasonable chance for success on the merits and that a denial of the injunction would result in the termination of the franchisee's business, rendering the pending arbitration moot. The court, unlike many other courts on this subject, found that damages "would not be an adequate substitute for uninterrupted continuation of the franchise."²⁶ Note, however, that the pending arbitration was on an expedited schedule and was to be completed within sixty days.

D. TRANSFER OF FRANCHISE RIGHTS

Franchisors commonly require a general release before approving a franchise transfer. While some states regulate a franchisor's ability to require such a release, a California court validated a franchise agreement term requiring release before transferring a franchise to a new location.²⁷ Obtaining the franchisor's formal approval before proceeding with a transfer is also important.²⁸

1997), in which the court dismissed a constructive or de facto termination claim as redundant of the breach of contract claim.

25. Bus. Franchise Guide (CCH) ¶ 11,299, at 30,127 (N.Y. App. Div. Oct. 27, 1997).

26. *Id.*

27. See *Alberts v. Southland Corp.*, Bus. Franchise Guide (CCH) ¶ 11,219, at 29,723 (S.D. Cal. July 18, 1997). In *Alberts*, the franchisor demanded, as provided for in the franchise agreement, release of all claims that the franchisee may have had arising from the existing franchise agreement before the franchisor would allow the franchisee to relocate without paying additional franchise fees. The franchisee claimed that this requirement was a breach of contract and constituted unfair competition. The court found that the release was not a breach but merely a condition precedent to the execution of a new agreement terminating the old franchise arrangement and installing a new franchise at the new location. See *id.* The release did not constitute unfair competition because it did not apply to other franchises owned by plaintiff, only to the franchise that the plaintiff wanted to move. See *id.* at 29,723-24.

28. *Stroh Brewery Co. v. Western Md. Distrib. Co.*, No. 96-2705, 1997 U.S. App. LEXIS 34027, at *2, Bus. Franchise Guide (CCH) ¶ 11,304, at 30,142 (4th Cir. Dec 3, 1997) illustrates the importance of obtaining the franchisor's formal approval of a transfer before proceeding. In this case, the franchise agreement provided for automatic termination if the franchise was transferred without the manufacturer's approval. The plaintiff agreed to buy the franchise from the prior franchisee, and both parties sought approval from Stroh and Stroh's representatives for the transfer. The transfer occurred before Stroh gave its official approval, and Stroh terminated the agreement when it learned that the transfer had been finalized. The court granted summary judgment to Stroh and dismissed the plaintiff's claims of promissory estoppel, fraudulent and negligent misrepresentation, and violations of Maryland's Beer Franchise Act. See *id.* at *4-5.

E. VICARIOUS LIABILITY

The number of suits seeking to hold franchisors liable for the acts or omissions of their franchisees is on the rise. Courts faced with these cases apply traditional agency law to determine whether a franchisor is vicariously liable for the actions of the franchisee. In determining whether a franchisor is vicariously liable, courts focus on two agency theories: (1) actual agency; and (2) apparent (ostensible) agency.

Texas law requires a party asserting agency to prove that the principal has both the right to assign the agent's tasks and the right to control the means and details by which the agent will accomplish those tasks.²⁹ Moreover, the right to control must pertain to a task or matter that is material to the lawsuit.³⁰

Under the right to control test, a court examines whether the franchisor has a contractual right to control the franchisee in the detail of its work. If the franchise agreement contains an express "no agency relationship" clause, the party attempting to prove agency must establish that the true operating agreement between the parties actually vested control with the franchisor.³¹

Even in the products liability arena, the same rule applies. In *Jackson v. Coldspring Terrace Property Owners Association*,³² Jackson, rendered a quadriplegic after diving into a swimming pool owned by the Association, alleged that the pool, built by a licensee of Blue Haven Pools, was negligently designed and built. Jackson also claimed that Blue Haven failed to police its trademark and maintain control over the quality of pools its licensee built and marketed. The court first recognized the absence of Texas authority on licensor/franchisor liability for sale of defective products.³³ Jackson's strict liability claims were largely based on: (1) sections 400 and 402 of the Restatement of Torts; and (2) the stream of commerce theory. The court refused to apply either of these strict liability theories to licensors/franchisors.³⁴ As for the trademark policing claim, the court recognized that the question of whether a private cause of action exists for failure to control quality was uncertain but noted that a trademark owner could be held vicariously liable if it puts out as its own a product manufactured by another.³⁵ A finding of vicarious liability requires proof that the licensor/franchisor of the trademark was significantly involved in

29. See *Newspapers Inc. v. Love*, 380 S.W.2d 582, 590-91 (Tex. 1964); *Webster v. Lipse*, 787 S.W.2d 631, 635 (Tex. App.—Houston [14th Dist.] 1990, writ denied); *Johson v. Owens*, 629 S.W.2d 873, 875 (Tex. App.—Fort Worth 1982, writ ref'd n.r.e.).

30. See *Exxon v. Tidwell*, 867 S.W.2d 19, 23 (Tex. 1993) (stating that "the nature of the matters to which the right of control extends [is] determinative"); *Barnes v. Wendy's Int'l Inc.*, 857 S.W.2d 728, 730 (Tex. App.—Houston [14th Dist.] 1993, no writ).

31. For example, see *O'Bryant v. Century 21 S. Cent. States, Inc.*, 899 S.W.2d 270, 272 (Tex. App.—Houston [14th Dist.] 1995, no writ).

32. 939 S.W.2d 762 (Tex. App.—Houston [14th Dist.] 1997, writ denied).

33. See *id.* at 765.

34. See *id.* at 768.

35. See *id.* at 767.

the design, manufacture, or distribution of the defective product.³⁶ In this case, however, the court granted summary judgment to Blue Haven and specifically refused to adopt a private cause of action against a licensor/franchisor for failure to police a trademark.³⁷

Notwithstanding the long established rules regarding franchisor liability for the acts of a franchisee, the Texas Supreme Court decision *Read v. Scott Fetzer Co. d/b/a the Kirby Co.*³⁸ provides the potential for increased franchisor liability in the franchise arena. In *Kirby*, a door-to-door vacuum cleaner salesman, who by himself was an independent contractor of Kirby's distributor, raped a customer during an in-home demonstration. The customer sued Kirby, the manufacturer, for damages arising from the acts of the door-to-door salesman. Although the appellate court reversed a jury's punitive damages award against Kirby, it affirmed the actual damages award.³⁹

Affirming the appellate court decision, the Texas Supreme Court focused on the question of "whether a company that markets and sells its products through independent contractor distributors and exercises control by requiring in-home demonstration and sales, owes a duty to act reasonably in the exercise of that control."⁴⁰ Although the *Kirby* decision was "not based on a notion of vicarious liability, but upon the premise that Kirby is responsible for its own actions,"⁴¹ the court focused on the fact that Kirby retained "control of specific details of the work by requiring the 'in home' sales of its vacuum cleaners."⁴² Although the distributor agreement between Kirby and its dealers contained a "no agency relationship" clause, the court concluded that "Kirby did in fact retain control by requiring in-home sales."⁴³

As Justice Abbott points out in his dissent, the plaintiff's injury was related to Kirby's failure to perform a background check on a prospective salesman.⁴⁴ The injury arising from this failure "specifically related to the control that Kirby abrogated [in its distributor agreements]—control over the selection of dealers."⁴⁵ Thus, the decision "rewrites Kirby's Distributor Agreement and Independent Dealer Agreement to require Kirby to assume control over dealer selection."⁴⁶ Justice Hecht cautioned that the court's attempt to "prevent its decision from impacting the multitude of businesses similar to Kirby's" will likely fail.⁴⁷

Problems arise in the application of the right to control test when con-

36. *See id.* at 765. .

37. *See id.* at 769.

38. No. 97-0707, 1998 Tex. LEXIS 160 (Tex. Dec. 31, 1998).

39. *See id.* at *5.

40. *Id.* at *1.

41. *Id.* at *6.

42. *Id.* at *7.

43. *Id.* at *9.

44. *See id.* at *14.

45. *Id.* at *15-16.

46. *Id.* at *16.

47. *Id.* at *39.

sidering the effect of the Lanham Act.⁴⁸ Most franchisors, as national entities, retain certain rights and powers under their franchise agreements to protect intangible property rights. The Lanham Act permits a trademark owner to license the use of its mark to a franchisee, provided that the mark is not used in a manner to deceive the public.⁴⁹ Thus, the Lanham Act contemplates that the franchisor may lose its mark by abandonment if it is not used, or if the manner in which it is used causes the mark to lose its significance as an indication of origin. Therefore, a franchisor to some extent must regulate its licensee's activities in order to preserve its property rights and protect the public against deceptive uses of its trademarks.

In the absence of any other evidence of a right to control, franchisees often attempt to establish that the franchisor's Lanham Act duties create the necessary level of control for an agency relationship. The argument is that a franchisor, in protecting its intellectual property rights, meets the requirements for the right to control test. Texas courts, however, have consistently refused to find a right to control based on a franchisor's duty to protect intangible property rights.⁵⁰

F. CONTRACT CLAIMS

The relationship between franchisor and franchisee is contractual. Thus, when no termination statute applies, Texas courts analyze the contract to determine whether termination was proper. In *Star Houston, Inc. v. Texas Department of Transportation*,⁵¹ the court upheld a Texas Department of Transportation ruling that an auto dealer breached its dealership agreement by refusing to participate in the manufacturer's new signage program. The dealer's refusal to participate constituted good cause, under the Texas Motor Vehicle dealer law, for terminating the dealership agreement.⁵²

Franchise and dealer agreements typically restrict the freedom to sell or otherwise dispose of the franchisee's or dealer's business. Challenges to transfer restrictions require courts to examine a franchisor's withholding of consent or its imposition of transfer conditions. In *Aalok Anita v. Shell Oil Co.*,⁵³ the court concluded that a franchisor's express contractual right to demand a release of claims before consenting to a franchise transfer was valid. In other jurisdictions, however, a franchisor's demand for a release before transfer may not be enforceable. In *Franchise Management v. America's Favorite Chicken*,⁵⁴ the Michigan Court of Appeals

48. 15 U.S.C. § 1051 (1994).

49. See *id.* at § 45(a).

50. See, e.g., *Smith v. Foodmaker*, 928 S.W.2d 683, 688 (Tex. App.—Fort Worth 1996, no writ); *O'Bryant*, 899 S.W.2d at 272.

51. 957 S.W.2d 102, 110 (Tex. App.—Austin 1997, writ denied).

52. See *id.*

53. No. 14-95-00682-CV, 1996 Tex. App. LEXIS 4234, at *9 (Tex. App.—Houston [14th Dist] 1996, no writ).

54. 561 N.W.2d 123, 125-26 (Mich. Ct. App. 1997).

overturned the trial court's holding that such a provision was unenforceable under the Michigan Franchise Investment Law. The case is currently before the Michigan Supreme Court, and an opinion will be rendered after this paper is published.

Other significant cases include *Yankee Enterprises, Inc. v. Dunkin' Donuts, Inc.*⁵⁵ in which the Fifth Circuit overturned a jury's award of damages and attorney's fees for a franchisee's breach of contract claim. The franchisee claimed that Dunkin' Donuts' reduction of franchise supervisory personnel and failure to maintain system standards constituted a breach of contract. The court concluded that no damages arose from this alleged breach.⁵⁶ In *RE/Max of Texas, Inc. v. Katar Corp.*,⁵⁷ the court held that RE/Max had breached its franchise agreement by terminating the franchisee's exclusivity.

G. CONTRACT-TORT DISTINCTION

The distinction between tort and contract is more than theoretical because parties contract to minimize future risk.⁵⁸ Allowing open-ended tort damages to distort contract relations turns every contract into a potentially riskier proposition.⁵⁹ The rule in Texas has long been that mere nonfeasance under a contract creates liability only for breach of contract.⁶⁰ To help clarify the boundary between contract claims and other causes of action, Texas courts consider both: (1) the source of the defendant's duty to act and (2) the nature of the remedy that a plaintiff seeks.⁶¹ As a practical matter, when a party's duty to act arises solely from a contract and the opposing party is seeking benefit of the bargain damages, the party's failure to perform will not constitute a tort.⁶²

*Formosa Plastic Corp. USA v. Presidio Engineers and Contractors*⁶³ symbolizes a retreat from previous limitations on tort claims. The *Formosa Plastic* court recognized that "tort damages are recoverable for a fraudulent inducement claim irrespective of whether the fraudulent representations are later subsumed in a contract or whether the plaintiff only suffers an economic loss related to the subject matter of the contract."⁶⁴ When one party enters into a contract with no intention of performing that contract, the misrepresentation of a willingness to perform a future act may give rise to a fraud action if the intent was to deceive the other

55. 121 F.2d 703, Bus. Franchise Guide (CCH) & 11,211, at 29,691 (5th Cir. July 8, 1997) (unpublished table decision).

56. *See id.* at 29,693.

57. 961 S.W.2d 324, 327 (Tex. App. - Houston [1st Dist.] 1997, no writ).

58. *See, e.g.,* Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d at 331, 346 (4th Cir. 1998).

59. *See id.*

60. *See Crim Truck*, 823 S.W. 2d at 597.

61. *See Crawford v. Ace Sign, Inc.*, 917 S.W.2d 12, 13 (Tex. 1996); *Southwestern Bell Tel. Co. v. Delanney*, 809 S.W.2d 493, 495 (Tex. 1991).

62. *See Delanney*, 809 S.W.2d at 495.

63. 960 S.W.2d 41 (Tex. 1998).

64. *Id.* at 47.

party.⁶⁵ Thus, a claim for fraudulent inducement requires proof of a fraudulent intent not to perform the contract at the outset.

H. DECEPTIVE TRADE PRACTICES—CONSUMER PROTECTION ACT

Franchisees, licensees, and distributors continue to assert claims based on the Texas Deceptive Trade Practices—Consumer Protection Act (DTPA).⁶⁶ In *Amstadt v. United States Brass Corp.*,⁶⁷ homeowners asserted DTPA violations against the manufacturer of defective polybutylene plumbing systems. The court first recognized that privity of contract is not a prerequisite for DTPA consumer status. After considering the privity issue, the court went on to conclude that the manufacturer was not liable under the DTPA, because any deceptive conduct must occur in connection with consumer transactions.⁶⁸ Because no proof existed that deceptive conduct occurred in this manner, DTPA liability did not follow.

*ARA Automotive Group v. Central Garage, Inc.*⁶⁹ addressed the issue of encroachment under the DTPA. A distributor alleged that a manufacturer violated the DTPA by opening a retail store in the same geographic area as the distributor. The appellate court upheld the jury's verdict that the manufacturer did not violate the DTPA, even if the manufacturer's store was in direct competition with its distributor.⁷⁰

Finally, in *Yankee Enterprises*⁷¹ the Fifth Circuit concluded that a franchisor's reduction of its supervisory force and/or failure to maintain system standards will not support a DTPA claim of gross disparity or unconscionability.

III. MARKETING THE FRANCHISE RELATIONSHIP

A. MISREPRESENTATION

Pursuant to the Federal Trade Commission Regulation Rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (the Disclosure Rule), the FTC promulgated pre-sale disclosure requirements for franchises and certain business opportunity ventures.⁷² The Disclosure Rule requires disclosure, but not registration, in connection with the offer and sale of franchises in the United States. The Disclosure Rule requires disclosure of twenty different categories of information that the FTC has determined are important

65. *See id.* at 46-47.

66. TEX. BUS. & COM. CODE §§ 17.41-.826 (Vernon 1996).

67. 919 S.W.2d 644 (Tex. 1996).

68. *See id.* at 647.

69. 124 F.3d at 720.

70. *See id.* at 722-23, 730.

71. Bus. Franchise Guide (CCH) ¶ 11,211, at 29,692.

72. 16 C.F.R. § 436 (1997). According to this rule, franchisors must make a full presale disclosure. A franchisor may not legally offer and sell franchises in a state in which the franchisor has failed to register, and illegal offers or sales create stiff civil and criminal liability for the franchisor as well as its officers. *See* 15 U.S.C. § 45(m) (1994).

to potential franchisees.⁷³ To accomplish this disclosure task, the FTC requires compliance with the Disclosure Rule through the issuance of a Uniform Franchise Offering Circular (the UFOC).

The FTC is authorized to seek injunctions and civil penalties and to assist in consumer redress against Disclosure Rule violations. Since the Disclosure Rule's 1979 inception, the FTC has determined a wide array of misrepresentations to be unfair and deceptive practices. The following cases provide guidance for Texas practitioners to determine the type of disclosure that the FTC Disclosure Rule requires.

In *United States v. QX International, Inc.*,⁷⁴ the FTC alleged that the defendants failed to disclose relevant information within the time requirements of the FTC Disclosure Rule. The allegations included alleged misrepresentations regarding earnings potential, reliability of company-selected references, territorial protection, and the amount of advertising provided to customers. The FTC criticized the defendants' advertising the sale of distributorships and earnings potential in classified ads. Once the parties met, the defendants made the same claims. According to the FTC, the defendants rarely achieved their earnings claims, and the sales figures disclosed for existing distributorships were not even average estimates of the earnings potential purchasers could reasonably expect.

In *FTC v. Summit Photographix*,⁷⁵ the defendants used seminars to sell trading card and postcard businesses. At these seminars, the defendants made representations about the profitability of the businesses and guaranteed exclusivity rights within specific market areas. Defendants would later contact new purchasers of the business venture and reassure them of the potential business earnings and the guaranty of geographic exclusivity. Defendants would then use this later contact to induce the purchaser to buy additional products from them. The FTC alleged that this conduct violated the Disclosure Rule.

Finally, in *FTC v. AmeraPress, Inc.*⁷⁶ the defendants invited prospective purchasers to attend informational seminars where they provided the purchasers with annual earning estimations. The FTC alleged that the defendants misrepresented the specific earning levels purchasers could expect to receive and expanded on the misrepresentations by making follow up phone calls espousing the same profitability claims.

The following cases underscore the difficulties that a franchisee faces when pursuing private actions under state law. In *America's Favorite Chicken*,⁷⁷ a franchisee alleged fraudulent inducement and misrepresentation resulting from the franchisor's promise of increased sales. The court dismissed the franchisee's fraud claims because: (1) the franchise agreement specifically disclaimed reliance upon any extra-contractual

73. See 16 C.F.R. § 436.1(a).

74. Bus. Franchise Guide (CCH) ¶ 11,353 (N.D. Tex. Feb. 20, 1998).

75. Bus. Franchise Guide (CCH) ¶ 11,355 (N.D. Tex. Feb. 20, 1998).

76. Bus. Franchise Guide (CCH) ¶ 11,353 (N.D. Tex. Feb. 20, 1998).

77. 130 F.3d at 183.

representations and (2) the statements were projections of possible future events, not subject to a fraud action under Louisiana law.⁷⁸ The court also dismissed the franchisee's misrepresentation claims regarding the franchisor's failure to disclose equipment problems and the opening of a competitor next door, because the franchisee was a sophisticated purchaser who could have investigated the condition of the building and learned of the competitor's relocation.⁷⁹

In *Hotels of Key Largo, Inc. v. RHI Hotels, Inc.*,⁸⁰ franchisees sought rescission of licensing agreements based upon the franchisor's failure to honor three promises relating to: (1) benefits associated with becoming a part of the Radisson Hotel network (i.e., access to the worldwide reservation system of 4,500 travel agents); (2) becoming the sole beneficiaries of the reservation system in the Florida Keys; and (3) the percentage of their room reservations that would be derived from the reservation system and travel agents. The court held that the franchisees were not justified in relying on the representations, because the license agreements contained clear, unambiguous language outlining the parties' rights and obligations and contained an integration clause.⁸¹ The court also reasoned that the economic loss rule bars certain fraudulent inducement claims, because contract law and tort law are separate. Courts should maintain that separation in the remedies allowed.⁸²

In *Loehr v. Hot Now, Inc.*,⁸³ a fast food franchisee allegedly relied on statements made by the franchisor regarding the sale of the franchise to Pepsico and plans for future expansion. The court rejected the franchisee's claim that the representations destroyed its business and held that a franchisor could not be held liable for any statement made regarding future intentions, absent an affirmative action by the defendant evidencing an intent to be bound by the statement.⁸⁴

In *Pang v. Jani King of California, Inc.*,⁸⁵ the court determined that a commercial cleaning franchisor, which structured its franchise program based on the amount of monthly contract business a franchisee purchased, was making an earnings claim as defined by the UFOC Guidelines. The franchisor's subsequent omission of the required earnings claims disclosures in the franchisor's offering circular was a willful violation under the California Franchise Investment Law.⁸⁶ The court further held that the franchisor's registration of the franchise offering circular was not a defense to disclosure violations because registration did

78. *See id.*

79. *See id.*

80. 694 So.2d 74 (Fla. App. 1997).

81. *See id.* at 75-76.

82. *See id.* at 77.

83. Bus. Franchise Guide (CCH) ¶ 11,352, at 30, 388 (S.D. Fla. Feb. 11, 1998).

84. *See id.*

85. Bus. Franchise Guide (CCH) ¶ 11,249, at 29,912 (Cal. App. Dep't Super. Ct. July 9, 1997).

86. *See id.*

not constitute regulatory approval of the franchisor's omissions.⁸⁷

B. DISCLOSURE

1. *Disclosures and Exemptions Under the Federal Trade Commission*

Over the last year, the FTC issued a number of Staff Advisory Opinions regarding disclosure requirements. In *Informal Staff Advisory Opinion No. 97-5*,⁸⁸ the FTC noted that direct communications by a franchisor to financial journals and trade press in connection with bona fide news releases do not constitute earnings representations. When a franchisor, however, disseminates those articles to prospective franchisees, the franchisor effectively ratifies the news stories and converts the article to an advertising piece, thereby making it an earnings claim.

The FTC confronted the practical issue of whether, under the FTC Rule, a franchisor must provide a disclosure document to an existing franchisee who purchases an additional outlet.⁸⁹ When a franchise agreement provides for additional outlets, the franchisor will not be obligated to provide disclosure unless the new relationship is under materially different terms and conditions, or if there has been a material change concerning the franchisor's business or the terms under which a new outlet would operate.⁹⁰

As the Internet has expanded, so has the reach of the FTC. In *FTC v. Greenhouse Communications, Inc.*,⁹¹ the FTC filed a complaint alleging that Greenhouse ran promotions on the Internet and in newspaper ads claiming that franchisees could expect to earn as much as \$134,000, working only part-time, within their first year of business for a minimum investment of \$14,000 to \$15,000. According to the FTC, Greenhouse violated the FTC rule by failing to provide the required disclosure or earnings substantiation documents. A consent decree was entered which: (1) prohibited Greenhouse from violating the FTC Rule in the future; (2) required it to send rescission notice to each franchisee; and (3) enjoined Greenhouse from disclosing names, addresses, telephone numbers, or any other identifying information of any franchisee.⁹²

Under section 18(g) of the FTC Act, an applicant may petition the FTC for an exemption to FTC trade rules or regulations dealing with unfair or deceptive acts or practices affecting commerce.⁹³ If the FTC finds an application of a rule to be unnecessary to prevent deceptive or unfair practices, it may grant an exemption.

Recently, an exemption evaluation was conducted for *Navistar Interna-*

87. *See id.*

88. Bus. Franchise Guide (CCH) ¶ 6485, at 9686 (July 31, 1997).

89. *See Informal Staff Advisory Opinion No. 97-8*, Bus. Franchise Guide (CCH) ¶ 6488, at 9691 (Dec. 8, 1997).

90. *See id.*

91. Bus. Franchise Guide (CCH) ¶ 11,402 (D. N.H. May 13, 1998).

92. *See id.* at 30,645-46.

93. *See* 15 U.S.C. § 57a(g) (1994).

*tional Transportation Corp.*⁹⁴ The truck manufacturer claimed that the application of the Disclosure Rule to its dealership sales was unnecessary because: (1) its dealers are sophisticated business people with experience in the industry; and (2) the negotiation process leading to the execution of the dealership agreement occurs over a period of four months to one year, ensuring adequate time for review. Navistar also claimed it had an interest in ensuring that its dealers were committed and well financed.

2. *Uniform Franchise Offering Circular Guidelines*

On August 7, 1998, the North American Securities Administrators Association, Inc. (NASAA) released for public comment a restated commentary relating to UFOC Guidelines.⁹⁵ These Guidelines are to act as an alternative form of disclosure document permitted by the FTC. The restated commentary addresses issues including risk factors, "predecessor" and "affiliate" definitions, litigation disclosures, non-uniform fees and fees paid to third parties, sourcing restrictions, financing, advertising funds, training staff, computer hardware and software, subfranchisor disclosure, and disclosure concerning international outlets. The comment period ended October 30, 1998.⁹⁶

C. EXEMPTIONS FROM REGISTRATION REQUIREMENTS

On May 3, 1998, NASAA adopted a Statement of Policy regarding offers of franchises on the Internet.⁹⁷ Under the Statement of Policy, internet offers will be exempted from state registration requirements if: (1) the offer indicates that the franchise is not being offered to residents of that state; (2) the offer is not directed to any person in the state by or on behalf of a franchisor or anyone acting with the franchisor's knowledge; and (3) no franchise is sold in the state by or on behalf of the franchisor until the offering has been registered and declared effective and an offering circular delivered to the prospective purchaser in compliance with the state's franchise law.⁹⁸ The goal is to create a uniform approach to handling internet franchise offers. To date, only Indiana and Maryland have adopted such exemptions.⁹⁹

D. FTC ENFORCEMENT POWERS

Under section 5(a) of the FTC Act, the FTC has the authority to initiate a court proceeding to prevent unfair and deceptive practices that affect commerce, including violations of the Disclosure Rule.¹⁰⁰ Under

94. Bus. Franchise Guide (CCH) ¶ 11,390, at 30,573.

95. See NASA Proposed Statement of Policy—1998 Commentary on the Uniform Franchise Offering Circular Guidelines, Bus. Franchise Guide (CCH) ¶ 11,485, at 31,088 (Aug. 7, 1998).

96. See *id.* at 31,089.

97. See Bus. Franchise Guide (CCH) ¶ 11,391; NASAA Reports (CCH) ¶ 3939.

98. See Bus. Franchise Guide (CCH) ¶ 11,391 at 30,574.

99. See Bus. Franchise Guide (CCH) ¶ 5200; Bus. Franchise Guide (CCH) ¶ 5140.01.

100. See Federal Trade Commission Act, 15 U.S.C. § 45(a) (1998).

section 13(b) of the FTC Act, the court has the ability to grant injunctive and other ancillary relief.¹⁰¹

Two enforcement actions are noteworthy. In the first, the FTC alleged claims of corporate and individual violations of the Disclosure Rule.¹⁰² The complaint sought injunctive relief although it presented no evidence that the defendants were currently violating the FTC Act or were likely to do so in the future. The court decided that it had the power to enjoin the defendant based on the defendant's past conduct.¹⁰³ In the second action, the defendant sought to stay a FTC action during the investigation of its corporate officer in a parallel criminal case.¹⁰⁴ Because the public's interest in a speedy resolution of civil suits outweighed the problems incurred by the defendant's officer, the court denied the stay.¹⁰⁵ The officer could assert the Fifth Amendment in the criminal proceeding and simply have another officer represent the defendant in the FTC action.

The FTC also enters into a number of consent decrees each year. In *FTC v. Majors Medical Supply, Inc.*,¹⁰⁶ the FTC filed a proposed consent decree involving a franchisor of medical equipment businesses and its two principal officers. The consent decree prohibited the franchisor and its officers from making misrepresentations in connection with the sale of any franchise. The decree also required franchisors to release all former and current franchisees from franchise agreement obligations. Finally, the two principal officers were required to post performance bonds of \$1,000,000 before engaging in the sale of any business venture franchises.¹⁰⁷

*FTC v. Carousel of Toys USA, Inc.*¹⁰⁸ involved a franchisor of display racks and one of its directors. The FTC claimed that the franchisor and director violated the Disclosure Rule and made misrepresentations in violation of the FTC Act. The decree enjoined defendants from violating, or assisting others in violating, the FTC Act or the Disclosure Rule in connection with the sale of any franchise or business opportunity. The director agreed to cooperate with the FTC and other law enforcement agencies in ongoing investigations and agreed to testify before a federal grand jury if asked to do so.¹⁰⁹

The FTC alleged that corporate marketers and a candy vending franchisor made material misrepresentations to franchise buyers and failed to disclose key information to prospective purchasers in *FTC v.*

101. See 15 U.S.C. § 53(b).

102. See *FTC v. Hayes*, No. 4:96-CV-2162, 1997 U.S. Dist. LEXIS 7805 (E.D. Mo. May 7, 1997); *Bus. Franchise Guide* (CCH) ¶ 11,201, at 29,644.

103. See *id.* at *6.

104. See *FTC v. Parade of Toys, Inc.*, No. 97-2367, 1997 U.S. Dist. LEXIS 17153; (D. Kan. Oct. 15, 1997), *Bus. Franchise Guide* (CCH) ¶ 11,292, at 30,106.

105. See *id.* at *5-6.

106. *Bus. Franchise Guide* (CCH) ¶ 11,245, at 29,886 (S.D. Fla. Sept. 19, 1997).

107. See *id.* at 29,889.

108. *Bus. Franchise Guide* (CCH) ¶ 11,267, at 29,977 (S.D. Fla., Sept. 29, 1997).

109. See *id.* at 29,980.

*Stillwater Vending Ltd.*¹¹⁰ The defendants consented to a preliminary injunction prohibiting the defendants from misrepresenting the sale of candy vending machine business ventures or other related products or services. The injunction further required the defendants to post a \$100,000 performance bond before selling additional vending machines.¹¹¹ The defendants also had to submit financial reports to the court and FTC. Pending resolution of the allegations, the defendants' assets were frozen.¹¹²

Finally, in *FTC v. Independent Travel Agencies of America, Inc.*,¹¹³ the FTC claimed that the owner of a home-based travel agency misled program buyers. The proposed consent decree permanently enjoined the owner from misrepresenting that purchasers would be able to operate functional, independent travel agencies or that they would be supported by major travel service providers.¹¹⁴ The decree also permanently enjoined the owner from engaging in the marketing or sale of any business opportunity relating to travel agencies.¹¹⁵

IV. DISPUTE RESOLUTION

A. ARBITRATION

Various threshold issues often arise before parties can be compelled to arbitrate. First, there must be an agreement to arbitrate the claims in dispute. Courts are often called upon to determine these threshold issues. For example, in *Morse v. Sir Speedy, Inc.*,¹¹⁶ the franchise agreement stated that all disputes, except certain ones involving intellectual property, were to be arbitrated. Another provision stated that the party aggrieved by a breach or default was to have all rights and privileges available by law. The franchisee, relying on the latter clause, argued that as the injured party it was entitled to a judicial remedy because such a remedy was clearly available under the law. The court, attempting to give meaning to all provisions of the contract, reasoned that if it interpreted the contract as asserted by the franchisee, any case could be brought in court and that would eviscerate the arbitration clause.¹¹⁷ Arbitration was therefore ordered, and, to give meaning to the clause, the court empowered the arbitrator to allow any remedy available at law.¹¹⁸

Arbitration has its own unique procedural issues. Sometimes each party files for arbitration separately, and one or the other party may want to consolidate the arbitration without a specific provision in the arbitra-

110. Bus. Franchise Guide (CCH) ¶ 11, 240, at 29,855 (D. N.H. Sept. 9, 1997).

111. *See id.* at 29,858.

112. *See id.*

113. Bus. Franchise Guide (CCH) ¶ 11,300, at 30,128 (S.D. Fla. Sept. 11, 1997).

114. *See id.* at 30,129.

115. *See id.*

116. No. 97-40013, 1997 U.S. Dist. LEXIS 18419 (D. Mass. Nov. 17, 1997); Bus. Franchise Guide (CCH) ¶ 11,320, at 30,212.

117. *See id.* at *4-5.

118. *See id.*

tion agreement. For example, in *Specialty Bakeries, Inc. v. RobHal, Inc.*¹¹⁹ the defendant brought a motion to consolidate two arbitration proceedings before the American Arbitration Association (AAA) or, in the alternative, to stay the arbitration initiated by the plaintiff pending a decision by the court of appeals on defendant's appeal of an earlier order compelling arbitration. The AAA rejected defendant's motion, and the defendant moved the court to consolidate the actions. Neither the Federal Arbitration Act (FAA), the franchise agreement, nor the Commercial Rules of the AAA adopted by the parties in their agreement provided for consolidation of arbitrations. The defendant argued that FED. R. CIV. P. 42(a) should apply by reason of FED. R. CIV. P. 81(a)(3), which states that "[i]n proceedings under Title 9, U.S.C., relating to arbitration . . . these rules apply only to the extent that matters of procedure are not provided for in those statutes."¹²⁰ The court rejected the argument because Rule 81(a)(3) applies only to judicial proceedings and not to proceedings before an arbitrator.¹²¹ Because New Jersey law applied to the franchise agreement, the defendant also argued that New Jersey state law authorized the court to order consolidation of the arbitrations. The court declined to decide whether New Jersey law allowed a court to order consolidation because, even if such power existed, consolidation would not be appropriate.¹²² The court also denied the defendant's alternative motion to stay.¹²³

Many arbitration clauses require that the arbitration take place in a selected forum, usually the franchisor's home state. In an effort to protect franchisees, several states have adopted statutes making such forum selection clauses unenforceable. Franchisors have challenged the right of states to curtail their contractual arbitration agreements on the basis that the FAA, which requires enforcement of arbitration agreements according to their terms, preempts such statutes. A "tentative ruling" in *Silka v. Surface Doctor, Inc.*¹²⁴ adopted the franchisor's argument and held that arbitration should be held in Atlanta, the selected forum in the arbitration clause. The court ruled that the FAA trumped the provision in the California franchise law¹²⁵ that made such forum selection clauses unenforceable.¹²⁶

A party desiring to enforce an arbitration agreement with a forum selection clause may be required to go to the selected forum to do so. Section 4 of the FAA requires that the arbitration hearing be held within the district in which the petition for an order to arbitrate is filed.¹²⁷ The

119. No. 97-1057, 1997 U.S. Dist. LEXIS 9095 (E.D. Pa. June 24, 1997), Bus. Franchise Guide (CCH) ¶ 11,200, at 29,639.

120. *Id.* at *8.

121. *See id.*

122. *See id.* at *15.

123. *See id.* at *17.

124. Bus. Franchise Guide (CCH) ¶ 11,314, at 30,185 (C.D. Cal. Dec. 1, 1997).

125. CAL. BUS. & PROF. CODE § 20,040.5 (1998).

126. *See Silka*, Bus. Franchise Guide (CCH) at 30,185-86.

127. *See* Federal Arbitration Act, 9 U.S.C. § 4 (1998).

court in *Im v. ATL International, Inc.*¹²⁸ ruled that where there is a forum selection clause in the arbitration agreement, the party seeking to enforce it must file its petition to compel arbitration in a court in the district in which the selected forum is located. In the instant case, the franchisor had filed a petition to compel arbitration in the selected forum and a few days later the franchisee filed suit in its home state. The franchisor moved to stay the home state litigation pending the outcome of the petition in the selected forum state, and the court granted the stay.¹²⁹

B. CHOICE OF LAW

In analyzing which state's law to apply to an issue, the courts give weight to the parties' choice of law provision in the franchise agreement. In a dispute over the applicability of such a provision, the court will look at the contacts that the transaction and parties have with the state chosen and whether or not a strong public policy of the forum state would be affected by applying the chosen state's laws.

The relationship between choice of law provisions in franchise agreements and the applicability of a state's franchise law where jurisdiction has been triggered was addressed in *America's Favorite Chicken*.¹³⁰ The franchise agreement between the fried chicken restaurant franchisee and its franchisor contained a choice of law provision that stated that Louisiana law applied to the interpretation or construction of the franchise agreement. The court noted that claims under the California Franchise Investment Law did not involve the interpretation or construction of the franchise agreement and, therefore, were not resolved by reference to that provision.¹³¹

This case also addressed the issue of whether Louisiana based suppliers tortiously interfered with contracts by artificially inflating prices of products that the franchisees were required to purchase.¹³² There was a conflict between California law and Louisiana law on this issue. California's law on tortious interference claims was more expansive than that of Louisiana.¹³³ The court found, however, that Louisiana had a more significant relationship to the transaction.¹³⁴ The allegedly tortious conduct occurred there, and Louisiana had an interest in shielding Louisiana corporations, such as the defendant, from unrecognized liability.¹³⁵ This outweighed California's interest in applying its expansive law to protect California franchisees.¹³⁶

128. Bus. Franchise Guide (CCH) ¶ 11,351, at 30,384-85 (N.D. Tex. Mar. 3, 1998).

129. *See id.*

130. 130 F.3d at 182.

131. *See id.*

132. *See id.* at 183.

133. *See id.*

134. *See id.* at 183-84.

135. *See id.* at 184.

136. *See id.*

C. JURISDICTION

A state court has personal jurisdiction over any action brought in its courts if the party's activities comply with the state's long-arm statute and if the exercise of jurisdiction comports with due process. Personal jurisdiction questions arise most often when a franchisor files suit against a franchisee in a place other than the franchisee's state of residence, such as the franchisor's principal place of business. In *Fish v. Tandy Corp.*,¹³⁷ the court concluded that a franchisee could be sued in the franchisor's home state of Texas due to the franchisee's sufficient minimum contacts with Texas. Sufficient contacts included the franchisee's long-running negotiations and numerous direct contacts (personal visits, telephone, mail and facsimile) with the franchisor in Texas. The franchisee visited Texas at least three times to negotiate a distribution agreement that was eventually executed.

D. CLASS ACTIONS

The recent decision in *Meineke*, though not a Texas or Fifth Circuit ruling, seriously restricts franchisee class actions.¹³⁸ In *Meineke*, the Fourth Circuit reversed the trial court's holding and remanded the case to the district court for further proceedings.¹³⁹ The class action suit centered on an advertising fund into which Meineke franchisees paid 10% of their weekly revenues. Plaintiffs, in seeking classwide damage exceeding \$190 million, claimed Meineke improperly disbursed \$32 million from the fund. The jury, after trebling damages under the North Carolina Unfair Trade Practices Act, returned an award against Meineke for \$390 million.¹⁴⁰

In overturning the trial court's decision, the Fourth Circuit pointed out several errors by the trial court. First, with respect to class certification, the Fourth Circuit determined that the disparate nature of the claims among different groups of franchisees could conflict with each other and thus precluded the franchisees' class certifications.¹⁴¹ One conflict arose because, during the pendency of litigation, Meineke offered its franchisees a new franchise package in exchange for release of damage claims, which excluded claims for replenishment of the advertising fund.¹⁴² Half of Meineke's franchisees accepted the new franchise package (termed the EDP package), while the class representatives rejected the package.¹⁴³

The Fourth Circuit determined that there was a serious conflict of interest between the plaintiff class representatives and the EDP franchisees who were part of the class, because "[p]ursuing a damage remedy that

137. 948 S.W.2d 886, 891-96 (Tex. App.—Fort Worth 1997, writ denied).

138. See *Meineke*, 155 F.3d at 352.

139. See *id.*

140. See *id.* at 337.

141. See *id.* at 337-39.

142. See *id.* at 336.

143. See *id.*

was at best irrelevant and at worst antithetical to the long-term interests of a significant segment of the putative class added insult to the injury of abandoning the only remedy in which that segment (the EDP franchisees) was interested."¹⁴⁴ The court further recognized that the conflict could not be cured by permitting the EDP franchisees to opt-out because the trial court had certified a non-opt out class under FED. R. CIV. P. 23(b)(2).¹⁴⁵ Consequently, the EDP franchisees were forced against their will to abandon their only claims for replenishment.¹⁴⁶

The franchisees further failed to satisfy the commonality and typicality requirements of Rule 23(a).¹⁴⁷ Because there were different contracts involved, the court found merit in Meineke's argument that it was permitted to make certain disbursements from the advertising fund.¹⁴⁸ Relying on *Sprague v. General Motors Corp.*,¹⁴⁹ the court held that "the plaintiffs cannot amalgamate multiple contract actions into one;"¹⁵⁰ however, the court did not discuss whether the commonality problem could be cured by creation of subclasses for different groups of contract holders.

Another failure of commonality was the fact that the fraud-related claims depended on non-standardized oral presentations.¹⁵¹ The plaintiffs offered approximately 170 tapes into evidence in an attempt to assert common misrepresentations contained in the UFOC's. The court rejected the assertion because there was no showing that all class members received, read, or relied on them.¹⁵² Furthermore, common law reliance was an individualized issue, depending on the information available to each franchisee from numerous sources.¹⁵³

The final death knell for class certification was the court's determination that damages could not be proven on a classwide basis but, rather, had to be proven on an individualized basis.¹⁵⁴ The plaintiff's expert had developed a classwide formula based on hypothetical averages rather than attempting to compute damages on an individual basis. Such a formula resulted in speculative damage awards. Lost profits can only be computed on an individualized basis.¹⁵⁵

The Fourth Circuit admonished the district court for transforming an ordinary contract dispute into a tort action that allowed a claim under the Unfair Trade Practices Act to piggy-back on a breach of contract claim.¹⁵⁶ In remanding the contract claims against Meineke, the court indicated

144. *Id.* at 339.

145. *See id.* at 338.

146. *See id.* at 339.

147. *See id.* at 340.

148. *See id.*

149. 133 F.3d 388 (6th Cir. 1998).

150. *Meineke*, 155 F.3d at 340.

151. *See id.* at 341.

152. *See id.* at 391.

153. *See id.*

154. *See id.* at 341-42.

155. *See id.*

156. *See id.* at 344-47.

that the franchisees could still seek restitution and lost profits.¹⁵⁷ The court even left open the possibility that "a class action might be used in a carefully controlled manner But in various ways this lawsuit managed to wander way beyond its legitimate origins, and at the end it spun completely out of control, with a diffuse class and proliferating theories of liability."¹⁵⁸ The Fourth Circuit indicated its concern about the effect of such judgments on corporate America by stating that "[i]f we permitted this judgment to stand, commercial disputes and contract law would be transformed—a string of tort claims advanced in a sprawling class action would put many companies—and their corporate parents—out of business."¹⁵⁹

Franchise class actions are often brought on behalf of both past and current franchisees. In *Meineke* the court noted a possible conflict between franchisees that did not materialize because the class representatives (current franchisees) selected a remedy consistent with the interest of former franchisees. Some cases have not permitted a current or past franchisee to represent a class of both current and past franchisees on the basis that there would be a conflict of interest.¹⁶⁰ For instance, the interests of the current franchisees to obtain certain relief from onerous contract clauses and the interests of the past franchisees to obtain a money judgment may conflict. The current franchisees may still have a desire to continue operating their franchises, whereas the past franchisees seek only damages. If such a claim is successful, the franchisor may not be able to continue operating and the current franchisees' interests will not be met.

But, in *E & V Slack, Inc. v. Shell Oil Co.*,¹⁶¹ class certification was denied because former franchisees were deemed to have a conflict of interest with current franchisees and therefore could not act as class representatives. Shell operated a voluntary rent discount program, whereby dealers would receive a discount on their monthly rent proportionate to the amount of gas they sold over a particular level. Plaintiff claimed that Shell, which operated a voluntary discount program based on the amount of gas its dealers sold, subsidized this program by increasing its gasoline prices. The plaintiff contended that the subsidization required greater rent payments than the contract stipulated. Class certification was denied because there were too many issues of fact not common to all class members, making class action treatment an inferior form for litigating the dispute.¹⁶²

The court further determined that named representatives could not fairly and adequately represent the interests of other class members, because the class contained both present and former dealers while the

157. *See id.* at 352.

158. *Id.*

159. *Id.*

160. *See, e.g.,* Plekowski v. Ralston Purina Co., 68 F.R.D. 443, 452 (M.D. Ga. 1975).

161. 969 S.W.2d 565, 571 (Tex. App.—Austin 1998, no pet. h.).

162. *See id.* at 569-70.

named representatives were former dealers only.¹⁶³ As a result, a conflict between the named representatives and present dealers over the goal of the litigation would arise because the named representatives desired to eliminate the rent discount program and many present dealers did not.¹⁶⁴ Furthermore, one of the named representatives presently owned several Chevron stations, which competed directly with Shell. Thus, while all of the present dealers had a reason to protect Shell's corporate goodwill, this named representative had an interest in damaging Shell's goodwill.¹⁶⁵

In *H&R Block, Inc. v. Haese*,¹⁶⁶ the class claimed that Block failed to disclose payments that it received from lenders in exchange for arranging loans in amounts of the clients' anticipated tax refunds. The class claimed that this practice constituted a breach of fiduciary duty and an unconscionable business practice under the DTPA. The court affirmed the class certification decision because the requirements for class certification were met, certification was not erroneous, and certification did not compromise Block's rights.¹⁶⁷

Texas franchisors continue to have success against liability claims under the Americans with Disabilities Act (ADA).¹⁶⁸ After trying to apply the ADA in the fast food franchise context, courts attempted to impose ADA liability in the hotel franchise context. For example, in *United States v. Days Inns of America, Inc.*,¹⁶⁹ the court rejected the government's attempt to impose ADA liability based upon the franchisor's control over the standards in the franchise agreement and the operations manual. Furthermore, the court concluded that a franchisor would not be deemed an "operator" under the ADA.¹⁷⁰

In *Cortez v. National Basketball Association*,¹⁷¹ an advocacy group for hearing impaired plaintiffs sued the National Basketball Association, as franchisor, the San Antonio Spurs, as franchisee, and the owner of the Alamodome seeking an injunction requiring captioning services as a reasonable accommodation at NBA games. The court recognized that a franchisor could be held liable under the ADA if it operates a public place of accommodation.¹⁷² The key issue was whether the NBA specifically controlled the franchise's modifications to improve accessibility for the disabled. The court determined that the NBA was not subject to the ADA as a franchisor-operator because the guidelines on which the plain-

163. See *id.* at 568-69.

164. See *id.*

165. See *id.*

166. 976 S.W.2d 237 (Tex. App.—Corpus Christi, 1998, no pet. h.).

167. See *id.* at 240-41.

168. See *Neff v. American Dairy Queen Corp.*, 58 F.3d 1063 (5th Cir. 1995); *Alonzo v. American Dairy Queen Corp.*, Bus. Franchise Guide (CCH) ¶10,563, at 26,198 (S.D. Tex. Oct. 26, 1994); *Young v. American Dairy Queen Corp.*, No. 5:93-CV-253-C, 1994 U.S. Dist. LEXIS 16909, Bus. Franchise Guide (CCH) ¶ 10,542, at 26,108 (N.D. Tex. June 22, 1994).

169. No. 96-5012, 1997 U.S. Dist. LEXIS 22947, at *9-11, Bus. Franchise Guide (CCH) ¶ 11,323, at 30,232-33 (D. S.D. Oct. 29, 1997).

170. See *id.* at *11.

171. 960 F. Supp. 113 (S.D. Tex. 1997).

172. See *id.* at 115.

tiffs relied did not support their theory that the NBA operated the facility.¹⁷³

E. ANTITRUST

Following the Supreme Court's decision in *Eastman Kodak Co. v. Image Technical Services, Inc.*,¹⁷⁴ substantial litigation has arisen regarding franchising practices that require a franchisee to utilize specific supplies or sources. Whether an antitrust case in this context will be successful seems to depend on whether the franchisor's supply arrangements were disclosed pre-contract or implemented as a post-contractual restriction.

In *Queen City Pizza v. Domino's Pizza*¹⁷⁵ Domino's, the franchisor, expressly retained the right to require all ingredients and materials to be purchased "exclusively from [Domino's] or from approved suppliers or distributors." Domino's later decided to exercise this contract clause. Its franchisees alleged that it was not foreseeable that Domino's would unreasonably interfere with their attempts to find alternative supply sources. The franchisees' claims of tying were twofold: (1) Domino's imposed an unlawful tying arrangement by requiring franchisees to buy ingredients and supplies from them as a condition of obtaining fresh dough; and (2) Domino's imposed an unlawful tying arrangement by requiring franchisees to buy ingredients and supplies as a condition of their continued enjoyment of rights and services under the franchise agreement.

The Third Circuit affirmed the district court's dismissal of both claims urged by the franchisees.¹⁷⁶ By focusing on the pre-contract stage as the relevant period for market power analysis, the court concluded Domino's economic power did not result from the unique nature of its products or its market share in the fast food franchise business, but instead, its economic power stemmed from the franchise agreement.¹⁷⁷ The court pointed out that the supplies used by Domino's stores were interchangeable with those available from other suppliers and used by other pizza companies.¹⁷⁸ The fact that the franchisees during the pre-contract stage had the capacity to assess and evaluate the potential costs and risks from the approved supplier clause distinguishes this case from *Kodak*.¹⁷⁹

In *Wilson v. Mobil Oil Corp.*,¹⁸⁰ (*Wilson I*), franchisees gained a short lived victory for application of the *Kodak* analysis of relevant markets in the franchise context. In *Wilson I*, a franchisee alleged that Speedee Oil Change Systems, the franchisor, created an unlawful tying arrangement by requiring franchisees to purchase Mobil's higher priced products. The

173. *See id.* at 117.

174. 504 U.S. 451 (1992).

175. 124 F.3d 430, 433 (3d Cir. 1997).

176. *See id.* at 444.

177. *See id.* at 439-40.

178. *See id.*

179. *See id.*

180. 940 F. Supp. 944, 953-54 (E.D. La. 1996), *modified*, 984 F. Supp. 450, 459 (E.D. La. 1997).

Wilson I court would not limit the market analysis to the pre-contract stage because the complaint and evidence were not clear on the extent of pre-contract disclosures.¹⁸¹ The court refused to allow a general contention that tie-ins disclosed at the outset of a franchise relationship are not actionable, especially if the franchisee did not have enough information to ascertain the life cycle pricing of a long-term exclusive supply requirement.¹⁸²

One year later in *Wilson v. Mobil Oil Corp.*,¹⁸³ (*Wilson II*), the same court, upon developing the record more thoroughly, characterized the case as an "up front tie-in" and recognized that growing circuit authority consistently finds that advance disclosure of the tying arrangement prevents the purchaser from being locked in. Although *Wilson II* appears to recognize the application of pre-contractual disclosure as a means to avoid tie-ins, the court did not eliminate the possibility of employing a *Kodak* analysis where the pre-contractual disclosure is deemed incomplete.¹⁸⁴

V. REMEDIES

A. FRANCHISEE'S REMEDIES

Franchisees generally have a private right of action with remedies ranging from actual damages, attorneys' fees, injunctive relief, rescission and, in cases where fraudulent inducement can be established, tort damages. Before lost profits may be awarded, the franchisee must establish that the injury suffered was caused by the franchisor's wrongful conduct. Where a franchisor is unable to establish this causal connection, dismissal of the claim will often follow.¹⁸⁵

In *Yankee Enterprises, Inc. v. Dunkin' Donuts, Inc.*,¹⁸⁶ a franchisee alleged the franchisor's failure to maintain high quality and uniform standards throughout its system resulted in damages. The jury found for the franchisee for breach of contract and violations of the Texas DTPA.¹⁸⁷ The court set aside the jury's verdict as based on conjecture and surmise.¹⁸⁸ In its decision to set aside the jury verdict, the court recognized that the franchisee's expert failed to account for other factors that could have led to poor sales in the franchisee's region.¹⁸⁹ Furthermore, the testimony of another franchisee, detailing poor quality standards at one store that resulted in customers applying those same attributes to

181. *See id.* at 952-54.

182. *See id.* at 953-54.

183. 984 F. Supp. 450, 459 (E.D. La. 1997).

184. *See id.* at 460-61.

185. *See* *Subway Restaurants, Inc. v. Kessler*, 931 P.2d 1270, Bus. Franchise Guide (CCH) ¶ 11,109, at 29,143 & 29,146-47 (Kan. Ct. App. Feb. 21, 1997) (unpublished table decision).

186. Bus. Franchise Guide (CCH) at 29,691.

187. *See id.* at 29,692.

188. *See id.* at 29,693.

189. *See id.*

other stores in the system, was not supported by adequate proof.¹⁹⁰ Thus, the claims failed because the franchisee failed to prove causation.

It is not uncommon for shareholders of a franchised entity to seek recovery of damages for harm to the franchise. In *Cottingham v. General Motors*,¹⁹¹ the court denied franchisee shareholders and employees of the dealer standing to bring claims arising from the dealership agreement.

B. FRANCHISOR'S REMEDIES

1. Liquidated Damages

Many franchise agreements stipulate that a franchisor may recover liquidated damages for a franchisee's breach of contract. These liquidated damages clauses are generally enforceable, unless they are proven to be a penalty provision.¹⁹²

Under Texas law, a liquidated damages provision is enforceable if such a clause constitutes "a reasonable forecast of the amount necessary to render just compensation" and if the anticipated breach was "difficult or impossible to estimate" at the time of contract formation.¹⁹³ A liquidated damages clause will be considered unenforceable only when it operates as a penalty or is "disproportionate to actual damages" at the time of breach.¹⁹⁴ Indeed, Texas courts look favorably upon provisions in agreements which fix specified amounts of damages—that is "liquidated damages"—in the event of breach.¹⁹⁵

Though no current Texas or Fifth Circuit cases address the availability of liquidated damages in franchise cases, courts in other jurisdictions routinely enforce liquidated damage provisions in franchise agreements.¹⁹⁶ These decisions hold that liquidated damages provisions are enforceable because of the inherent difficulty and impossibility of accurately estimating actual damages.¹⁹⁷

2. Post-Termination Remedies for Use of Franchisor's Intellectual Property

Termination does not necessarily mark the end of the franchisor/franchisee relationship. As is often the case, an involuntarily terminated fran-

190. *See id.*

191. 119 F.3d 373, 375 (5th Cir. 1997).

192. *See* *Thanksgiving Tower Partners v. Anros Thanksgiving Partners*, 64 F.3d 227 (5th Cir. 1995).

193. *See id.* at 232. *See also*, *Phillips v. Phillips*, 820 S.W.2d 785, 788 (Tex. 1991); *R. Conrad Moore & Assocs. v. Lerma*, 946 S.W.2d 90, 95 (Tex. App.—El Paso 1997, no writ).

194. *See* *Baker v. International Record Syndicate*, 812 S.W.2d 53, 55 (Tex. App.—Dallas 1991, no writ); *Thanksgiving Tower*, 64 F.3d at 232.

195. *See, e.g.*, *Murphy v. Cintas Corp.*, 923 S.W.2d 663 (Tex. App.—Tyler 1996, writ denied).

196. *See, e.g.*, *Downtowner/Passport Int'l Hotel Corp. v. Norlew, Inc.*, 841 F.2d 214, 218 (8th Cir. 1988); *Ramada Inns, Inc. v. Gadsen Motel Co.*, 804 F.2d 1562, 1566 (11th Cir. 1986); *Ramada Franchise Sys. v. Motor Inn Inv. Corp.*, 755 F. Supp. 1570, 1578 (S.D. Ga. 1991).

197. *See* *Ramada Franchise Sys.*, 755 F. Supp. at 1577-78.

chisee may refuse to remove signage, promotional materials or other items which identify the franchisee with the franchise system. To avoid public confusion and dilution of the franchisor's marks, the injunction remedy is extremely important.¹⁹⁸ The Lanham Act provides the federal statutory foundation for injunctions against terminated franchisees.¹⁹⁹ Three potential claims are available to a franchisor under the Lanham Act when there is a continued, unauthorized use of its marks. Under section 32(1) the commercial use of a registered mark "is likely to cause confusion, or to cause mistake or to deceive" and is "without consent of the registrant" will form the basis for a Lanham Act claim.²⁰⁰ On the other hand, section 43(a) protects both registered and unregistered marks and makes unlawful "false designation of origin, false or misleading description of fact, or false or misleading representation of fact, (a) [that] is likely to cause confusion or to cause mistake or to deceive as to . . . origin, sponsorship or approval of" goods or services.²⁰¹ Finally, section 43(c) prohibits a party from using and "diluting" the quality of another party's famous and distinctive marks.²⁰²

198. The intent of the Lanham Act is to:

regulate commerce within the control of Congress by making actionable the deceptive and misleading use of marks in such commerce: . . . to protect persons engaged in such commerce against unfair competition; . . . to prevent fraud and deception in such commerce by the use of reproductions, copies, counterfeits, or colorable imitations of registered marks.

15 U.S.C. § 1127 (1998). *See also* *Ocean Garden v. Marktrade Co.*, 953 F.2d 500, 503 (9th Cir. 1991).

199. The Lanham Act expressly provides for injunctive relief to prevent infringement. 15 U.S.C. § 1116(a) (1998); *see also* *Century 21 Real Estate Corp. v. Sandlin*, 846 F.2d 1175, 1180 (9th Cir. 1988) ("[I]njunctive relief is the remedy of choice for trademark and unfair competition cases, since there is no adequate remedy at law for the injury caused by a [franchisee's] continuing infringement.").

200. 15 U.S.C. § 1114(1)(a). The pertinent part of section 32 provides that:

(1) any person who shall, without the consent of the registrant -
 (a) use in commerce any reproduction, counterfeit, copy, or colorable imitation of a registered mark in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive . . . shall be liable in a civil action by the registrant. . .

Id.

201. 15 U.S.C. § 1125(a)(1). Section 43(a) provides, in part, as follows:

(1) [A]ny person who, on or in connection with any goods or services . . . uses in commerce any word, term, name, symbol or device . . . or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact which

(A) is likely to . . . deceive as to the affiliation, connection or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person . . .

shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.

Id.

As for unregistered marks, *see* *Controls Int'l, Inc. v. Kinetrol, Ltd.*, 1998 U.S. Dist. LEXIS 4794, at *9 (N.D. Tex. Mar. 25, 1998).

202. 15 U.S.C. § 1125(c). Section 43(c) provides, in part, the following:

(c) Remedies for dilution of famous marks

To obtain a preliminary injunction, many courts require a franchisor to establish the following elements of the so-called "traditional" test: (1) there is a substantial likelihood that the franchisor will prevail on the merits; (2) the franchisor will suffer irreparable injury if the injunction is not granted; (3) the injury to the franchisor greatly outweighs any injury the franchisee may suffer under the injunction; and (4) an injunction would not be adverse to the public interest.²⁰³ Other courts may apply an "alternative" test wherein the injunction may issue if the moving party demonstrates either: (1) a combination of probable success on the merits and the possibility of irreparable injury or (2) that serious questions are raised and the balance of hardships tips sharply in the movant's favor.²⁰⁴

Recent decisions indicate the importance of preliminary injunctions as a procedural tool to combat trademark infringement and unfair competitions. In *Paisa, Inc. v. N&G Auto, Inc.*,²⁰⁵ a terminated franchisee was enjoined from using the franchisor's registered trademarks. The franchisee was also enjoined from using the franchisor's confidential or proprietary business information, order forms or other materials bearing trademarks and/or tradenames.²⁰⁶

In *Pappan Enterprises*,²⁰⁷ the Third Circuit reversed a district court's denial of preliminary injunction a franchisor sought. The franchisee argued that the franchisor's reduction in the number of franchisees demonstrated a lack of interest in the franchise system. The circuit court rejected this argument and noted that "[c]ourts have recognized that a trademark owner's decision to reduce the size of its business or to cease operations alone does not undermine the owner's legal right to enforce and protect its trademark."²⁰⁸

The owner of a famous mark shall be entitled, subject to the principles of equity and upon such terms as the court deems reasonable, to an injunction against another person's commercial use in commerce of a mark or trade name, if such use begins after the mark has become famous and causes dilution of the distinctive quality of the mark, and to obtain such other relief as is provided in this subsection.

Id.

203. See *Pappan Enters. v. Hardee's Food Sys., Inc.*, 143 F.3d 800, 803 (3d Cir. 1998); *Vision Ctr. v. Opticks, Inc.*, 596 F.2d 111, 114 (5th Cir. 1979).

204. See *First Brands Corp. v. Fred Meyer, Inc.*, 809 F.2d 1378, 1381 (9th Cir. 1987).

205. 928 F. Supp. 1009, 1013-14 (C.D. Cal. 1996).

206. See *id.* at 1014.

207. 143 F.3d at 802.

208. *Id.* at 806.