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## Franchise Law

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# FRANCHISE LAW

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## I. INTRODUCTION

**T**HIS 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. FRANCHISE BASICS

### A. WHAT IS A FRANCHISE

A franchise is a contractual relationship consisting 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 power over, or provide significant assistance to, the franchisee in the operation of its business. This black letter definition, however, cannot define the entirety of the relationship as was recognized by the Seventh Circuit when it stated "[l]egal terms often have specialized meanings that can surprise even a sophisticated party. The term 'franchise,' or its derivative 'franchisee,' is one of those words."<sup>1</sup> Given the evolving relationship between parties in the franchise context, the decisions provided below offer valuable insight into the specialized meanings provided by franchise law.

### B. THE FTC RULE

Pursuant to the Federal Trade Commission ("FTC") regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchis-

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1. *To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc.*, 152 F.3d 658, 659-60 (7th Cir. 1998).

ing and Business Opportunity Ventures” (the Disclosure Rule), the FTC promulgated presale disclosure requirements for franchisors and certain business opportunity ventures.<sup>2</sup> The Disclosure Rule requires disclosure, but not registration, in connection with the offer and sale of franchises in the United States. This disclosure requirement is accomplished through a franchisor’s 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 in deceptive practices.

Most recently, the FTC has proposed several changes to its disclosure requirement, posting a Notice of Proposed Rulemaking (NPR) to its website on October 22, 1999.<sup>3</sup> The NPR is designed to modernize the franchise rule’s presale disclosure mandates by taking into account the dramatic growth of franchising, the increased size and sophistication of many franchisees, the desire of prospective franchisees to obtain more relevant information and the vast technological changes of the past two decades. The FTC proposal will scrap its present UFOC format and will require several new disclosures and significant modifications to existing disclosure obligations. The FTC would also put an end to the current controversy concerning extraterritorial application of the Franchise Rule by clearly stating its application only to domestic sales and transactions.<sup>4</sup> The proposed revisions would also allow franchisors to deliver disclosure documents electronically. This is a significant change from the previous rule which required exchange of paper documents and the franchisee’s manual signature as evidence of receipt the documents. Furthermore, the FTC would eliminate the “first personal meeting” disclosure trigger which requires a franchisor to give the disclosure document to its prospective franchisee at the first substantive face-to-face meeting between the parties. The only requirement under the new rules would be that the prospective franchisee have the disclosure document in its hand at least fourteen business days before signing any franchise agreement or paying any money to the franchisor.<sup>5</sup>

Congressman Howard Coble introduced H.B. 3308 on November 10, 1999, a revised version of the “Small Business Franchise Act of 1999.”

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2. See 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).

3. See Franchise Rule, 64 Fed. Reg. 57, 293 (1999) (to be codified at 16 C.F.R. pt. 436) (proposed Oct. 22, 1999).

4. See *Nieman v. Dryclean U.S.A. Franchise Co.*, Bus. Franchise Guide (CCH) ¶ 11,166 (S.D. Fla. Mar. 26, 1997).

5. See Franchise Rule, 64 Fed. Reg. 57, 293 (1999) (to be codified at 16 C.F.R. pt. 436) (proposed Oct. 22, 1999).

### III. MARKETING THE FRANCHISE RELATIONSHIP

#### A. MISREPRESENTATION

The FTC's primary means of enforcing its powers is contained in section 5 of the Federal Trade Commission Act (the "FTCA") which provides that "[u]nfair methods of competition in or affecting commerce, and unfair deceptive acts or practices in or affecting commerce, are declared unlawful."<sup>6</sup> To establish a violation of section 5, the FTC must prove (1) a reasonably prudent person would rely on the deceptive advertisements, practices or representations; (2) the advertisements, practices or representations were widely disseminated; and (3) consumers purchased the product.<sup>7</sup> Furthermore, the omission of material information, whether or not a misrepresentation, may also constitute a violation of section 5.<sup>8</sup> More importantly, liability under section 5 may be found against a corporation even when based upon the actions of an individual. This will result when the individual either has (1) directly participated in the violative action; (2) played a part in controlling, directing or formulating the policies and practices of the company which violate section 5; or (3) has the authority to control the actions of other individuals combined with the actual or constructive knowledge that those individuals were committing misrepresentations.<sup>9</sup>

Furthermore, the FTC may utilize the Disclosure Rule to punish franchisors for disclosure violations.<sup>10</sup> The Disclosure Rule requires franchisors to provide prospective franchisees, prior to the sale of the franchise, a detailed disclosure stating (1) the franchisor's corporate history, (2) the franchisor's financial condition, (3) the track record of other franchisees, and (4) the background of the franchisor's principal officers.<sup>11</sup> In establishing a violation, the FTC must demonstrate that the franchise sales were subject to the Rule and that the violations of the Disclosure Rule were made knowingly.<sup>12</sup> Franchise sales will be subject to the Disclosure Rule if: (1) the franchisee grants or promises the right to distribute goods or services which bear the franchisor's trademark, tradename, advertising or other commercial symbol; (2) that franchisor exerts or has the right to exert significant control over the franchisee's method of operation or the franchisor promises to provide the franchisee significant assistance in the franchisee's operation; and (3) as a condition to obtain or begin the franchise relationship, the franchisee must pay or commit to pay at least \$500 to the franchisor or the franchisor's affiliate at any time before or within six months after the franchise business

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6. 15 U.S.C. § 45 (2000).

7. *See id.*

8. *See id.*

9. *See* Federal Trade Comm'n v. P.M.C.S., Inc., 21 F. Supp.2d 187, 191 (E.D. N.Y. 1998).

10. *See* 16 C.F.R. § 136 (2000).

11. *See id.*

12. *See id.*

begins.<sup>13</sup>

The following cases provide guidance for Texas practitioners in determining the type of disclosure that the FTC Disclosure Rule requires and establish the lengths the FTC may go to enforce its powers. In *FTC v. Inetintl. Com, Inc.*,<sup>14</sup> the founder of an Internet-based company had a warrant issued for his arrest following a ruling on the FTC's charges of false earnings claims and inadequate disclosures. The Court's ruling permanently barred the company, its founders, and a division marketing director from participating in the sale of any business venture, franchise, or investment opportunity and ordered \$1,760,000 in consumer redress.<sup>15</sup> The FTC originally claimed that the defendants engaged in repeated false and unsubstantiated earnings claims, failed to provide disclosure documents, and resorted to the use of actors, posing as "satisfied franchisees," to corroborate the claims.<sup>16</sup>

In *FTC v. iMALL, Inc.*,<sup>17</sup> a marketing company and its principal sold Internet consulting businesses to consumers through infomercials, seminars, radio commercials, direct mailings and promotional audio and video cassettes. In these presentations, investors were offered the opportunity to purchase their own web page or advertising space on iMALL's Internet site. The FTC claimed that iMALL made false earnings claims and failed to provide complete and accurate disclosure documents to potential purchasers. The FTC negotiated a settlement with iMALL and two of its former principals, forcing them to pay \$4,000,000 for violation of the FTCA and Disclosure Rule. In addition to the fine, the parties were enjoined from participating in the advertising, promotion, or sale of any Internet-related business opportunity to pay-per-call service for ten years after entry of the stipulated judgment.

In *United States v. Oliver*,<sup>18</sup> the FTC alleged that Oliver induced potential franchisees to purchase franchises by falsely implying that his business was affiliated with the federal government. The FTC further alleged that Oliver failed to provide purchasers with basic disclosure documents required by the Disclosure Rule. The FTC successfully stopped Oliver's business of promoting Consumer Protection Agency franchises over the Internet and forced Oliver to agree to a stipulated judgment permanently barring him from claiming affiliation with any government entity. In addition, Oliver was required to create business records for any company he controls and retain those records for a period of five years after the company's creation.

In *Federal Trade Commission v. P.M.C.S., Inc.*, the FTC alleged that the defendants misrepresented to prospective purchasers (1) the amount of profits they could earn, (2) the demand for electronic medical billing

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13. *See id.*

14. Bus. Franchise Guide (CCH) § 11,659 (C.D. Cal. Mar. 29, 1999).

15. *See id.*

16. *See id.*

17. Bus. Franchise Guide (CCH) ¶ 11,624 (C.D. Ca. Apr. 15, 1999).

18. Bus. Franchise Guide (CCH) ¶ 11,549 (N.D. Fla. Dec. 1, 1998).

services, and (3) the amount of support they would provide to franchisees in the operation of their business.<sup>19</sup> P.M.C.S. is a New York based company that sold business opportunity packages containing software that could be purchased at retail for \$69 for fees ranging between \$6,000 and \$7,500.<sup>20</sup> Aqua Marketing Group, Inc., a Nevada corporation and its sole shareholder, agreed to serve as the exclusive provider of marketing services for P.M.C.S. and the business opportunities it sold. As part of this arrangement, Aqua hired and trained independent sales representatives to sell the business opportunities and distribute advertising and promotional materials. The FTC filed a Motion for Summary Judgment in the case which was denied by the Court on a finding that sufficient issues of material fact existed. The Court appeared unwilling to grant summary judgment against Aqua and its sole shareholder because it was unclear the extent to which they participated in the alleged violations of the FTCA and FTC Franchise Rule, the extent of consumer injury caused by any violations, their knowledge of P.M.C.S.'s activities, and the extent to which the shareholder controller had authority to control Aqua.<sup>21</sup>

In *FTC v. Minuteman Press, et al.*,<sup>22</sup> the FTC alleged that a franchisor and its affiliate engaged in deceptive and unfair practices in violation of section 5A of the FTCA. The FTC further alleged that the defendants violated the disclosure requirements of the Disclosure Rule. After submission of evidence, the Court concluded that the franchisor did make false claims regarding gross sales and profitability, failed to provide the required documentation for those representations, and failed to disclose transfer and training fees as required by law.<sup>23</sup> Interestingly, after the Court established corporate liability, it then held the individual defendants jointly and severally liable for their participation in and/or their authorization of the Deceptive Practices. Furthermore, pursuant to section 13B of the FTCA the Court granted permanent injunctive relief and concluded that monetary damages and consumer redress would be appropriate. The defendants had argued that written contractual disclaimers displaced any prior contrary oral representations. The Court concluded that "a reasonable consumer could legitimately conclude that he or she was being furnished important specific earnings information . . . to assist in the decision-making process notwithstanding the general disclaimers . . . ."<sup>24</sup> The case suggests not only that written contractual disclaimers will be overlooked, but also that individual defendants will be held liable regardless of corporate status.

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19. 21 F. Supp.2d 187, 190 (E.D. N.Y. 1998).

20. *See id.* at 189.

21. *See id.* at 192.

22. Bus. Franchise Guide (CCH) ¶ 11,516 (E.D. N.Y. Oct. 2, 1998).

23. *See id.*

24. *Id.* at 31,263.

## B. DISCLOSURE

On March 17, 1999, the North American Securities Administrators Association ("NASAA") released its new disclosure requirement declaring that franchisors must disclose potential Y2K problems under the Uniform Franchise Offering Circular Guidelines.<sup>25</sup> These NASAA guidelines require franchisors to "disclose information about any computer systems a franchisee is required to purchase or update" and encourages the disclosure of potential Y2K problems in dealing with suppliers, financial institutions, and landlords.<sup>26</sup> Where franchisors fail to disclose the information listed above, they may face potential lawsuits from franchisee and even actions by government authorities.

## C. EXEMPTIONS FROM THE FRANCHISE RULE

Proof that exemptions can be granted by the FTC is found in *In re Navistar Transportation Corp.*<sup>27</sup> In this case, the FTC granted a truck manufacturer an exemption from the Franchise Rule which required franchisors to provide information to investors. The FTC conceded that the franchise rule is designed to prevent abuses in instances where potential investors are inexperienced and unsophisticated, have inadequate time to review and digest franchise agreements terms, and are at a significant information imbalance which makes them unable to gather adequate information.<sup>28</sup> Navistar demonstrated to the FTC that its dealers were a select group of highly sophisticated and experienced business people who had more than adequate time to consider the dealership offer and obtain information about it before investing. Given the sophistication of the potential investors, the FTC granted Navistar an exemption.

## D. FTC ENFORCEMENT POWERS

As discussed earlier, under section 5(a) of the FTCA, 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.<sup>29</sup> The following cases demonstrate the FTC's enforcement powers.

In *Oklahoma Department of Securities v. AdmaxNets International Corp.*,<sup>30</sup> the State of Oklahoma was granted a temporary restraining order, temporary injunction and the appointment of a receiver for the defendant's company because the Court concluded that AdmaxNets ran afoul of Oklahoma's Business Opportunity Sales Act. The Court's restraining orders prohibited AdmaxNets from violating section 806 of the Oklahoma Business Opportunity Sales Act by offering or selling business

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25. NASAA Release Regarding Y2K Disclosures, Bus. Franchise Guide (CCH) ¶ 11,625 (Mar. 17, 1999).

26. *Id.*

27. Bus. Franchise Guide (CCH) ¶ 11,558 (F.T.C. Nov. 23, 1998).

28. *See id.*

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

30. Bus. Franchise Guide (CCH) ¶ 11,469 (D. Okla. June 24, 1998).

opportunities without being registered in the state; from violating section 819(2) of the Act by making misstatements or omitting material facts from statements; and from violating section 819(3) of the Act in engaging in behavior that defrauded people in connection with the offer or sale of opportunities in Oklahoma.<sup>31</sup> As a result, AdmaxNets was forbidden to conceal or dispose of any assets it owned or possessed and the receiver was appointed for the specific purpose of accepting and accounting for the company's funds in the event of later litigation or prosecution.

In *Lang, Lang & Suhor Investors, L.L.C. v. The American Bagel Co.*,<sup>32</sup> American Bagel franchisees in Ohio brought suit against the franchisor and the owners of Restaurant Development Company ("RDC"), a marketing company hired by American Bagel to market its franchises. In their lawsuit, the franchisee plaintiffs claimed that the defendants misrepresented the earnings and profitability of the Chesapeake Bagel Bakery franchise, that the plaintiffs relied on these misrepresentations and that this behavior constituted fraud and violation of the Ohio Business Opportunity Purchaser's Protection Act. The franchisees further alleged that the defendants breached their contracts by failing to provide adequate support to the plaintiffs. American Bagel and RDC moved for summary judgment and filed a counterclaim for damages arising out of the termination of the franchise agreement. Defendants obtained a substantial victory when the Court granted their motions for summary judgment and denied the plaintiff franchisees' motion for summary judgment on the counterclaim. The Court concluded that the plaintiffs were under a duty to conduct an independent investigation of the profitability of the Chesapeake Bagel Bakery franchise and as such could not have reasonably relied on information regarding sales and cost history provided by the franchisor.<sup>33</sup> Furthermore, because the plaintiffs admitted to reading the UFOC, their claims of oral misrepresentation by RDC were wholly against the express language provided in the UFOC stating that the franchisor "does not furnish or authorize its salespersons to furnish any oral or written information concerning the actual or potential sales, costs, income or profits of a Chesapeake Bagel Bakery."<sup>34</sup>

In *FTC v. AmeraPress, Inc.*,<sup>35</sup> the FTC filed an action against three corporations which operated joint enterprises to sell business opportunities involving the sale of calendars, business cards and trading cards. In its complaint, the FTC alleged that the defendants represented to consumers that they could earn between \$20,000 and \$200,000 per year by investing in the business opportunities.<sup>36</sup> According to the FTC, these representations were in violation of the FTCA since purchasers of the business opportunities often did not come close to the earnings potential

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31. *See id.*

32. Bus. Franchise Guide (CCH) ¶ 11,447 (D. Md. Apr. 29, 1998).

33. *See id.*

34. *Id.*

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

36. *See id.*

promised by the defendants.<sup>37</sup> The FTC sought consumer redress, injunctive relief, litigation costs and other relief the Court deemed proper.

Likewise, in *FTC v. Summit Photographix*,<sup>38</sup> the FTC filed an action against a corporation, two of its owners and two of its officers alleging practices similar to those complained of in *AmeraPress*. In addition to the unlawful claims pertaining to earnings, the FTC also claimed that the defendants made misrepresentations regarding the exclusivity of the territory the purchasers were granted.<sup>39</sup> The FTC sought similar relief as well.

In *United States v. QX International, Inc.*,<sup>40</sup> the FTC filed an action against a seller of display rack distributorships for automobile engine lubricants. The FTC alleged that the defendant failed to provide purchasers the complete and accurate disclosure documents and that the defendant misrepresented (1) the level of earnings purchasers could expect to derive, (2) information pertaining to the company's selected references, (3) exclusivity of territory granted, (4) the reliability of location companies, and (5) the amount of assistance in advertising assistance that the purchasers would receive.<sup>41</sup>

#### IV. THE FRANCHISE RELATIONSHIP

##### A. TERMINATIONS AND NON-RENEWAL

###### 1. *Non-Statutory Termination*

A common requirement for termination or non-renewal of a franchise agreement is that the franchisor give appropriate notice. Failure to give proper notice may render a termination wrongful. For example, in *University Motors Ltd. v. General Motors Corp.*<sup>42</sup> in a not-for-publication *per curiam* opinion, the Fourth Circuit in an affirmed a district court's order enjoining termination of an automobile dealership and requiring General Motors to pay the plaintiff's legal fees. The district court concluded that GM, as a matter of law, had failed to provide sufficient notice and lacked good cause for its attempted termination.<sup>43</sup> West Virginia's Motor Vehicle Dealer Franchise statute required notice of termination to be served by certified mail. GM's termination letter was hand delivered. After the dealer sued, GM sent notice by certified mail. The court found that the later notice was insufficient to cure the deficiency in the manner of delivery because the statute lacked any provision authorizing supplemental notice.<sup>44</sup>

The district court also found that GM lacked good cause for termina-

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37. *See id.*

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

39. *See id.*

40. Bus. Franchise Guide (CCH) ¶ 11,354 (N.D. Tex. Feb. 20, 1998).

41. *See id.*

42. No. 97-2612, 98-1811, 1999 WL 11270 (4th Cir. Jan. 13, 1999).

43. *See id.*

44. *See id.* at \*2

tion of the franchise.<sup>45</sup> The bases for GM's termination were the dealer's failure to obtain permission to carry a Nissan line and other unspecified deficiencies in sales, service, and working capital. However, under the West Virginia statute, good cause for termination required proper notice and 180 days to cure. Because GM had given inadequate notice and had allowed only a 90-day cure period, the Fourth Circuit affirmed the district court's judgment granting a permanent injunction against GM.<sup>46</sup>

In contrast, good cause for termination was found in *Thacker v. Gymboree Corp.*<sup>47</sup> The California court held that a franchise agreement authorized termination of a franchisee who: (1) offered unauthorized programs; (2) incurred excessive customer complaints; and (3) engaged in conduct which reflected "materially and unfavorably upon the operation of the franchise business."<sup>48</sup> The Gymboree franchisee had instituted "drop-off" and "combined-age programs" that essentially turned the children's gymnastic franchise into a babysitting service. Citing concerns about safety and quality of instruction and the large number of customer complaints, the franchisor gave notice of termination. The court found that even after notice and an opportunity to cure, the franchisee continued to offer unauthorized programs involving serious safety and insurance issues, offered drop-off babysitting programs in an unsafe environment, combined ages and classes, and received excessive customer complaints, justifying termination.<sup>49</sup>

Wrongful termination cases do not always arise in the context of a franchisee seeking injunctive relief to prevent an impending termination. They also arise in the context of a franchisor's claims for trademark infringement by a franchisee continuing to use the franchisor's marks after the franchise has been terminated. To obtain an injunction for trademark infringement by a terminated franchisee, a franchisor must first establish that it had a legal right to terminate the franchise. In *McDonald's Corp. v. Robertson*,<sup>50</sup> the Eleventh Circuit affirmed a district court's grant of preliminary relief enjoining a terminated franchisee's continued use of the McDonald's trademark. The franchise agreement required the Robertsons to operate in accordance with quality, safety, and cleanliness ("QSC") standards and allowed McDonald's to terminate the contract if they failed to do so. On several occasions in 1995 and 1996, McDonald's conducted audits of the Robertsons' restaurants and found non-compliance with QSC standards. On each occasion, McDonald's advised the Robertsons of the deficiencies and recommended corrective action. In 1996, McDonald's advised the Robertsons that McDonald's had purchased property one block from their restaurant to build a new restaurant and offered the Robertsons the new location. Because of increased rent

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45. *See id.*

46. *See id.*

47. Bus. Franchise Guide (CCH) ¶ 11,623 (Cal. Super. Sept. 23, 1998).

48. *See id.*

49. *See id.*

50. 147 F.3d 1301 (11th Cir. 1998).

and service fees applicable to the new franchise, the Robertsons declined. McDonald's offered an income guarantee at the new location. The Robertsons declined. McDonald's offered to purchase the Robertsons' franchise. Again, the Robertsons refused. In the spring of 1997, McDonald's conducted two more inspections of the restaurant. These audits disclosed many of the same deficiencies uncovered during earlier audits. The Robertsons failed to provide McDonald's with a plan to cure the deficiencies. McDonald's then delivered a notice of default containing a cure period of 60 days. During the 60-day cure period, the Robertsons failed two more audits. McDonald's sent the Robertsons a notice of termination. The Robertsons refused to surrender the premises and continued to operate the restaurant as a McDonald's using various trade names and trademarks registered to McDonald's. McDonald's sued for trademark infringement and asked for a preliminary injunction. The district court enjoined the Robertsons.<sup>51</sup>

In a question of first impression, the Eleventh Circuit followed the Third Circuit holding that, to prevail on the merits of a trademark infringement claim against a franchisee, a franchisor must show that he properly terminated the contract purporting to authorize the trademark's use.<sup>52</sup> Thus, in order to obtain an injunction, McDonald's had to show that it properly terminated the Robertsons' franchise agreement. The Robertsons claimed that the QSC failures were merely pretextual because McDonald's wanted to make more money by moving the Robertsons' McDonald's to another location. The Eleventh Circuit found that, even if this allegation were correct, the Robertsons' failure to comply with McDonald's QSC and food safety standards constituted a material breach of the franchise agreement sufficient to justify termination, and thus, it did not matter whether McDonald's also possessed an ulterior, improper motive for termination.<sup>53</sup>

The New Jersey Court of Appeals relied on *Robertson* in finding against a franchisor in *Ispahani v. Allied Domecq Retailing USA*.<sup>54</sup> In *Ispahani*, the franchisee sued Dunkin' Donuts alleging that it unjustifiably withheld approval of a new store location after he had incurred substantial expenses in preparing a new site. Dunkin' Donuts counterclaimed for breach of contract due to the franchisee's failure to pay royalties. When the franchisee failed to cure after receiving notices of default and notices to cure, Dunkin' Donuts terminated the franchise. Dunkin' Donuts then moved for a preliminary injunction prohibiting the franchisee from using Dunkin' Donuts' marks. The appellate court affirmed the trial court's denial of injunctive relief because Dunkin' Donuts failed to establish that it had the legal right to terminate the franchise agreement.<sup>55</sup> The court refused to follow the small minority of jurisdic-

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51. See *id.* at 132.

52. *S & R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371 (3d Cir. 1992).

53. See Section V, *infra* for further discussion of *McDonald's Corp. v. Robertson*.

54. 727 A.2d 1023 (N.J. Super. Ct. App. Div. 1999).

55. See *id.* at 1025.

tions in which wrongful termination claims are not valid defenses to a Lanham Act claim but merely independent claims for damages. The court found that under New Jersey law, franchisees cannot be preliminarily enjoined from operating their franchises and utilizing Lanham Act trademarks without proof that the franchise was rightfully terminated for cause. Facts bearing on termination for cause were "sparse and contested."<sup>56</sup> Dunkin' Donuts proved that Ispahani had not paid royalties and advertising fees on time. The amount due and unpaid was disputed. Both sides relied on conclusory statements without underlying records to substantiate their claims, and neither party offered proof of the total amount of royalties and advertising fees paid. Ispahani's testimony that Dunkin' Donuts consented to late payments was uncontroverted. On these facts, the court found that Dunkin' Donuts had failed to carry its burden of establishing that termination was proper.<sup>57</sup>

## 2. Statutory Termination

In addition to contractual or common law requirements limiting rights to terminate, franchisors must also satisfy any applicable statutes. For example, the Petroleum Marketing Practices Act ("PMPA")<sup>58</sup> prohibits termination or non-renewal of franchisees engaged in the sale, consignment, or distribution of motor fuel except for statutorily defined grounds and subject to notice and cure provisions. Congress enacted the PMPA in 1978 to protect petroleum franchisees from arbitrary or discriminatory termination or non-renewal of their franchises. In keeping with the Act's acknowledgment of the inferior economic and bargaining position of franchisees, a franchisor who terminates or does not renew a franchise has the burden of proving compliance with all statutory requirements of the PMPA. Additionally, the Act allows franchisees to obtain a preliminary injunction upon a lesser showing than is usually required.<sup>59</sup> The effect of the PMPA is to create a presumption that any termination of a franchise is unlawful.

The PMPA was invoked by Amoco branded dealers in the Pittsburgh, Pennsylvania area to enjoin Amoco from terminating their dealer leases in *Fink v. Amoco Corp.*<sup>60</sup> Amoco sent the dealers a notice that Amoco was terminating the leases effective when Amoco closed the sale of assets to a purchaser approved by the FTC. Amoco contended that it was divesting itself of the stations pursuant to a consent decree negotiated under threat of civil litigation by the FTC following the merger of Amoco Corporation and British Petroleum Company. Amoco also claimed that the negotiated consent decree was "an occurrence of an event which is relevant" under section 2802(b)(2)(c) of the PMPA and, therefore,

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56. *Id.*

57. *See id.* at 1023-25.

58. 15 U.S.C. §§ 2801-2806 (1999).

59. *See id.*

60. 55 F. Supp. 2d 350, 351 (W.D. Pa. 1999).

Amoco's proposed termination of the franchise agreements was lawful.<sup>61</sup> Pursuant to the consent order, Amoco negotiated the sale of twenty-nine regional independent Amoco gasoline service stations to Tosco Corporation. As a result, plaintiffs were notified that their leases had been cancelled and their contracts terminated and were instructed to quit the premises or sign new leases with Tosco. Plaintiffs received no compensation for the contract terminations or cancelled leases and were denied any opportunity to purchase their stations. The terms of the Tosco leases were unfavorable to the dealers. The court concluded that nothing in the PMPA permits a franchisor to terminate a franchise agreement due to the threat of civil litigation by a third party, including a government agency, and that Amoco's attempted termination was unlawful. In addition, the court found that Amoco's conduct was arbitrary and capricious and entered a preliminary injunction enjoining Amoco from terminating plaintiffs' agreements.<sup>62</sup>

Another injunction in favor of a franchisee under the PMPA was affirmed in *Kamel v. Shell Oil Co.*<sup>63</sup> Shell attempted to terminate Kamel's franchise due to alleged financial hardship caused by the State of California's pending enforcement of certain environmental regulations. The district court granted the franchisee a preliminary injunction. Shell appealed. The Ninth Circuit affirmed, citing the liberal preliminary injunction standards under the PMPA.<sup>64</sup>

Under the PMPA, a district court should grant a preliminary injunction if a franchisee shows that "there exists sufficiently serious questions going to the merits to make such questions a fair ground for litigation" and "the court determines that, on balance, the hardships imposed upon the franchisor by the issuance of such preliminary injunctive relief will be less than the hardship which would be imposed upon such franchisee if such preliminary injunctive relief were not granted."<sup>65</sup> Noting Kamel's testimony that the income generated by the station constituted the primary source of income for him and his family, that Kamel expended considerable money in maintaining the station, and balancing his injury against the trial court's determination that a ruling adverse to Shell would require only that Shell continue the franchise relationship until the lawsuit was resolved, the appellate court concluded that the balance of hardship weighed in Kamel's favor. The court also found that Kamel would likely prevail on the merits because Shell had failed to comply with the notice provisions of the PMPA.<sup>66</sup> To satisfy the notice requirements, a franchisor must demonstrate it first acquired actual or constructive knowledge "of an event which is relevant to the franchise relationship and as a result of which termination of the franchise . . . is reasonable . . .

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61. *Id.* at 353.

62. *See id.* at 354-56.

63. No. 98-56812, 199 WL 413414 (9th Cir. June 11, 1999).

64. *See id.* at \*3.

65. 15 U.S.C. § 2805(b)(2)(ii) & (iii) (2000).

66. *See Kamel*, 1999 WL 413414, at \*2.

not more than 120 days prior to the date on which notification of termination . . . is given . . . ."<sup>67</sup> Because Shell knew the State of California would enforce the relevant regulations well over 120 days before Shell sent a termination notice to Kamel, it failed to comply with the procedural requirements of the PMPA. Hence, the district court did not abuse its discretion when it concluded that Kamel was likely to prevail on the merits.<sup>68</sup>

In contrast, in *Mercer v. Texaco, Inc.*,<sup>69</sup> a franchisee sought to avoid application of the PMPA. Mercer sued Texaco Star, a Texaco partnership entity, and Spencer, an affiliate of Texaco who distributed franchises, for tortious interference with business relations and improper debranding arising from Spencer's termination of Mercer. Texaco removed the case to federal court claiming plaintiff "artfully pled" his tortious interference and wrongful debranding claims to avoid a previous adverse judgment. Texaco further claimed that the state law claims were preempted by the PMPA giving the court federal question jurisdiction.<sup>70</sup> The district court granted defendants' summary judgment, holding that the PMPA preempted any state law claims "arising out of" or "incident to" an alleged wrongful termination and any attempt by Mercer to reallege its claims under the PMPA would be time barred by the statute's one-year statute of limitations.<sup>71</sup>

## B. ENCROACHMENT, GOOD FAITH AND FAIR DEALING

Encroachment occurs when a franchisor places a new franchise in an existing franchisee's market. Many franchise agreements have express provisions dealing with this issue.<sup>72</sup> In the absence of a contractual provision expressly granting or reserving territorial rights, a question arises whether a franchisee can assert an encroachment claim. The most recent noteworthy case involving encroachment is *Burger King Corp. v. Weaver*.<sup>73</sup> *Weaver*, however, must be considered against the background of *Scheck v. Burger King Corp.*<sup>74</sup> which held that a franchisor could breach an implied covenant of good faith and fair dealing by placing a new franchise in an existing franchisee's market even when the existing franchisee's franchise agreement granted no exclusive territory or protected area.<sup>75</sup>

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67. 15 U.S.C. § 2802(b)(2)(C) & (i) (2000).

68. See *Kamel*, 1999 WL 413414, at \*2.

69. No. Civ. A.3:98-CV-1011-R, 1999 WL 451224 (N.D. Tex. June 28, 1999).

70. See *id.* at \*1-\*2.

71. See *id.* at \*4-\*5.

72. See *Clark v. America's Favorite Chicken Co.*, 110 F.3d 295, 299 (5th Cir. 1997) (holding that any competition created by a franchisor did not breach a covenant of good faith and fair dealing because in the franchise agreement the franchisor specifically reserved the right to establish competing businesses).

73. 169 F.3d 1310 (11th Cir.), cert. dismissed, 145 L.Ed.2d 287, 120 S. Ct. 370 (1999).

74. 756 F. Supp. 543 (S.D. Fla. 1991), on rehearing, 798 F. Supp. 692 (S.D. Fla. 1992).

75. See *id.* at 548-50.

Weaver was a party to two franchise agreements with Burger King authorizing him to operate restaurants in Great Falls, Montana. Neither contract expressly limited the location of further Burger King restaurants nor expressly reserved the right to Burger King to establish competing businesses in the area. After Burger King authorized the opening of another restaurant in Great Falls, Weaver stopped all payments. Burger King sued to collect past due amounts and Weaver counterclaimed for breach of an implied covenant of good faith and fair dealing. The district court rejected Weaver's implied covenant claim, reasoning that Florida courts do not recognize a claim for breach of an implied covenant of good faith and fair dealing absent breach of an express contractual provision. Because Weaver did not allege Burger King's action violated an express provision of the franchise agreement, the court held that his claim under an implied covenant of good faith and fair dealing failed as a matter of law.<sup>76</sup> The Eleventh Circuit affirmed, rejecting the reasoning of *Scheck*, finding that Florida common law neither recognized an independent claim for breach of an implied covenant of good faith absent a breach of an express contractual provision nor allowed an implied covenant to be used to vary the express terms of a contract.<sup>77</sup> The court found the reasoning of *Scheck* unconvincing stating:

The *Scheck* court held that the franchisee had a cause of action, even though the franchise agreement provided no right to exclusive territory, because BKC had not expressly reserved the right to license additional Burger King Restaurants nearby. The flaw in this reasoning is that right and duty are different sides of the same coin; if one party to a contract has NO RIGHT to exclusive territory, the other party has NO DUTY to limit licensing new restaurants.<sup>78</sup>

Thus, because Weaver's franchise agreements did not grant him the right to an exclusive territory, Burger King had no duty to refrain from licensing new franchises in the same market.

An encroachment claim grounded in part on an implied covenant also failed in *Linguist & Craig Hotels & Resorts, Inc. v. Holiday Inns Franchising, Inc.*<sup>79</sup> The franchisee sued after the franchisor licensed three new hotels in the same vicinity as the franchisee's existing hotels, claiming that the franchisor had breached an implied covenant of good faith and fair dealing. The court rejected this argument and granted summary judgment for Holiday Inns because the franchise agreement expressly granted the franchisee a non-exclusive license and specifically authorized the franchisor to "engage in or license any business activity at any other locations."<sup>80</sup> In rejecting the franchisee's implied covenant claim, the court concluded that because the contracts gave Holiday Inns the express right to license new franchisees at any location that right could not be circum-

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76. See *Weaver*, 169 F.3d at 1314.

77. See *id.* at 1314-18.

78. *Id.* at 1317 (emphasis added).

79. Bus. Franchise Guide (CCH) ¶ 11,514 (C.D. Cal. Sept. 24, 1998).

80. *Id.* at 31,245.

scribed by an implied covenant of good faith.<sup>81</sup>

The opposite result was reached in *Unidrug, S.A.R.L. v. E.T. Browne Drug Co., Inc.*<sup>82</sup> based upon New Jersey law that a claim for breach of a duty of good faith and fair dealing exists even when a party does not breach an express term of a contract. Unidrug was the exclusive distributor of Browne's skin and hair care products. The contract was terminable by either party on 90 days' notice. Browne terminated the agreement. Before 90 days had passed, Browne entered into an exclusive distribution agreement with a Unidrug competitor and refused to fill a Unidrug order. Unidrug sued for breach of contract and violation of an implied covenant of good faith and fair dealing. The district court granted summary judgment for Browne.<sup>83</sup> The Third Circuit reversed, holding that under New Jersey law every contract contains an implied covenant of good faith and fair dealing that can be breached even when a party does not breach an express term of the contract. The Third Circuit remanded the case for consideration of whether the manufacturer violated a duty of good faith and fair dealing by refusing to ship goods to its distributor and selling to the distributor's competitor while the distributor had an exclusive contract.<sup>84</sup>

Good faith and fair dealing cases often turn on choice of law issues. For example, in *Miller v. KFC Corp.*,<sup>85</sup> KFC franchisees sued for failure to award them a "3N1" (KFC, Taco Bell, and Pizza Hut) franchise at an outlet mall. Among other things, the plaintiffs contended that KFC breached an implied covenant of good faith and fair dealing. KFC argued Texas law does not recognize an implied covenant of good faith and fair dealing. The court rejected the defendant's argument, finding that Kentucky law applied and that under Kentucky law every contract has an implied covenant of good faith and fair dealing. KFC countered that Kentucky law required a fiduciary relationship to exist for the breach of an implied covenant of good faith and fair dealing. The court denied KFC's motion to dismiss, because under Kentucky law, it is not always necessary for a fiduciary relationship to exist in order to assert a claim for breach of good faith.<sup>86</sup>

### C. TRANSFERS OF FRANCHISE RIGHTS

The Texas Supreme Court refused to review an appellate court's decision in a franchise transfer case over a vigorous dissent in *Re/Max, Inc. v. Katar Corp.*<sup>87</sup> Katar operated a Re/Max Realty office. After two years Katar decided to sell its franchise and enlisted Re/Max's assistance in locating a buyer. About the same time Katar defaulted in payment of fees

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81. See *id.* at 31,246.

82. Bus. Franchise Guide (CCH) ¶ 11,415 (3d Cir. Mar. 2, 1998).

83. See *id.* at 30,701.

84. See *id.* at 30,705-06.

85. No. Civ. A.3:99-CV-1566-D, 1999 WL 820389 (N.D. Tex. Oct. 13, 1999).

86. See *id.* at \*1-\*4.

87. 989 S.W.2d 363 (Tex. 1999).

to Re/Max. Re/Max repeatedly notified Katar that it was in default and that failure to pay the fees would result in termination. After Katar failed to pay royalties for six months, Re/Max notified Katar that it would no longer honor the exclusivity provision of their agreement unless all fees were paid current. By that time Katar had found a buyer, but the buyer was not interested in a non-exclusive franchise, and Re/Max refused to offer the buyer an exclusive franchise even if delinquent royalties were paid. The sale fell through and Katar sued Re/Max for breach of contract and tortious interference with the prospective sale. The trial court awarded Katar \$65,000 in damages and \$28,000 in legal fees. The court of appeals affirmed<sup>88</sup> and the Supreme Court denied review.<sup>89</sup> On appeal, Re/Max contended that because it had the right to terminate the entire agreement for Katar's failure to pay royalties, it could terminate the exclusivity portion of the agreement. The appellate court disagreed reasoning:

By analogy, a jeweler who sells a diamond ring on installment payments may have the right to repossess the ring upon default by the buyer. However, the jeweler does not have the right to replace the diamond with a cubic zirconia and then hold the customer to the original contract price.<sup>90</sup>

In his dissent to denial of review by the Texas Supreme Court, Justice Hecht declared it a fundamental principle of contract law that a breach by one party excuses the other from any obligation to perform.<sup>91</sup> A franchisee cannot refuse to pay franchise fees and then complain when the franchisor refuses to continue the exclusive arrangement.

#### D. NONCOMPETITION AGREEMENTS

The importance of careful drafting, particularly of noncompetition and other restrictive covenants, is illustrated by *Grease Monkey International, Inc. v. Ralco Lubrication Services, Inc.*<sup>92</sup> In that case, the court denied a franchisor's request for preliminary injunction to enforce a non-competition agreement precluding a former franchisee and its principal from operating a fast service auto lube business at a former franchise location. Robert Lieberman, the franchisee, was the sole officer, director, and shareholder of Ralco Lubrication Services. The franchise agreement contained a two-year, 50-mile noncompete provision. Two days after the franchise expired, Ralco sold its inventory to Roadrunner Lube and Go, LLC, which was owned by Lieberman's wife and mother-in-law. Roadrunner then employed Lieberman, replaced Grease Monkey's logos, signs, and promotional and advertising materials with its own and began operation of a fast service auto lube business under the name "Roadrun-

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88. See *Re/Max, Inc. v. Katar Corp.*, 961 S.W.2d 324, 328 (Tex. App.—Houston [1st Dist.] 1997, pet. denied).

89. See *Re/Max, Inc.*, 989 S.W.2d at 363.

90. See *Re/Max, Inc.*, 961 S.W.2d at 327.

91. See *Re/Max, Inc.*, 961 S.W.2d at 364-65.

92. 24 F. Supp. 2d 120 (D. Mass. 1998).

ner Lube and Go” at the Grease Monkey location. Grease Monkey sued Lieberman and Ralco, seeking a preliminary injunction to enforce the noncompete. The trial court denied the injunction, finding a serious question whether Roadrunner and its principals were the alter ego of Lieberman and the former franchisee. Because the franchise agreement prescribed only post-termination conduct of the “franchisee” and did not expressly address the conduct of officers, directors, and shareholders and because Lieberman signed only in his capacity as Ralco’s president and not individually, it was uncertain whether Lieberman was individually bound by the agreement. The court also found that Grease Monkey failed to demonstrate that it would suffer irreparable harm should preliminary relief be denied, while Lieberman’s ability to earn a living in his chosen field would be substantially curtailed if he were enjoined. Finally, the court concluded that the public interest would be adversely affected by granting Grease Monkey’s motion because consumers would be deprived of a fast service automobile lubrication service.<sup>93</sup>

Even in the absence of noncompetition covenants, a franchisor may limit the ability of a departing franchisee employee to compete if it is probable that the employee would use or disclose confidential information learned while working for the franchisor. In *Conley v. DSC Communications Corp.*,<sup>94</sup> the Dallas Court of Appeals affirmed an injunction against a former employee of DSC, a manufacturer of telecommunications equipment.<sup>95</sup> Conley had worked for DSC for 16 years when he resigned and went to work for Advanced Fiber Communications (AFC), a DSC competitor. Within days after Conley resigned, DSC obtained a temporary restraining order prohibiting him from using or disclosing DSC’s confidential or proprietary information, particularly any information relating to his marketing efforts towards Sprint. The trial court found that Conley would inevitably disclose or use confidential information or trade secrets of DSC in connection with his employment with AFC.<sup>96</sup>

On appeal, the court recognized that a former employee may be enjoined from using or disclosing a former employer’s confidential or proprietary information if the employee is in a situation where use or disclosure is probable. Conley suggested the court adopt five factors to determine whether to enjoin an employee: (1) the existence of misconduct on the part of the departing employee; (2) the new employer’s apparent need for the trade secret information of its competitors because of its lack of comparable technology; (3) a significant degree of similarity between the employee’s former and current position; (4) the absence of efforts of the new employer to protect the trade secrets of the former

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93. *See id.* at 123-26.

94. No. 05-98-01051-CV, 1999 Tex. App. LEXIS 1321 (Tex. App.—Dallas 1999, no pet. h.) (unpublished).

95. *See id.* at \*3.

96. *See id.* at \*1-\*3.

employer; and (5) the existence of a noncompetition agreement.<sup>97</sup> With respect to the first factor, misconduct, the court agreed that the misconduct of an employee in taking or threatening to use a former employer's confidential information was a factor supporting issuance of a temporary injunction. However, the court disagreed that a finding of misconduct was necessary for a temporary injunction. With respect to the second factor, the court disagreed that the new employer's lack of comparable technology was determinative. Rather the focus should be on whether the new employer could use the trade secret information to its benefit or to the detriment of the former employer. With reference to the third factor, degree of similarity, the court found it could be a factor only to the extent the evidence showed whether the former employee was in a position to use the former employer's confidential information. The court rejected Conley's fourth suggested factor, new employer's efforts to protect the trade secrets, observing:

At best, relying on the new employer to protect the trade secrets of the former employer when those trade secrets could work to the new employer's advantage is little better than asking the fox to guard the henhouse. The richer the henhouse, the less wise it is to trust even the most responsible and reliable of foxes.<sup>98</sup>

The court similarly rejected Conley's fifth factor, the existence of a noncompetition agreement, finding that it had no bearing on whether an employee possessed confidential information and was in a position to use it in his new job. The court concluded that the trial court did not err in issuing a temporary injunction because Conley was in a position to use DSC's confidential information for his or AFC's benefit or to DSC's detriment.<sup>99</sup>

In contrast, a preliminary injunction to enforce post-termination provisions of a franchise agreement was denied in *Snelling & Snelling, Inc. v. Ryvis, Inc.*<sup>100</sup> Ryvis, Inc., had two franchise agreements to operate personnel placement service businesses in Las Vegas and Reno, Nevada. Ryvis advised Snelling of its intent to terminate the franchise agreements; Snelling responded by terminating the agreements for cause. Snelling then sought a preliminary injunction to require Ryvis to comply with post-termination obligations under the franchise agreements including: (1) that for a two-year period Ryvis not solicit clients or employees whom it served or employed; (2) that it relocate any continuing personnel business to a place situated at least ten miles from former franchise locations; and (3) that it return materials as required by the agreement.<sup>101</sup> The court refused a preliminary injunction, finding Snelling failed to demonstrate a substantial threat of irreparable injury because Snelling was not currently competing in the Las Vegas or Reno markets, nor had it ex-

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97. *See id.* at \*4.

98. *Id.* at \*6.

99. *See id.* at \*12 - \*18.

100. No. 3:99, CV-2028-D, 1999 U.S. Dist. LEXIS 17928 (N.D. Tex. 1999).

101. *See id.* at \*2 - \*4.

pressed an intent to enter those markets. Therefore, Snelling could not establish that it was currently losing customers it would otherwise have served or employees it would have otherwise employed or that its goodwill or reputation were being damaged.<sup>102</sup>

#### E. CONTRACT CLAIMS

The benefits of a carefully drafted franchise agreement were again demonstrated in *Love Pontiac, Cadillac, Buick, GMC Truck, Inc. v. General Motors Corp.*<sup>103</sup> In *Love*, the Fourth Circuit in an unpublished opinion affirmed summary judgment in favor of General Motors on a dealer's claims for breach of contract and violation of South Carolina's "Regulation of Manufacturers, Distributors, and Dealers" law.<sup>104</sup> *Love* operated a General Motors dealership in Burton, South Carolina. The contract expressly reserved GMC's "right to revise Dealer's Area of Primary Responsibility ["APR"] at Division's sole discretion consistent with dealer network planning objectives."<sup>105</sup> The agreement further provided that GMC "reserve[d] the right to appoint additional dealers" and explicitly left the final decision solely to GMC "pursuant to its business judgment."<sup>106</sup> *Love* proposed establishing a satellite dealership on Hilton Head Island. GMC turned down *Love*'s proposal and notified *Love* that it had decided to appoint another dealer to sell GMC trucks on Hilton Head. *Love* sued, claiming GMC breached the terms of its contract by appointing an additional dealer in *Love*'s APR and reducing its APR without adequate consideration of *Love*'s interest. The court found that the contract was not ambiguous and clearly reserved GMC's "right to resolve Dealer's Area of Primary Responsibility at division's sole discretion consistent with dealer network planning objectives."<sup>107</sup> Further, the contract clearly left the final decision to GMC "pursuant to its business judgment."<sup>108</sup> Plaintiff also contended that GM violated a South Carolina law regulating unfair methods of competition dealing with manufacturers, distributors, and dealers of motor vehicles which prohibited "any

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102. *See id.* at \*8, \*14.

103. 173 F.3d 851 (4th Cir. 1999) (unpublished opinion).

104. *See id.* at \*11.

105. *Id.* at \*3.

106. *See id.* at \*3 - \*4.

107. *Id.* at \*6.

108. *Love Pontiac*, at \*4. Other courts have construed similar clauses favorably to manufacturers. *See Clair Int'l, Inc. v. Mercedes-Benz of N. Am., Inc.*, 124 F.3d 314, 317 (1st Cir. 1997) (affirming dismissal of suit by dealer claiming new dealership was improperly awarded to third party by construing contract provision that final decision to establish additional dealers was to be made solely by manufacturer pursuant to its own business judgment without dealer's consent); *Hubbard Chevrolet Co. v. General Motors Corp.*, 873 F.2d 873, 878 (5th Cir.), *cert. denied*, 493 U.S. 978 (1989), (affirming summary judgment for defendant because exercise of sole discretion granted by contract cannot constitute breach when GM cited reasons for its decision); *Olympic Chevrolet, Inc. v. General Motors Corp.*, 959 F. Supp. 918, 927 (N.D. Ill. 1997) (finding that although the contract stated that its purpose was to permit dealers to fully realize opportunities for business success, that language did not render ambiguous, or contradict, other provisions in the contract that left the decision solely to GM).

action which is arbitrary, in bad faith, or unconscionable."<sup>109</sup> The court rejected this claim, finding GMC's actions were not in bad faith because they were based on a reasonable exercise of business judgment.<sup>110</sup>

#### F. FIDUCIARY DUTY

The majority of courts hold that a franchisor-franchisee, dealer-distributor, or manufacturer-distributor relationship does not create a fiduciary duty.<sup>111</sup> For example, in *Collins v. International Dairy Queen*,<sup>112</sup> a Georgia court dismissed plaintiffs' claim that International Dairy Queen breached a fiduciary duty to them in its management of an advertising fund. Plaintiffs alleged Dairy Queen breached a fiduciary duty "to manage, in the best interests of the Dairy Queen system, an advertising fund to which the franchisees pay contractually required advertising fees."<sup>113</sup> In so doing, the plaintiffs rely on a letter written by Dairy Queen's vice president of marketing stating that the "corporation has a fiduciary responsibility and contractual obligation to each store to expend the advertising dollars and select the method and ad agency that does the best job for the benefit of the majority of stores."<sup>114</sup> In addition, company representatives had stated that the Dairy Queen franchise system is a "family" and that Dairy Queen will look out for the franchisees' best interests and be accountable to them for management of the advertising fund. Pointing out that the marketing representative was not a lawyer and that his statement was made after the franchisees had already entered into franchise agreements and, therefore, could not have induced reliance, the court found that the extra-contractual statements of defendant's representatives were insufficient to create a fiduciary relationship and to modify a contractual provision which gave Dairy Queen sole discretion to establish advertising and promotion programs.<sup>115</sup>

#### G. VICARIOUS LIABILITY

Generally, a franchisor is not vicariously liable for the negligence of a franchisee unless the franchisor has the right to control the work from which the claim arises. An express disclaimer of an agency relationship in the franchise agreement is not determinative; courts look at the actual practices of the parties in determining operating control. The essential

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109. *See id.* at \*8.

110. *See id.* at \*9.

111. *See* *ARA Auto. Group v. Central Garage, Inc.*, 124 F.3d 720, 721 (5th Cir. 1997); *Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies*, 970 F.2d 273, 280 (7th Cir. 1992); *McGuirk Oil Co. v. Amoco Oil Co.*, 889 F.2d 734, 738 (6th Cir. 1989); *O'Neal v. Burger Chef Sys., Inc.*, 860 F.2d 1341, 1349-50 (6th Cir. 1988); *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*, 732 F.2d 480, 485 (5th Cir. 1984); *Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 592-93 (Tex. 1992); *Adolph Coors Co. v. Rodriguez*, 780 S.W.2d 477, 481 (Tex. App.—Corpus Christi 1989, writ denied).

112. 54 F. Supp. 2d 1351 (M.D. Ga. 1999).

113. *Id.* at 1352.

114. *Id.* at 1353.

115. *See id.* at 1354.

issue is whether the franchisor has the right to control both the means and details of the process by which the alleged agent is to accomplish his task.<sup>116</sup>

In *Arguello v. Conoco, Inc.*,<sup>117</sup> the court granted Conoco's motion for summary judgment, holding that it was not liable for the racially discriminatory acts of employees of a franchisee. The alleged incidents occurred at five gas stations in Texas, four of which were owned and operated by franchisees. Plaintiffs claimed that the franchisor and his franchisees engaged in "intentional discrimination" in violation of 42 U.S.C. § 1981 and that the franchisor discriminated by not providing the "full and equal enjoyment of goods" in violation of 42 U.S.C. § 2000a. The court defined the issue as "to what extent can a third-party hold a franchisor liable for the torts of the employees of a franchisee."<sup>118</sup>

The court first addressed the basic question whether an agency relationship existed between Conoco and Conoco branded stores by focusing on the essential element, the right of control. Plaintiff attempted to establish the element of control by introducing agreements between Conoco and its franchisees which required each store to treat all customers "fairly, honestly, and courteously."<sup>119</sup> The agreements also contained a provision defining the relationship between the parties as follows:

The [store] is an independent business and is not, nor are its employees, an employee of Conoco. Conoco and the [store] are completely separate entities. They are not partners, general partners, limited partners, joint venturers, nor agents of each of other in any sense whatsoever and neither has the power to obligate or bind the other.<sup>120</sup>

To overcome this express "no agency" clause, the court required plaintiffs to produce evidence showing the true operating agreement was one which vested the right to control in Conoco. Plaintiffs produced no evidence that Conoco controlled the details of the daily operation of the stores. In contrast, Conoco presented evidence that hiring and firing decisions were left to the absolute discretion of each store. Therefore, the court held as a matter of law that the stores were not agents of Conoco and, therefore, Conoco was not liable for the discriminatory acts of the franchisees' employees.<sup>121</sup>

Next, the court considered whether Conoco was liable for the discriminatory acts of an employee working at a company-owned station. Under the common law of agency, an employer is liable only for torts of an employee committed within the course and scope of employment.<sup>122</sup> Inten-

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116. *In re Carolin Paxson Adver., Inc.*, 938 F.2d 595, 598 (5th Cir. 1991).

117. No. 3:97-CV-0638-H, 1998 WL 713277 (N.D. Tex. Oct. 7, 1998), *aff'd in part and rev'd in part*, 207 F.3d 803 (5th Cir. 2000).

118. *Id.* at \*5.

119. *Id.*

120. *Id.*

121. *See id.*; *see also* *Perry v. Burger King Corp.*, 924 F. Supp. 548, 554 n.4 (S.D.N.Y. 1996) (listing analogous cases finding franchisee is not the agent of the franchisor).

122. *See id.* at \*6.

tional torts are usually outside the scope of employment. However, an employer may be liable for actions of an employee which are outside the scope of employment if (1) the employer intended the conduct or consequences of the action; (2) the employer was negligent or reckless; (3) the conduct violated a non-delegable duty of the employer; or (4) the employee purported to act or speak on behalf of the employer and there was reliance on apparent authority.<sup>123</sup> The court concluded that the employees' actions were outside the scope of employment, and the plaintiffs failed to offer any supporting evidence of any factor which would render Conoco liable under section 219 of the RESTATEMENT (SECOND) OF AGENCY. Therefore, the court granted summary judgment for Conoco on this claim as well.<sup>124</sup>

Of course, a franchisor may have direct liability for its own negligence in discharging an independent duty to a customer. The leading case in this area is *Read v. Scott Fetzer Co.*<sup>125</sup> In *Read*, Kirby, a manufacturer of vacuum cleaners, sold its cleaners to independent distributors pursuant to a uniform distributorship agreement which required the distributor to establish an independent sales force of door-to-door dealers. The distributorship agreement specifically provided that Kirby "shall exercise no control over the selection of . . . Dealers."<sup>126</sup> Dealers were required to sell Kirby products exclusively through in-home demonstrations. A dealer, who was an independent contractor of Kirby's distributor, raped a customer during an in-home demonstration. The distributor did not check the dealer's references. If it had, it would have learned that he had been terminated from a previous job because he had received deferred adjudication on a charge of indecency with a child and that, at other jobs, employers had received complaints from women about his sexually inappropriate behavior. The Texas Supreme Court held that when a company that markets and sells its product through independent contractor distributors exercises control by requiring in-home demonstration sales, it owes a duty to act reasonably in the exercise of that control.<sup>127</sup> Because plaintiff was attempting to hold Kirby directly responsible for its own conduct rather than vicariously responsible for the acts of its distributor, the distributor's status as an independent contractor and the amount of control exercised by Kirby over its distributor were irrelevant. What was relevant was the undisputed fact that Kirby retained control over the method by which its products were marketed. The Texas Supreme Court held the manufacturer directly liable because the manufacturer was negligent in discharging an independent duty to the customer.<sup>128</sup> The *Kirby* decision places franchisors in a Catch-22. If they exercise greater control over hiring, they will face possible increased vicarious liability. If they exercise

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123. RESTATEMENT (SECOND) OF AGENCY § 219(2) (1957).

124. See *Arguello*, 1998 WL 713277, at \*7.

125. 990 S.W.2d 732 (Tex. 1998).

126. *Id.* at 735.

127. See *id.* at 735.

128. See *id.*

no control, they may face direct liability if they are found to have an independent duty to an injured third party.

The *Kirby* case was distinguished in *Guidry v. National Freight, Inc.*<sup>129</sup> In that case, a University of Texas co-ed was raped by a long-haul truck driver who made an unauthorized stop in Austin. Guidry sued National, the truck driver's employer, for negligent hiring. If National had checked the truck driver's background, it would have discovered that he had a history of sexual misconduct contained in his military records, criminal records, and previous employment records. The Austin court distinguished the *Kirby* case because Guidry was not a member of any vulnerable or specially protected group with whom the truck driver could be expected to come into contact during his work.<sup>130</sup> Consequently, the sexual assault was not foreseeable.

When a franchisor is faced with vicarious liability for claims arising out of alleged racial or gender discrimination committed by a franchisee, the issue is whether the franchisor is an "employer" under the relevant statute. For example, in *Lockard v. Pizza Hut, Inc.*,<sup>131</sup> a waitress at Pizza Hut was sexually assaulted by a male customer and sued her employer, the franchisee, and Pizza Hut, the franchisor, alleging a hostile work environment sexual harassment claim. In order to establish a *prima facie* case under Title VII, Ms. Lockard was required to prove that Pizza Hut was her employer.<sup>132</sup> Referring to *Lambertsen v. Utah Department of Corrections*,<sup>133</sup> the court identified three approaches to determining whether an entity is an employer for Title VII purposes: (1) the common law agency inquiry; (2) the "hybrid" common law-economic realities method; and (3) the single employer or true economic realities test.<sup>134</sup>

Under the common law agency inquiry, the focus is on whether the putative employer controls the means and manner by which the work is accomplished. The hybrid method combines the focus on the common law right to control with additional factors relating to the degree of economic dependence of the worker on the putative employer.<sup>135</sup> The single employer test considers the following factors: (1) interrelation of operations, (2) centralized control of labor relations, (3) common management, and (4) common ownership or financial control.<sup>136</sup> The key factor of the four-part test is whether the putative employer has centralized control of labor relations. Broad general statements regarding employment matters are not enough; a franchisor must control the day-to-day employment decisions of a franchisee. To prove her claim under the single employer test, Ms. Lockard pointed to the fact that: (1) the policies and procedures in

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129. 944 S.W.2d 807 (Tex. App.—Austin 1997, no pet.).

130. *See id.* at 811.

131. 162 F.3d 1062 (10th Cir. 1998).

132. *See id.* at 1069 (citing *Frank v. U.S. West, Inc.*, 3 F.3d 1357, 1361 (10th Cir. 1993)).

133. 79 F.3d 1024, 1024 (10th Cir. 1996).

134. *Lockard*, 162 F.3d at 1069.

135. *Id.*

136. *See id.*

effect at the restaurant were those of Pizza Hut; (2) Pizza Hut and the franchisee set forth a joint defense to the EEOC complaint; (3) Pizza Hut's letter to the EEOC said Ms. Lockard was employed by the "Company"; and (4) an individual was a vice president of both the franchisor and the franchisee.<sup>137</sup> The court found these facts insufficient to satisfy the common management requirement of the single employer test.<sup>138</sup> There was no evidence Pizza Hut controlled the day-to-day employment decisions of the franchisee. Although Pizza Hut's policies were in effect at the restaurant, there was no evidence indicating what role, if any, Pizza Hut played in implementing the policies. The court, therefore, reversed the jury verdict against Pizza Hut.

#### H. TORTIOUS INTERFERENCE

Under Texas law, the elements of tortious interference with respect to prospective business relations are: (1) a reasonable probability that the plaintiff would have entered into a contractual relationship, (2) a malicious and intentional act, performed with the purpose of harming the plaintiff, that prevented the relationship from occurring, (3) without privilege or justification to do that act, and (4) actual harm or damage resulted from defendant's interference.<sup>139</sup> In *Miller v. KFC Corp.*,<sup>140</sup> the franchisees of KFC sued for KFC's failure to award them a "3N1" (KFC, Taco Bell, and Pizza Hut) franchise at an outlet mall asserting a claim for, among other things, tortious interference with prospective business relationships. Plaintiffs claimed that KFC tortiously interfered with their prospective business relations by denying their request to expand, thereby precluding them from engaging in business with prospective patrons. The court denied a motion to dismiss this claim.<sup>141</sup>

The opposite result was reached in *Re/Max of Texas, Inc. v. Katar Corp.*<sup>142</sup> In that case, Re/Max licensed Katar to operate a Re/Max franchise. Katar decided to sell the franchise, but because Katar was delinquent in payments to Re/Max, Re/Max refused to honor the exclusivity provision of the agreement. The sale fell through, and Katar sued for, among other things, tortious interference with its prospective sale. The district court rendered judgment against Katar on its interference claim.<sup>143</sup>

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137. *See id.* at 1070-71.

138. *See id.* at 1071.

139. *See Gaia Techs., Inc. v. Recycled Prods. Corp.*, 175 F.3d 365, 377 (5th Cir. 1999); *Hill v. Heritage Resources, Inc.*, 964 S.W.2d 89, 109 (Tex. App.—El Paso 1997, pet. denied).

140. No. CIV.A.3:99-CV-1566-D, 1999 WL 820389, at \*1 (N.D. Tex. Oct. 13, 1999).

141. *See id.* at \*2.

142. 989 S.W.2d 363 (Tex. 1999).

143. *See id.* at 364-65.

## I. ANTITRUST

The relationships between franchisors and franchisees can violate Sherman Act prohibitions against tying and attempted monopolization. For example, in *Re/Max International, Inc. v. Realty One, Inc.*,<sup>144</sup> the Sixth Circuit reversed the grant of a summary judgment against Re/Max and its franchisees and remanded the case for further proceedings.<sup>145</sup> In that case, Re/Max, a national real estate brokerage franchisor, and its franchisees brought suit against two local real estate firms operating in northeast Ohio alleging antitrust violations in connection with the defendants' practice of paying brokers associated with Re/Max franchisees lower commissions on split-commission transactions. Re/Max paid brokers 95 to 100% commission on real estate sales less expenses. Local real estate agencies required agents to pay one-half their commissions to the agency. To deter their agents from going to Re/Max, two defendant agencies reduced the commission to Re/Max agents who were involved in transactions with them from 50% to between 25 – 30%. Re/Max sued under sections 1 and 2 of the Sherman Act, as well as state antitrust laws, alleging that the two incumbent agencies dominated the relevant market, and the adverse split policy was a concerted refusal to deal or group boycott in contravention of section 1 of the Sherman Act. In addition, Re/Max contended that defendants' conduct constituted an illegal monopoly or attempt to monopolize in violation of section 2 of the Sherman Act.<sup>146</sup>

The district court dismissed judgment on plaintiffs' section 1 conspiracy claim "because there was insufficient evidence that the defendants mutually agreed to adopt adverse splits, rather than imposing them independently."<sup>147</sup> The district court granted summary judgment on plaintiffs' section 2 monopolization claims because plaintiffs failed to meet their burden of defining the relevant geographic markets in which the defendants were alleged to wield monopoly power and also failed to show defendants had the power to set prices or exclude competition in the geographic markets plaintiffs claimed.<sup>148</sup>

The Sixth Circuit reversed as to both the section 1 conspiracy and the section 2 monopolization claims. The Sixth Circuit held that the district court erred in finding plaintiffs had not adduced evidence of defendants' alleged conspiracy sufficient to survive summary judgment.<sup>149</sup> Although the facts show that defendants had opportunities to conspire; they imposed adverse splits at almost the same time and in almost the same manner, and that their principals had preexisting business relationships seemed to show a conspiracy, additional circumstantial evidence that adverse splits would not have been in either defendant's independent eco-

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144. 173 F.3d 995 (6th Cir. 1999), *petition for cert. filed*, 68 USL W 3138 (1999).

145. *See id.* at 1025-26.

146. *See id.* at 1000-02.

147. *Id.* at 1008.

148. *See id.* at 1004.

149. *See id.* at 1016.

conomic interest, and the statement of a witness that Realty One's CEO admitted entering into an agreement were sufficient to enable a reasonable jury to conclude that the defendants conspired. The court also concluded that the record contained sufficient evidence for a reasonable jury to conclude that the likely effect of defendants' conduct was primarily anticompetitive.<sup>150</sup>

The appellate court also concluded that the district court erroneously dismissed plaintiffs' section 2 monopolization claims. "Although the district court correctly concluded that Re/Max failed to define the relevant geographic markets, the court erroneously rejected evidence tending to show that the defendants had the ability to exclude competition."<sup>151</sup> For instance, Re/Max presented evidence showing that the adverse split policy had prevented new Re/Max franchises from forming and may have driven several franchises out of business.<sup>152</sup>

Finally, the district court held that the franchisor and sub-franchisor plaintiffs had no standing to bring antitrust claims because their injury was too indirect. The Sixth Circuit disagreed reasoning that:

[T]he defendants prevented Re/Max agents from earning their normal commission on most transactions, which in turn prevented Re/Max's 100 [%] Concept from functioning, which prevented Re/Max from attracting top agents, which prevented Re/Max franchises from succeeding, which prevented Re/Max from earning revenue from those franchises and agents and from opening new franchises. While this chain of causation is long, it is direct and unbroken.<sup>153</sup>

To avoid duplicative damage awards, the court required that if Re/Max franchisees are successful on remand, the franchisees should be fully compensated for any lost earnings. "Once these franchisees are made whole, the franchisor-plaintiffs will then be due their portion."<sup>154</sup> Because damages could be apportioned without duplicative recovery, the court reversed the dismissal of the franchisor and sub-franchisor plaintiffs.<sup>155</sup>

In *Metro Ford Truck Sales, Inc. v. Ford Motor Co.*,<sup>156</sup> the Fifth Circuit granted summary judgment for a manufacturer in a dealer suit alleging that the manufacturer's pricing program constituted vertical price fixing in violation of the Sherman Act and price discrimination under the Robinson-Patman Act.<sup>157</sup> Ford had a pricing program known as competitive price assistance ("CPA") used to reduce the wholesale price of a truck to authorized Ford dealers. Ford conducted an audit of Metro and discovered that Metro was receiving more CPA than it was entitled to. Accordingly, Ford decided to charge back the amount of CPA obtained

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150. *See id.*

151. *Id.*

152. *See id.*

153. *Re/Max*, 173 F.3d at 1023.

154. *Id.*

155. *See id.* at 1025-26.

156. 145 F.3d 320 (5th Cir. 1998), *cert. denied*, 525 U.S. 1068 (1999).

157. *See id.* at 323-24, 328.

by Metro. In response, Metro filed suit against Ford for price discrimination under the Texas Antitrust Act. Ford removed the action to federal court on the basis that the Texas Antitrust Act does not prohibit price discrimination and, therefore, Metro's antitrust claim for price discrimination could arise, if at all, only under the federal Robinson-Patman Act. With respect to Metro's claim that Ford's CPA program constituted vertical price fixing in violation of the Sherman Act, the district court found the lack of evidence of an agreement fatal. With respect to Metro's contention that Ford's CPA program resulted in price discrimination, the court found that Metro was treated the same as all other Ford dealers with respect to CPA for products of like grade and quality.<sup>158</sup> Therefore, the Fifth Circuit held that price discrimination did not exist, and no violation of the Robinson-Patman Act occurred.<sup>159</sup>

In *Chawla v. Shell Oil Co.*,<sup>160</sup> several Shell brand gasoline dealers sued Shell Oil Company for illegal tying, fraud, and price discrimination in violation of the Sherman Act, the Clayton Act, and the Robinson-Patman Act. The dealership agreements required the dealers to use Shell's credit card processing system and charged the dealers more for gasoline than non-dealers. Plaintiffs alleged, among other things, that Shell Oil's operation of its "pay-at-the-pump" program, that allowed consumers to pay for gas with a credit card at the gasoline pump, resulted in an illegal tying arrangement. More specifically, the plaintiffs claimed the practice of coercing plaintiffs to agree to lease "island card readers" ("ICRs") and forcing plaintiffs to agree to utilize only Shell's chosen bank to process the credit card transactions created an illegal tying arrangement in violation of the Sherman Act. The tying products were Shell brand gasoline and the Shell trademark, and the tied product was Shell's selected bank for processing transactions.<sup>161</sup> The court concluded that plaintiffs failed to state a legally cognizable claim of illegal tying because the tying arrangement arose from contractual provisions contained in the dealer agreements between Shell and its dealers.<sup>162</sup> The court also held that the plaintiffs "failed to allege any anti-competitive effect on the market for the tied products, ICRs and related credit card processing services."<sup>163</sup> Addressing the alleged injury to retail gasoline consumers, the court concluded that Shell gasoline was not a legally cognizable relevant market.<sup>164</sup> Therefore, plaintiffs had not alleged the defendant had market power in the tying product and therefore could not state a claim under either the Sherman or Clayton Acts.

For franchisors, the significant part of the court's analysis was the effect of a contractual relationship on antitrust analysis. Plaintiffs complained

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158. *See id.* at 325.

159. *See id.* at 326.

160. 75 F. Supp. 2d 626 (S.D. Tex. 1999).

161. *See id.* at 630-31.

162. *See id.* at 635.

163. *Id.*

164. *See id.*

that the tying arrangement in the ICR policy was forcing plaintiffs out of business because plaintiffs were “locked in” to the ICR policy in order to continue their supply of Shell gasoline. The court concluded that the *Kodak*<sup>165</sup> “lock in” theory did not govern plaintiffs’ tying claims because the plaintiffs’ had a preexisting and continuing contractual relationships with defendant.<sup>166</sup> Plaintiffs were “locked in” to defendant’s ICR policy because of their supply contracts and contractual marketing requirements rather than because of any market power Shell unlawfully exerted in the market for its own brand of gasoline. The court concluded that “[p]laintiffs’ challenge to [d]efendant’s ICR policy amount[ed] to an attack on the scope of the parties’ franchise relationship, and thus sound[ed] in contract, or conceivably tort, not antitrust.”<sup>167</sup>

The court expressly declined to follow *Wilson v. Mobil Oil Corp.*,<sup>168</sup> which held that *Kodak* was applicable in a franchise situation, and that there was no “principled distinction . . . between the franchise context and the durable equipment market involved in *Kodak*.”<sup>169</sup> In addition, the court found that *Kodak* failed to assist plaintiffs because plaintiffs did not allege that defendant’s tying arrangement had an anticompetitive effect on the ICR market or the market for bank processing services of ICR transactions. Thus, plaintiffs failed as a matter of law to allege an illegal tying claim.<sup>170</sup>

The court also rejected plaintiffs’ second illegal tying theory—that defendant’s policy harmed retail gasoline purchasers. The court found that plaintiffs’ allegations as to retail consumers failed as a matter of law for two reasons. First, the court found that plaintiffs’ failure to allege there were no close substitutes for Shell gasoline from the consumer’s perspective defeated a viable relevant market. Second, plaintiffs failed to allege defendant’s ICR policy created an adverse effect on the retail consumer market for any tied product because consumers viewed the gasoline they purchased and related credit card processing service as part of the same transaction and thus did not demand the products separately.<sup>171</sup>

The court also dismissed plaintiffs’ Clayton Act tying claim because the Clayton Act applies only when both the tying and the tied products are goods.<sup>172</sup> Plaintiffs’ tying claim that the required lease of defendant’s choice of ICRs was part and parcel of the “pay-at-the-pump” service involved only services, not goods. Therefore, the claim was outside the

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165. *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992).

166. *See Chawla*, 75 F. Supp. at 638.

167. *Id.* at 639; *see also* *Queen City Pizza v. Domino’s Pizza*, 124 F.3d 430, 441 (3d Cir. 1997), *cert. denied*, *Boughan’s, Inc. v. Domino’s Pizza*, 523 U.S. 1059 (1998) (“Unlike the plaintiffs in *Kodak*, plaintiffs here must purchase products from Domino’s Pizza not because of Domino’s market power over a unique product, but because they are bound by contract . . . plaintiffs’ remedy, if any, is in contract, not under the antitrust laws.”).

168. 940 F. Supp. 944 (E.D. La. 1996).

169. *Chawla*, 75 F. Supp. at 641 n.17.

170. *See id.* at 641-42.

171. *See id.* at 642-43.

172. *See id.* at 644-45.

scope of the Clayton Act.<sup>173</sup> With respect to plaintiffs' Robinson-Patman Act claim, the court ordered plaintiffs to file an amended complaint that would demonstrate that a competitive injury had occurred.<sup>174</sup>

## J. DTPA

Franchisees continue to assert claims based on the Texas Deceptive Trade Practices-Consumer Protection Act (DTPA).<sup>175</sup> In *Miller v. KFC*,<sup>176</sup> a franchisee sued KFC and Taco Bell after they denied plaintiff's request for a new "3N1" (KFC, Taco Bell, and Pizza Hut) franchise in an outlet mall. The franchisors' motion to dismiss the DTPA count was granted.<sup>177</sup> Under the DTPA, a "consumer" includes an individual, partnership or corporation which seeks or acquires by purchase or lease any goods or services.<sup>178</sup> To qualify as a consumer, a person must establish that: (1) he sought or acquired goods or services by purchase or lease and (2) the goods or services formed the basis of the complaint.<sup>179</sup> Franchise agreements can involve the transfer of goods or services for purposes of the DTPA.<sup>180</sup> However, the goods and services must form the basis of the complaint.<sup>181</sup> In *Miller*, plaintiff alleged various misrepresentations and unconscionable actions in business negotiations and refusal to grant plaintiff's application for a franchise outlet. Because these claims did not involve the goods or services purchased, plaintiff's DTPA claims were dismissed.

## V. FEDERAL ISSUES IMPACTING FRANCHISES

### A. TRADEMARKS AND TRADENAMES

Trademarks and other intellectual property are at the heart of every franchise system and, as a matter of course, are frequently at issue in litigation. These items are particularly litigious because a company or product name is a symbol that indicates who stands behind a service or good and "may be a valuable corporate asset as it facilitates communica-

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173. *See id.*

174. *See Chawla*, 75 F. Supp. at 654.

175. *See* TEX. BUS. & COM. CODE ANN. § 17.41 (Vernon 1987 & Supp. 2000).

176. No. CIV.A.3:99-CV-1566-D, 1999 WL 820389 (N.D. Tex. Oct. 13, 1999).

177. *See id.* at \*1, 4.

178. TEX. BUS. & COM. CODE ANN. § 17.45(4) (Vernon 1987 & Supp. 2000).

179. *See Cameron v. Terrell & Garrett*, 618 S.W.2d 535, 539 (Tex. 1981).

180. *See Texas Cookie Co. v. Hendricks & Peralta, Inc.*, 747 S.W.2d 873, 877 (Tex. App.—Corpus Christi 1988, writ denied) (purchaser of franchise qualified as consumer due to provision of collateral services).

181. *See, e.g., Americom Distrib. Corp. v. ACS Communications, Inc.*, 990 F.2d 223, 227 (5th Cir.), *cert. denied*, 520 U.S. 867 (1993) (a cause of action based on suspension of distributorship, without any defect in purchased goods, does not properly come under DTPA); *Meineke Discount Muffler v. Jaynes*, 999 F.2d 120, 125 (5th Cir. 1993) (franchisee whose complaint focused on validity of trademark ownership not a consumer under DTPA); *Footloose, Inc. v. Stride Rite Children's Group*, 923 F. Supp. 114, 116-17 (N.D. Tex. 1995) (distributor whose complaint was based on termination of distribution agreement, rather than goods and services, not a consumer).

tion with a customer.”<sup>182</sup> The value of a trademark, and its associated good will, generally increases as advertising and sales using the mark continue. Pursuant to the terms of the Trademark Act of 1946 (the “Lanham Act”),<sup>183</sup> a trademark is defined as a distinctive word, name, symbol, phrase, design, or combination thereof that is used by a business to identify and distinguish its own products from those of other businesses. A “service mark,” on the other hand, is the same thing as a trademark but identifies and distinguishes services rather than tangible products.<sup>184</sup>

Franchisors generally utilize three different sections of the Lanham Act to enforce their rights as to trademarks and service marks. First, section 32 of the Lanham Act provides, *inter alia*, that:

[a]ny person who shall, without the consent of the registrant (a) use in commerce any reproduction, counterfeit, copy, or colorable imitation of the 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 . . . .<sup>185</sup>

Second, a franchisor may use § 43(a) of the Lanham Act which provides in pertinent part that:

[a]ny person who, on or in connection with any goods or services . . . uses in commerce any word, term, name, symbol . . . or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which (A) is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation . . . or as to origin, sponsorship, or approval of . . . goods [or] services . . . shall be liable in a civil action . . . .<sup>186</sup>

Finally, franchisors may also seek redress pursuant to section 43(c) of the Lanham Act which provides in pertinent part that:

[t]he owner of a famous mark shall be entitled, subject to the principals 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.<sup>187</sup>

In the past year, court decisions have continued to refine the application of these doctrines regarding the protection of intellectual property rights in franchise disputes.

In *McDonald’s Corp. v. Robertson*,<sup>188</sup> the Eleventh Circuit upheld a

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182. *CardService, Int’l, Inc. v. McGee*, 950 F. Supp. 737, 741 (E.D. VA 1997) (citing *MTV Networks, Inc. v. Curry*, 897 F. Supp. 202, 203-04 (S.D. N.Y. 1994)).

183. 15 U.S.C. § 1111 (1994).

184. 15 U.S.C. § 1127 (1994).

185. 15 U.S.C. § 1114(1)(a) (1994).

186. 15 U.S.C. § 1125(a)(1) (1994).

187. 15 U.S.C. § 1125(c) (1994).

188. 147 F.3d 1301 (11th Cir. 1998).

Florida district court's granting McDonald's a preliminary injunction against trademark infringement, preventing a former franchisee from continuing to run a McDonald's restaurant.<sup>189</sup> In the Eleventh Circuit, when a franchisee is contesting a termination by a franchisor, the franchisor, as part of its burden in proving likely success on the merits, must demonstrate that the termination was proper in order to obtain a trademark injunction.<sup>190</sup> In the instant case, McDonald's terminated the former franchisee because of its failure to comply with safety requirements and other franchise regulations. The franchisee countered that the termination was nothing more than an excuse for McDonald's to move the restaurant to a different location. This case is unique because other circuits have held that the propriety of termination is irrelevant when considering an injunction of the Lanham Act.<sup>191</sup>

In *Foodmex, Inc. v. Foodmaker International Franchising, Inc.*,<sup>192</sup> Foodmaker, the international franchisor of "Jack in the Box," terminated Foodmex, its master licensee for Mexico. The termination was allegedly a result of Foodmex's breach of the parties' master licensing agreement, that included Foodmex's use of products from non-approved suppliers in its restaurants. After being terminated, Foodmex continued to operate using Foodmaker's trademarks. Foodmex then sued Foodmaker in California federal court for wrongful termination, breach of the implied covenant of good faith and fair dealing, tortious interference, and violations of the California Franchise Relations Act.<sup>193</sup> Upon review of the master licensing agreement, the court concluded that Foodmex had violated the agreement's mandatory standards and continued to violate them even after being provided with express written notice. In the court's view, Foodmaker had proper grounds to terminate Foodmex and, therefore, dismissed Foodmex's claims. More importantly, because Foodmex was promptly terminated, its continued use of Foodmaker's trademarks after the termination date constituted trademark infringement, dilution, and unfair competition. A permanent injunction was issued against Foodmex and its licensees enjoining them from further use of Foodmaker's marks and ordering Foodmex to give notice of the injunction to the Mexican courts and the proper Mexican government agencies.<sup>194</sup>

In *Piccoli A/S v. Calvin Klein Jeanswear Co.*,<sup>195</sup> a Danish licensee of Calvin Klein jeans provoked a dispute over the extraterritorial application of the Lanham Act. Piccoli, a former licensee with an exclusive license to distribute Calvin Klein products in Scandanavia, sued Calvin Klein ("CK") Jeanswear, an American licensee, for breach of contract, breach of implied duty of good faith and fair dealing, unjust enrichment,

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189. *See id.* at 1314.

190. *See id.* at 1308.

191. *See supra* Section IV(A) for a further discussion of this case.

192. No. 96CV2090-J, slip op. (S.D. Cal. June 28, 1999).

193. *See id.*

194. *See id.*

195. 19 F. Supp. 2d 157 (S.D.N.Y. 1998).

tortious interference, unfair competition and Lanham Act violations, after CK Jeanswear began exporting excess inventory to Denmark to be sold at lower end retail stores.<sup>196</sup> CK Jeanswear moved to dismiss. The court dismissed the breach of contract claim and Piccoli's argument that it was a third party beneficiary. The court also dismissed the claim for breach of implied covenant of good faith and fair dealing since there was no contract.<sup>197</sup> Additionally, the court dismissed Piccoli's claims of unjust enrichment and tortious interference on similar grounds.<sup>198</sup> The court further rejected Piccoli's section 32 Lanham Act claim for trademark infringement because it lacked sufficient ownership interest to support such a claim.<sup>199</sup>

The court, however, spent a considerable amount of time analyzing section 43(a) of the Lanham Act and whether it has extraterritorial application. The court recognized that there "is little doubt that the Lanham Act has some extraterritorial effect"<sup>200</sup> and pointed out three factors for determining whether extraterritory application of the Lanham Act is appropriate: (1) where the defendant is United States citizen, (2) whether there exists a conflict between the defendant's trademark rights under foreign law and the plaintiff's trademark rights under domestic law, and (3) whether defendant's activities have a substantial effect on United States commerce.<sup>201</sup> Because Piccoli claimed that CK Jeanswear had engaged in a "use of the physical stream of American commerce that was essential to the alleged infringement,"<sup>202</sup> the court refused to dismiss the Lanham Act claim based on the current status of the litigation.<sup>203</sup> Thus, after summarizing the case law on the issue, the court held that the actions in the United States by the defendant precluded dismissal of the Lanham Act claims at the motion to dismiss stage of the lawsuit.<sup>204</sup>

## B. BANKRUPTCY

A few decisions rendered this year illustrate the potential effects the United States Bankruptcy Code has on the relationship between franchisors and franchisees. For the most part, the Bankruptcy Code has been used in the past as a shield to protect franchisees who avoid obligations under the franchise agreement, or used by franchisors as a sword to force a debtor franchisee into involuntary bankruptcy.<sup>205</sup> Given the possible uses by either party to a franchise agreement, it is important to note

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196. *See id.* at 160.

197. *See id.* at 163-65.

198. *See id.* at 167-68.

199. *See id.* at 168.

200. *Id.* at 170.

201. *Id.*

202. *Id.* at 171.

203. *See id.* at 172.

204. *See id.*

205. *See, e.g.,* Matter of Sims, 994 F.2d 210 (5th Cir. 1993) (finding that three affiliates of a franchisor constituted three independent creditors for purposes of involuntary bankruptcy).

the way the Bankruptcy Code may be used to alter the expectations created by the franchise agreement. The following cases give insight into the alteration of expectations that may result from the Bankruptcy Code.

In *In re 6100 Columbus, Inc.*,<sup>206</sup> the franchise agreement between the parties provided for automatic termination upon the happening of certain events, including the failure of the franchisee to satisfy a final judgment for thirty days or more without posting of a bond. The franchisee lost in arbitration with a third party and had a final judgment entered against it based upon the arbitration award. The franchisee appealed, but failed to post bond. The franchisor, pursuant to its contract rights, delivered a termination notice to the franchisee. The franchisee then filed for bankruptcy that same afternoon. Over the next several weeks following issuance of the termination notice, the franchisor took possession of the franchisee's offices and transferred its telephone numbers.<sup>207</sup>

Pursuant to section 362 of the Bankruptcy Code, the filing of a bankruptcy petition triggers an automatic stay of several actions against the debtor's estate, including "any act to obtain possession of property of the estate . . . or to exercise control over property of the estate."<sup>208</sup> These prohibitions will not apply to prevent a lessor from taking back its property if the lease was terminated before the filing of bankruptcy. Furthermore, the prohibitions of section 362 do not prevent a franchisor from taking back its property if the franchise agreement is terminated as a matter of law before the bankruptcy petition was stamped by the clerk of the court. In such a situation, a lease or franchise agreement will no longer be considered an asset of the estate.<sup>209</sup>

The franchisee sought a temporary restraining order, and argued that the franchisor's conduct improperly interfered with the assets of the bankruptcy estate. The court concluded that the franchisee failed to establish: (1) its likelihood of success on the merits and (2) that it faced irreparable harm from the franchisor's operation of the business.<sup>210</sup>

The lesson to the franchisee contemplating bankruptcy is to remain vigilant in order to avoid losing Bankruptcy Code protections by virtue of the swift delivery of a termination notice delivered prior to a bankruptcy filing. In the instance where a bankruptcy trustee is appointed to reorganize or liquidate an estate for the benefit of creditors, the franchisor may often obtain a new audience for its claims which may not have previously persuaded the debtor. The role of trustee, however, is a limited one and cannot bind the debtor without court approval. Where the court determines that the resolution of a debtor's claim will not bring substantial value to the bankruptcy estate, the court may order that the cause of action be abandoned back to the debtor for prosecution.

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206. Bus. Franchise Guide (CCH) ¶ 11462 (Bankr. N.D. Ohio June 24, 1998).

207. *See id.*

208. *See* 11 U.S.C. §362(a)(3) (1994).

209. *See* 11 U.S.C. § 365 (1994).

210. *See In re 6100 Columbus*, Bus. Franchise Guide (CCH) § 1146Z (Bankr. N.D. Ohio June 24, 1998).

In *Northview Motors, Inc. v. Chrysler Motors Corp.*,<sup>211</sup> Chrysler terminated its dealership agreement with Northview in 1991. Northview filed for bankruptcy, and was later converted to Chapter 7, at which time a trustee was appointed. Northview, without the trustee's knowledge, filed a claim against Chrysler. When the trustee learned of the suit, he took control and agreed to settle the matter in exchange for Chrysler paying \$115,000 and withdrawing its claims against the estate. The settlement with the trustee expressly provided that it was subject to approval of the bankruptcy court.<sup>212</sup> Northview objected vigorously to approval of the settlement and moved to compel the trustee to abandon the litigation back to the debtor because those claims were of "inconsequential value to the estate."<sup>213</sup> The bankruptcy court ordered the lawsuit abandoned to the debtor's principals and denied as moot the trustee's motion to approve the settlement.<sup>214</sup> Northview then forwarded a new settlement demand to Chrysler for \$3,500,000. Chrysler moved to enforce the settlement agreement and the district court granted Chrysler's motion to enforce the original settlement.<sup>215</sup> The Third Circuit later reversed in all respects, holding that the trustee's authority was limited to agreeing to settle matters subject to court approval, a condition that was never met.<sup>216</sup> Accordingly, the trustee could impair Northview's interest only in accordance with the bankruptcy court or with their consent.

### C. CIVIL RIGHTS

In *Brown v. Goodyear Tire & Rubber Co.*,<sup>217</sup> the plaintiff was a minority owner of a tire dealership. The plaintiff claimed to have received unequal treatment in comparison to the treatment accorded to white franchisees and that he had therefore been denied an appropriate share of new franchise opportunities, loans, advertising funds, insurance coverage and, other business opportunities. Plaintiff filed a federal action claim for violations of section 1982 and alleged claims for breach of franchise agreement.<sup>218</sup> In analyzing this matter, the court determined that the existence of the franchise agreement between the parties was relevant only for the point that it placed the plaintiff in the group of franchisees with whom Goodyear traditionally dealt.<sup>219</sup> The court concluded that the plaintiff did have a cause of action under section 1982 if, and, or when other franchisees were accorded rights to buy and sell certain kinds of property beyond their respective franchise agreements. The court rec-

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211. 186 F.3d (3rd Cir. 1999).

212. *See id.* at 347-48.

213. *Id.* at 348.

214. *See id.*

215. *See id.*

216. *See id.* at 352.

217. No. 99C1641, 1999 WL 569543 (N.D. Ill. July 28, 1999).

218. *See id.* at \*1; *see also* 42 U.S.C. § 1982 (1994) ("All citizens of the United States shall have the same right, in every State and Territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property.").

219. *See id.* at \*2.

ognized, however, that Illinois provided a two-year statute of limitations for such claims and ultimately dismissed all of the plaintiff's claims as untimely.<sup>220</sup>

In *Adcock v. Chrysler Corp.*,<sup>221</sup> the Ninth Circuit held that the protections of Title VII of the Civil Rights Act of 1964 did not apply to a prospective car dealer who alleged that Chrysler discriminatorily denied a dealership based on gender. Chrysler won on summary judgment at the district court level. The primary issue on appeal was whether the contemplated dealership agreement created an employment relation triggering the protections of Title VII.<sup>222</sup> The court quickly concluded that the question of whether a relationship is one of employment or independent contractual affiliation requires a "fact specific inquiry which depends on economic realities of the situation."<sup>223</sup> In the court's view, the primary factor to consider was "the employer's right to control the means and manner of the worker's performance."<sup>224</sup> In the instant case, the court viewed the dealership agreement as the only relevant evidence regarding the parties' relationship and determined that, under the terms of that agreement, it was the dealer who controlled the day-to-day operations of the business and had discretion over hiring, advertising and the actual hours of operation.<sup>225</sup> Accordingly, it was the dealer, not Chrysler, who owned the vehicles, premises, and equipment in the dealership. This factor weighed heavily in favor of finding that the dealership created an independent contractual affiliation. In addition, since Chrysler did not pay the dealer's salary, benefits or social security taxes, nor did it have exclusive control over the manner of termination, the contemplated relationship was independent.<sup>226</sup> Accordingly, the district court's summary judgment ruling was affirmed for want of the requisite employment relationship required under Title VII to be established.<sup>227</sup>

#### D. AMERICANS WITH DISABILITIES ACT

The Americans with Disabilities Act ("ADA")<sup>228</sup> sets forth several obligations that franchisors of concepts from hotels to quick-serve restaurants must consider. In addition to the *Days Inns of America* cases reported last year,<sup>229</sup> other cases also demonstrate that the ultimate boundaries of franchiser liability under the ADA are far from settled. In

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220. See *id.* at \*2-\*3.

221. Bus. Franchise Guide (CCH) ¶ 11574 (9th Cir. 1999).

222. See *id.*

223. *Id.* at 31, 521 (quoting *Lutcher v. Musicians Union Local 47*, 663 F.2d 880, 883 (9th Cir. 1980)).

224. *Id.*

225. See *id.*

226. See *id.* at 31,522

227. See *Adcock v. Chrysler Corp.*, Bus. Franchise Guide (CCH) ¶ 11574 (9th Cir. 1999).

228. 42 U.S.C. §§ 12101-12213 (1998).

229. See *United States v. Days Inns of Am., Inc.*, 151 F.3d 822 (8th Cir. 1998), cert. denied, 526 U.S. 1016 (1999); see *United States v. Days Inns of Am., Inc.*, 22 F. Supp. 2d 612 (E.D. Ky. 1998).

*Colorado Cross-Disability Coalition v. Taco Bell Corp.*,<sup>230</sup> the district court certified for class treatment the ADA claims of disabled plaintiffs who challenged the width of customer cue lines at Taco Bell outlets. The plaintiffs argued that they were required by their disabilities to use wheel chairs for mobility and were impeded in their efforts to obtain access to Taco Bell because the lines that the customers were required to use were narrower than the specifications outlined in the ADA's accessibility guidelines. Accordingly, plaintiffs claimed that Taco Bell violated the ADA and the Colorado Anti-discrimination Act.<sup>231</sup> Pursuant to Federal Rule of Civil Procedure 23(a), the court concluded that the proposed class satisfied the necessary requirements: (1) the class members were sufficiently numerous and geographically diverse to make joinder impracticable; (2) combinations of fact and law existed; (3) the claims of defenses that are represented of parties would be the same as those of the absent class members; and (4) the representative parties would fairly and adequately protect the interest of the class concerning the alleged violations.<sup>232</sup>

#### E. NEW FEDERAL SWEEPSTAKES LAW

For many years, the Attorneys General of various states have been engaged in ongoing legal battles with the high-profile magazine publishing clearing houses over what they consider to be deceptive sweepstakes solicitations. Every few years, these lawsuits result in an agreed judgment against the defendants, imposing substantial fines and setting forth rules to govern the defendants' future sweepstakes promotions. Within a year or so after each agreed judgment, the defendants invariably pushed the envelope and the cycle continued. In 1999, three separate bills affecting direct mail sweepstakes were introduced in the United States Senate—the Deceptive Mail Prevention Enforcement Act, the Deceptive Sweepstakes Mailings Elimination Act and the Honesty in Sweepstakes Act.<sup>233</sup> As a result of the introduction of these three bills, President Clinton signed the Deceptive Mail Prevention & Enforcement Act of 1999 (the "Act") into law on December 12, 1999.<sup>234</sup> The Act amends federal law relating to non-mailable material, and imposes new mailability requirements for certain materials relating to sweepstakes and skill contests. Although portions of the Act deal with the mailability of other matters, franchise systems and other businesses using sweepstakes and other contests via the mail as part of their marketing strategy are now faced with the new requirements under this law. This new law requires that certain disclosures be made in the mailing, in the rules, and on the order or entry form of the sweepstake or contest.<sup>235</sup> Sweepstakes and

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230. 184 F.R.D. 354 (D. Colo. 1999).

231. COLO. REV. STAT. § 24-34-601 (1998).

232. See *Colorado Cross Disability Coalition*, 184 F.R.D. at 357-61.

233. S. 301, 106th Cong. (1999); H.R. 170, 106th Cong. (1999).

234. Pub. L. No. 106-168 (1999).

235. See *id.*

contest materials failing to make the required disclosures will be disposed of by the U.S. Postal Service.<sup>236</sup> Additionally, the sponsors may be subject to fines and civil penalties ranging from \$25,000 to \$2 million depending upon the size of the mailing.<sup>237</sup>

The new law also allows individuals to elect to be excluded from sweepstakes or contest mailings. Sponsors of these types of promotions are required to establish (and to conspicuously disclose the existence of) a notification system for individuals to make the selection. The consequences of mailing sweepstakes or contest materials to an individual who has properly submitted a removal request include civil penalties of up to \$10,000 for each mailing, and a private right of action by the recipient for injunctive relief and/or damages measured by the greater of \$500 or actual damages. The reckless mailing of materials may also subject the sponsor to civil liability in an amount of \$10,000 per violation for each mailing to an individual. Furthermore, the Act does not preempt any state or local law that imposes more restrictive requirements, regulations, damages, costs or penalties, nor does it prohibit any authorized state official from proceeding in state court on the basis of an alleged violation of any general or specific civil or criminal statute of a state.<sup>238</sup>

## VI. PROCEDURE

### A. JURISDICTION

The nature of the franchise relationship makes for an interesting determination of proper jurisdiction and venue. Generally, a state court has personal jurisdiction over any action brought in its courts if the parties' activities comply with the state's long arm statute and if the exercise of jurisdiction affords due process. Where a franchisee is required to pay royalties and/or send regular reports to a forum state, where out of state investors guarantee a performance scheduled to occur within a forum state, or where courts simply believe that a franchisee has purposely availed itself to the benefits of a relationship with a franchisor in the forum state, jurisdiction will usually be established. Although there were several cases outside of the Texas dealing with this situation, the case of *Fish v. Tandy Corp.*,<sup>239</sup> as discussed in last year's update, gives clear guidance to franchisees who are sued in a franchisor's home state. Generally speaking, Texas courts will find sufficient contacts by the franchisee to satisfy personal jurisdiction in the franchisor's forum state—Texas.

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236. See *id.* at § 104.

237. See *id.* at § 106.

238. Robert E. Vinson, Jr., a partner of Strasburger & Price, L.L.P., presented *The Official Rules: A Primer on Sweepstakes Law for Franchise and Distribution Systems* to the Dallas Bar Association Franchise and Distribution Law Section on December 21, 1999. For a more indepth analysis of the new sweepstakes law Mr. Vinson may be contacted at [vinsonr@strasburger.com](mailto:vinsonr@strasburger.com).

239. 948 S.W.2d 886, 896 (Tex. App.—Fort Worth 1997, writ denied).

## B. CHOICE OF LAW AND FORUM

The outcome of litigation in the franchise context is often influenced by the choice of law and forum. Because of this fact, most franchisors will insist on choice of venue/forum clauses in their respective franchise/li-cense agreements. The following case lends insight into how courts will treat these clauses. In *Snapper, Inc. v Redan*,<sup>240</sup> a franchise contract and its related guarantees provided for all litigation to occur in Georgia state or federal court at the sole discretion of Snapper.<sup>241</sup> One of the distributors later sued Snapper in New Jersey federal court. Snapper then sued the guarantors of the distributor in Georgia state court, seeking to collect a large debt. The guarantors later removed the Georgia case to federal court and then moved to transfer the entire case to New Jersey for consolidation.<sup>242</sup> Snapper's motion to remand to state court was granted by the United States District Court for the Northern District of Georgia on the grounds that the guarantors had waived their right to removal by agreeing to the forum selection clause.<sup>243</sup> The Eleventh Circuit affirmed the district court's ruling stating that the forum selection clause granted "Snapper the absolute right to choose the forum for litigation."<sup>244</sup> *Snapper* thus demonstrates the extent to which a contract can enable a franchisor to control the forum, especially where the court is not hostile to forum selection clauses.

An example of what happens when a franchisor does not provide a forum selection clause in their franchise agreement is found in *Bertrand v. McDonald's Corp.*<sup>245</sup> In this case, the Bertrands filed suit against McDonald's claiming that by approving them as McDonald's franchisees McDonald's had lured them into selling their Virgin Island businesses and moving to Argentina for training and site selection. Once McDonald's had signed them up for this program, McDonald's revoked and replaced the offer of the desirable locations for ones less attractive. The Bertrands then refused the locations offered to them by McDonald's and were subsequently denied the right to operate any McDonald's franchise. McDonald's sought to dismiss the case under Rule 19(b) of the Federal Rules of Civil Procedure for failure to join indispensable parties, and also sought dismissal on grounds of forum non-convenience. In the absence of a contractual forum selection clause, the court concluded that when the factors are either a evenly balanced or in favor of protecting the plaintiff's choice of forum motion to dismiss for forum non-convenience will be denied.<sup>246</sup> The court reasoned was that Virgin Island's jurors have an interest in deciding cases in which the allegations include luring Virgin Island residents and business people to sell their assets and leave the ter-

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240. 171 F.3d 1249 (11th Cir. 1999).

241. *See id.* at 1252.

242. *See id.* at 1251.

243. *See id.* at 1251-52.

244. *Id.* at 1260.

245. No. 96-275, 1998 WL 777032 (D.V.I. Aug. 21, 1998).

246. *See id.* at \*3, \*4.

ritory for business opportunities elsewhere. Thus, the court declined to dismiss the action or to disturb plaintiff's choice of forum.<sup>247</sup>

### C. CLASS ACTIONS

In *E&V Slack, Inc. v. Shell Oil Co.*,<sup>248</sup> plaintiffs comprising of “[a]ll past and present lessee-dealers of Shell gas stations in the United States who participated in Shell’s Variable Rent Program” sought certification as a class.<sup>249</sup> The State District Court refused to certify the class action finding that the putative class did not satisfy the requirements for class certification under Texas Rule of Civil Procedure 42(a). The appellate court affirmed the lower court’s finding.<sup>250</sup> The plaintiffs, all former Shell dealers, asserted that the Variable Rent Program was designed to collect secret rent in excess of the contract rent specified in the leases with Shell, and also alleged breach of contract in a variety of common law statutory fraud claims. The appellate court, considering all evidence in the light most favorable to the trial court, determined that the lower court’s ruling was correct.<sup>251</sup> The appellate court reasoned that the putative class may not be fairly and adequately represented because of the conflict of interest between the named representatives, all of whom were former dealers—and at least one of whom operated a gas leased station that competed with Shell—and the rest of the class. The dichotomy became clear because while current dealers were concerned about damaging Shell’s reputation as a result of the lawsuit, the plaintiffs and other former dealers had no similar concern. Furthermore, there was evidence to suggest that common questions of law and fact did not predominate. Thus, a conflict of interest existed between former dealers interested in maximizing damages, and current dealers interested in the long term financial health of Shell. Under such circumstances, Texas courts will not favor class certification.

### D. ARBITRATION

A review of the leading reported decisions relating to arbitration demonstrates that arbitration clauses are viewed, at least by federal courts, as valid and enforceable methods of conflict resolution. For the most part, this acquiescence to arbitration clauses can be traced to the preemptive sweep of the Federal Arbitration Act.<sup>252</sup> Notwithstanding this favorable treatment, parties seeking to enforce an arbitration clause need to be aware of three potential pitfalls. First, to enforce an arbitration clause, the franchisor should expressly provide an arbitration clause in each generation of its franchise contracts. Second, in seeking to enforce an arbi-

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247. *See id.* at \*4.

248. 969 S.W.2d 565 (Tex. App.—Austin 1998, no pet.).

249. *Id.* at 567.

250. *See id.* at 571.

251. *See id.* at 567, 571.

252. 9 U.S.C. §§ 1-13 (Supp. 1999).

tration clause, a franchisor should always seek federal court jurisdiction pursuant to the terms of the Federal Arbitration Act. If federal jurisdiction is not available, the franchisor should still attempt to rely on the Federal Arbitration Act. Third, the language used in the arbitration clause should be clear and concise and drafted with expansive language that leaves nothing to the judicial imagination for enforcement.

In instances where the franchisor wants to use arbitration as the method of dispute resolution, the franchisor must include an express arbitration clause within the franchise agreement. The franchisor in *In re Howard*<sup>253</sup> learned this rule the hard way. In 1993, Whigham & Associates (“Whigham”) and Royal Body Care, Inc. (“RBC”) entered into a distributorship agreement. Whigham acknowledged in the distributorship agreement that it had received RBC’s Policies, Procedures and Compensation Plan and that these might be amended and updated from time to time by RBC. One year later, RBC amended the Policies, Procedures and Compensation Plan and included an express arbitration clause. In 1997, RBC terminated its distributorship agreement. Whigham then sued RBC as a result of the termination. RBC attempted to enforce the arbitration clause contained in the 1994 amendment to the Policies, Procedures and Compensation Plan. The trial court denied RBC’s argument for arbitration. The appellate court affirmed, acknowledging that although the FAA applied, Texas law controlled the issues and the general rules of contract construction required a meeting of the minds with no material terms left open.<sup>254</sup> Accordingly, the court determined that the arbitration agreement contained in the 1994 amendment was not a policy, procedure or part of compensation plan and that the arbitration clause did not conform with the scope of subject matter of the original agreement.<sup>255</sup> Thus, the court determined that the arbitration agreement was not a part of the distributor agreement because the arbitration clause was not in existence when the parties had a meeting of the minds. The court concluded that the 1994 amendment to arbitrate was a “new contract to which Whigham did not consent and which is unsupported by consideration.”<sup>256</sup> In its reasoning, the court appears troubled by the idea that an arbitration clause could be slipped into a contract by an amendment without the franchisee’s express, contemporaneous consent.

One of the most common defenses to arbitration is waiver. In *Subway Equipment Leasing Corp. v. Forte*,<sup>257</sup> the Fifth Circuit reversed the district court’s denial of Doctor’s Associates, Inc.’s (“DAI”) motion to stay pending arbitration. The court concluded that DAI had not waived its right to arbitrate, even though the company’s affiliates had sued the plaintiffs first and then put the plaintiffs into involuntary bankruptcy,

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253. Bus. Franchise Guide (CCH) ¶ 11,536 (Tex. App. 1998).

254. See *id.* at \*1, \*2.

255. See *id.* at \*2.

256. *Id.*

257. 169 F.3d 324 (5th Cir. 1999).

causing almost a decade long delay in the arbitration process.<sup>258</sup> Procedurally, the case started in 1988 when several franchisees filed a demand for arbitration against DAI alleging breach of development agreement. Shortly thereafter, DAI's affiliates, Subway Restaurant's, Inc. ("SRI") and Subway Equipment Leasing ("SEL"), sued the franchisees in federal court in Louisiana to recover amounts due under subleases and equipment leases. The franchisees then filed a counterclaim against DAI alleging the same claims as those in the arbitration. Prior to the filing of the franchisee's answer and counterclaim, however, SEL presented and filed involuntary bankruptcy petition against the franchisees. By 1990, two other DAI affiliates filed involuntary bankruptcy petitions. As a result, the franchisee's arbitration claims were held in abeyance pending the bankruptcy proceedings. The bankruptcy proceedings concluded in 1996, and the franchisees moved to activate their original claims. DAI moved to stay the action to compel arbitration. The district court denied DAI's motion, holding that it had waived its right to arbitrate by invoking a judicial process. The Fifth Circuit reversed, finding that asserting unrelated litigation as a means of delaying arbitration is not "invoking" the judicial process such that DAI would have waived its right to arbitrate.<sup>259</sup> The Fifth Circuit also stated that "a party only invokes the judicial process to the extent it litigates a specific claim and it subsequently seeks to arbitrate."<sup>260</sup>

## VII. REMEDIES

### A. DAMAGES

While the Fifth Circuit did not weigh in heavily on the issue of franchise damages during the survey period, both the First and Third Circuits issued opinions which provide provocative subject matter for the franchise community.

In *Cooper Distributing Co. v. Amana Refrigeration, Inc.*,<sup>261</sup> several appeals and remands had already taken place between the Third Circuit and the District Court of New Jersey when the case was once again remanded on the sole issue of damages.

By way of background, in 1991, Amana sought to terminate Cooper, a distributor of Amana appliances since 1961, on ten days notice, per the parties' agreement. The distributor then filed suit in state court for violation of the New Jersey Franchise Practices Act ("NJFPA"), breaches of the implied covenant of good faith and fair dealing, tortious interference with prospective economic advantage, and breach of contract. The case was removed to federal court. The district court issued a preliminary injunction prohibiting Amana from taking any action that would in any way

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258. *See id.* at 329.

259. *See id.*

260. *Id.* at 328.

261. 180 F.3d 542 (3d Cir. 1999).

interfere with the distributor's activities as a distributor of Amana products. That injunction was effective until trial in February 1994.

At trial, the jury found Amana liable on all counts and awarded the distributor \$9.375 million in damages, \$4.375 million in compensatory damages on the NJFPA count, \$2 million for breach of contract, and \$3 million in punitive damages on the tortious interference count. The Third Circuit affirmed liability under the NJFPA on appeal but reversed the award of \$2 million for breach of contract, holding as a matter of law that no breach had occurred.<sup>262</sup> The court also vacated the jury's award of \$3 million in punitive damages on the tortious interference claim because the jury had awarded no actual damages on that particular claim.<sup>263</sup> The court vacated the \$4.375 million in NJFPA damages and remanded the case for a new trial on damages, finding that the jury incorrectly found that Cooper's franchise was exclusive and thereby had overvalued it.<sup>264</sup> The court also found that the jury had been improperly instructed to calculate the value of the franchise from the date of Amana's attempted termination, rather than the actual date of termination, thus resulting in double recovery for Cooper.<sup>265</sup>

During a second trial, the district court limited the issue to the fair market value of the franchise to a hypothetical buyer and seller as of the date of termination, barring the distributor from seeking recovery under other damage theories.<sup>266</sup> The distributor was awarded \$377,000 in the second trial. The distributor appealed, arguing that the district court erred in preventing it from proving the value of the franchise to actual parties, its lost profits from the date of the termination notice and actual termination date, the value of the distributor's complimentary lines, and the enhanced value of the franchise due to Amana's later expansion of its own lines.

On the various appeal points, the Third Circuit held that Amana was liable to Cooper for a loss equal to the value of the franchise measured by its fair market value to a hypothetical buyer and seller, minus the value of assets that could be liquidated by the distributor.<sup>267</sup> Thus, the Third Circuit concluded: (1) that the value to hypothetical, rather than actual parties, was appropriate; (2) that the district court had indeed erred in precluding the distributor from offering evidence on loss profits, and, therefore, reversed and remanded the case on that issue; and (3) that no new trial was warranted based on the distributor's claim that the district court improperly precluded it from offering evidence of damages based on the value of product lines it carried in complement to the Amana line.<sup>268</sup> The court held that even though the distributor might not have

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262. *See id.* at 545.

263. *See id.*

264. *See id.*

265. *See id.*

266. *See id.* at 546.

267. *See id.* at 547.

268. *See id.* at 547-48.

carried the complementary lines if it did not carry the Amana line, that fact did not have any legal significance.<sup>269</sup> Because those lines were retained by the distributor, the court held that they were properly excluded from the damages calculation.<sup>270</sup>

The court also found that while Amana was required by the injunction to maintain the status quo, it had no obligation to offer additional added lines to the distributor, even if it offered them to other distributors. Therefore, evidence of any "enhanced value" that the franchise may have gained if it had access to the additional lines was excluded properly by the trial court.<sup>271</sup>

Mitigation of damages was the issue in *Cooney Industrial Trucks v. Toyota*.<sup>272</sup> In *Cooney*, Cooney Industrial Trucks, Inc. ("CITI") sold Toyota forklifts in Massachusetts and New Hampshire pursuant to a series of dealer agreements it had entered with Toyota since 1970. Toyota removed New Hampshire from CITI's area of primary responsibility, and later failed to renew its dealership agreement when the agreement expired, stating that CITI poor sales performance caused both decisions. CITI sued Toyota for breach of contract and unfair practices under the Massachusetts Motor Vehicle Dealer Act.

When Toyota chose not to renew the dealership agreement with CITI, CITI contracted with Mitsubishi Caterpillar to deal Mitsubishi forklifts. The testimony showed that CITI never intended to represent both Toyota and Mitsubishi concurrently, and that CITI had entered the agreement with Mitsubishi in an attempt to mitigate the damages caused by Toyota's nonrenewal. As a Mitsubishi dealer, CITI made more money than it had in its relationship with Toyota. The jury found that CITI, in fact, had avoided its losses by mitigating its damages and, thus, awarded no damages.

On appeal, the First Circuit affirmed the jury charge and judgment reasoning that CITI could not have made the profitable contract with Mitsubishi had its relationship with Toyota not been terminated.<sup>273</sup> The court was unpersuaded by CITI'S unfairness complaint that it bore the risk of the Mitsubishi operation not being successful. The court stated that had the Mitsubishi operation failed, Toyota's damages for liability would not have been offset and the mitigation factor would not have weighed in so heavily to preclude damages.<sup>274</sup>

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269. *See id.* at 548.

270. *See id.*

271. *See id.*

272. 168 F.3d 545, 546 (1st Cir. 1999).

273. *See id.* at 546.

274. *See id.* at 545-47.

## B. INJUNCTIVE RELIEF

In *Conley v. DSC Communications Corp.*,<sup>275</sup> in an unpublished opinion, the Dallas Court of Appeals reformed and affirmed a temporary injunction against Troy Conley, a salesperson who had marketed products for DSC Communications Corp. ("DSC"), a manufacturer of telecommunications equipment.

The court affirmed the trial court's conclusion that Conley's former and current job positions were substantially similar and that it was probable that he would use or disclose the confidential information that he had learned at DSC in performing his new responsibilities at Advanced Fibre.<sup>276</sup>

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275. No. 05-98-01051-CV, 1999 WL 89955 (Tex. App.—Dallas Feb. 24, 1999, no pet. h.) (not designated for publication); see section IV(D), *supra* for further discussion of *Conley v. DSC Communications Corp.*

276. See *id.* at \*8.

