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FRANCHISE LAW

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I. INTRODUCTION

THIS article provides an update of case law and legislative efforts that had, or will have, a significant impact on franchise and dealership law in Texas and the Fifth Circuit. This article also includes an analysis of recent legislative efforts from the Federal Trade Commission that will leave a profound mark on franchise businesses for years to come.

II. FRANCHISE BASICS

A. WHAT IS A FRANCHISE?

Although definitions vary somewhat from jurisdiction to jurisdiction, a franchise can generally be described as a continuing commercial relationship consisting of (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 provide significant assistance to, or exercise significant control of, the franchisee in the operation of its business.¹ This black letter definition, however, does not define the entirety of the relationship nor does it provide the unschooled with any direction for advising on the relationship. Given the many developments discussed in this update, it is once again apparent that franchise lawyers must remain vigilant both to current legislative movements and to case law to advise their franchise clients on the complexities of the franchise relationship.

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1. 16 C.F.R. § 436.2(a) (2004).

B. THE FRANCHISE RULE

Franchising is governed primarily by laws that require franchisors to disclose to prospective franchisees certain items about the franchise system.² Under the guidelines set by the North American Securities Administrators Association (“NASAA”), franchisors are required to provide very specific information about themselves, the franchise system, the relationship between the franchisor and the franchisee, and the documents the franchisee will be required to sign.³ This information is contained in a document called the Uniform Franchise Offering Circular (“UFOC”). The FTC has its own form of disclosure format under the Franchise Rule,⁴ but has traditionally accepted the NASAA format in lieu of its own.⁵

On August 25, 2004, the Federal Trade Commission (the “Commission”) made public its staff report on the Trade Regulation Rule entitled “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures—(Franchise Rule)”⁶ (the “Report”). The Report represents the first significant development in the past five years to the Commission’s efforts to revise the federal franchise law. The Report analyzes the rulemaking effort to date and details the staff’s recommendations to the Commission on proposed amendments to the Franchise Rule.

The Franchise Rule has been in place since 1978. In 1995, the Commission began reviewing the Franchise Rule to determine whether changes were necessary and, if so, to revise the Franchise Rule. In 1997, the Commission published an Advanced Notice of Proposed Rulemaking (the “ANPR”)⁷ and, two years later, published a Notice of Proposed Rulemaking (the “NPR”)⁸ containing the first draft of proposed changes to the Franchise Rule.

The Report contains the Commission’s recommended revisions to the Franchise Rule. Thus, it provides a glimpse into what will likely become a new federal franchise law when enacted. The Commission accepted public comments on the Report until November 12, 2004.

The following summary details some of the key recommendations contained in the Report. The Report contained over 400 pages of recommendations and analysis; therefore, this summary is not an exhaustive analysis, but instead provides a brief overview of the more significant rec-

2. RUPERT M. BARKOFF & ANDREW C. SELDEN, *FUNDAMENTALS OF FRANCHISING* 121-22 (ABA Publishing 2004).

3. *Id.* at 98-99.

4. 16 C.F.R. § 436.1 (2004).

5. Rupert M. Barkoff, Mary Beth Brody & Lane Fisher, *The Basics of Disclosure*, IFA 37th Annual Legal Symposium, Tab 8, ii-iii (May 23-25, 2004).

6. Federal Trade Commission, *Disclosure Requirements & Prohibitions Concerning Franchising* at <http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf> (Aug. 2004) [hereinafter Report].

7. Trade Regulation Rule on Disclosure Requirements and Prohibitions concerning Franchising and Business Opportunity Ventures, 62 Fed. Reg. 9,115 (Feb. 28, 1997).

8. Franchise Rule, 64 Fed. Reg. 57,294 (Oct. 22, 1999).

ommendations proposed by the Commission's staff in order to help the franchise lawyer prepare for the FTC's potential adoption of the revised rule.

APPLICATION TO FRANCHISE SALES AND BUSINESS OPPORTUNITY SALES. The Report recommends revising the Franchise Rule to apply solely to franchise sales and not to business opportunity sales. The staff recommended that the Commission establish a yet-unproposed separate rule to regulate business opportunities.

COMPLIANCE WITH THE UFOC GUIDELINES. The Report also recommends that the Commission revise the Franchise Rule's disclosures, based upon the UFOC Guidelines model, to reduce inconsistencies between the Franchise Rule and various state pre-sale disclosure laws. The Report does not recommend mirroring the UFOC Guidelines in all cases, but rather recommends making the Franchise Rule more similar to the UFOC Guidelines.

APPLICATION OF THE FRANCHISE RULE TO DOMESTIC FRANCHISE SALES ONLY—PROPOSED § 436.2. The current Franchise Rule does not specify whether the pre-sale disclosure requirements apply to international franchise sales, and the issue has been the subject of much debate and uncertainty in the franchise community. Although the Commission has publicly stated that the Franchise Rule applies to international franchise sales, it has never sought to enforce it in this manner. In the ANPR, the Commission noted the following reasons that support the application of the Franchise Rule to domestic franchise sales only: (1) the Commission did not contemplate international franchising when it promulgated the Franchise Rule; (2) the Franchise Rule's disclosures are aimed at the domestic market; (3) foreign franchise purchasers are sophisticated and do not need the Franchise Rule's protections; (4) attempting to comply with the Franchise Rule in foreign markets might result in franchisors disseminating inaccurate or misleading information; and (5) application of the Franchise Rule to international sales would unnecessarily impede competition. As a result, the staff recommends that the Franchise Rule specifically apply only to domestic franchise sales and not to international franchise sales.⁹

DELIVERY OF DISCLOSURE DOCUMENT—TIMING CHANGES—PROPOSED § 436.2(A). The current Franchise Rule requires franchisors to deliver the pre-sale disclosure to prospective franchisees at the earlier of (1) the first personal meeting; and (2) "the time for making disclosures," which is ten business days before execution of the franchise agreement or other binding agreements or payment of any fees in connection with the franchise sale.¹⁰ The staff recommends eliminating the requirement to provide disclosure at the first personal meeting. In addition, the staff recommends requiring franchisors to provide disclosure at least fourteen calendar days (instead of ten business days) before the execution of the

9. Report, *supra* note 6, at 72; Franchise Rule, 64 Fed. Reg. at 57,299.

10. Report, *supra* note 6, at 75; Franchise Rule, 64 Fed. Reg. at 57,300.

franchise agreement or other binding agreements or payment of any fees in connection with the franchise sale.

PRE-SIGNING CONTRACT REVIEW PERIOD—PROPOSED § 436.2(B). The current Franchise Rule requires franchisors to furnish prospective franchisees with a copy of the completed franchise agreement at least five business days before its execution. The staff recommends eliminating the contract review period entirely, *except* where the franchisor has materially altered the terms and conditions of the standard contract attached to the disclosure document, and such changes were not requested by the prospective franchisee. When the exception applies and the franchisor must therefore deliver a completed franchise agreement, the staff recommends allowing the prospective franchisee seven days (instead of five business days) to review the agreement.¹¹

LIABILITY OF THIRD-PARTY BROKERS AND FRANCHISOR EMPLOYEES—PROPOSED § 436.2(D). The current Franchise Rule holds franchisors and brokers jointly and severally liable for complying with the Franchise Rule (e.g., timely furnishing accurate and complete disclosures to prospective franchisees). The staff recommends altering the rule to hold franchise sellers (including third-party brokers and franchisor employees) liable for the content of a disclosure document, only if they either directly participated in the document's creation or had authority to control it.¹²

ITEM 19: EARNINGS CLAIMS—PROPOSED § 436.5(s). The current Franchise Rule and the UFOC Guidelines permit, but do not require, franchisors to make earnings claims to prospective franchisees. The staff recommends that earnings claims remain voluntary. However, it proposes elimination of the current requirement that the earnings claim have geographic relevance and that franchisors disclose the number and percentage of franchisees who have attained the numbers presented in the earnings claim. The Report asserts that such requirements are unnecessarily restrictive and prevent franchisors from sharing material, truthful performance information about subgroups of existing franchisees. The Report also confirmed the staff's position that earnings claims need not be prepared in accordance with GAAP, reflecting the desire to provide franchisors with the flexibility to formulate their earnings claims as they see fit, so long as the representations are reasonable.¹³

ITEM 20: OUTLETS AND FRANCHISEE INFORMATION—PROPOSED § 436.5(T). The staff recommends adopting proposed revisions to Item 20 that were suggested by the NASAA to solve the Item 20 double-counting problem. NASAA's proposed Item 20 would contain five tables that detail for each of the last three fiscal years (1) the status of a franchisor's system, including the number of franchised and company-owned outlets at the beginning and end of each of the last three fiscal years, and the

11. Report, *supra* note 6, at 80; Franchise Rule, 64 Fed. Reg. at 57,301.

12. Report, *supra* note 6, at 84; Franchise Rule, 64 Fed. Reg. at 57,301.

13. Report, *supra* note 6, at 158; Franchise Rule, 64 Fed. Reg. at 57,308.

total net change; (2) transfers in each state; (3) the turnover rate of franchised outlets, including the number of franchised outlets at the beginning of the year, new outlets opened, terminations, non-renewals, re-acquisitions by the franchisor, outlets that ceased to do business, and outlets at the end of the year; (4) the turnover rate at company-owned stores, including the number of company-owned outlets at the beginning of the year, new outlets, reacquired outlets, closed outlets, outlets sold to franchisees and outlets open at the end of the year; and (5) projected openings and the number of franchise agreements signed in the previous year where a store has not yet been opened. The staff also recommends that the Commission include a new provision in Item 20 that requires a franchisor selling an existing unit to provide the prospective franchisee with a history of that unit for the last three fiscal years, including the names, addresses, and telephone numbers of each previous owner and the reasons for the change in ownership.¹⁴

CONFIDENTIALITY AGREEMENTS—PROPOSED § 436.5(T). The staff expressed concern that confidentiality clauses signed in connection with dispute settlements and terminations may impede a prospective franchisee's ability to conduct due diligence investigations of franchise offerings, and thwart the goal of pre-sale disclosure. The staff recommends that the Commission adopt the approach set forth in the NPR, which provides that if a franchisee signed a contract containing a confidentiality clause in the last three fiscal years, the franchisor would provide a statement in Item 20 alerting prospects to the fact that some franchisees may not be able to speak openly with prospects because of these clauses. The franchisor has the option of providing the number and percentage of current and former franchisees who have signed confidentiality provisions and the circumstances under which the provisions were signed. The staff does not recommend disclosure of confidentiality clauses that address specific contract negotiation terms and conditions.¹⁵

ITEM 21: FINANCIAL STATEMENTS—PROPOSED § 436.5(U). The staff recommends that Item 21 require the disclosure of a parent's financial information only in two circumstances: (1) where the parent commits to perform post-sale obligations for the franchisor; or (2) where the parent guarantees obligations of the franchisor. The staff also recommends that the Commission require subfranchisors to furnish financial disclosures in all instances. "Subfranchisor" only applies to situations where a subfranchisor steps into the shoes of the franchisor by selling and performing post-sale obligations. "Subfranchisor" does not include individuals who, without any post-sale commitments, act like brokers. The staff also recommends that Item 21 requires franchisors to attach a copy of any guarantee in their disclosures.¹⁶

14. Report, *supra* note 6, at 172; Franchise Rule, 64 Fed. Reg. at 57,311.

15. Report, *supra* note 6, at 181; Franchise Rule, 64 Fed. Reg. at 57,311.

16. Report, *supra* note 6, at 198; Franchise Rule, 64 Fed. Reg. at 57,315.

AUDITED FINANCIAL STATEMENTS. The current Franchise Rule and the UFOC Guidelines require franchisors to include within their disclosure documents audited financial statements prepared according to GAAP. The staff recommends that the Commission update Item 21 to require that financial statements be prepared according to U.S. GAAP, or as permitted by the SEC, subject to any future government mandated accounting principles. The SEC allows foreign companies registering securities to prepare financial statements using accounting procedures other than U.S. GAAP under certain circumstances, including the following: (1) the statements must be prepared "according to a comprehensive body of accounting principles;" (2) the company must disclose the specific comprehensive body of accounting principles used to prepare the statements and explain the material differences between the principles and U.S. GAAP; (3) the company must reconcile its statements with U.S. GAAP; and (4) the statements must provide all additional disclosures required by U.S. GAAP.¹⁷

NEW EXEMPTIONS—PROPOSED § 436.8. The staff recommends retaining the current Franchise Rule exemptions for fractional franchises, leased departments, oral contracts and franchise sales under \$500. The staff also recommends adding additional exemptions for petroleum marketers and franchisees deemed to be "sophisticated investors." Three sophisticated investor exemptions have been proposed: a large investment exemption, a large business entity-franchisee exemption, and an officer and owner exemption.¹⁸

THE LARGE INVESTMENT EXEMPTION. The staff recommends adopting an exemption from the Franchise Rule for franchise sales where the total investment made in acquiring the franchise totals at least \$1 million, excluding the cost of real estate and excluding any financing provided by the franchisor. The investment threshold should apply to the purchase of both single-unit and multiple-unit franchise rights.¹⁹

THE LARGE FRANCHISEE EXEMPTION. The staff recommends adopting an exemption from the Franchise Rule for franchise sales to large entities. A "large entity" is an entity that has been in business for at least five years and has a net worth of at least \$5 million. "Entity" includes corporations, partnerships and similar business arrangements. The staff also recommends allowing the assets of affiliated entities to be aggregated in determining whether the \$5 million net worth threshold is met.²⁰

THE OFFICER, OWNER AND MANAGER EXEMPTION. The staff recommends allowing sales to owners, operators and those with direct management experience over a franchise system to be exempt from the Franchise Rule when the owner, operator or manager purchases an outlet from such franchisor. To qualify, the prospective franchisee must have been

17. Report, *supra* note 6, at 200; Franchise Rule, 64 Fed. Reg. at 57,315.

18. Report, *supra* note 6, at 225; Franchise Rule, 64 Fed. Reg. at 57,319.

19. Report, *supra* note 6, at 235; Franchise Rule, 64 Fed. Reg. at 57,321.

20. Report, *supra* note 6, at 245; Franchise Rule, 64 Fed. Reg. at 57,321.

employed by the franchisor for at least two years, and the relationship between the franchisor and prospective franchisee must have existed within sixty days of the sale.²¹

As of January 2005, the Report has not been reviewed or adopted by the Commission and, therefore, does not have the force of law. Once the FTC staff provides final comments to the Commission and assuming the Commission adopts the staff's revised Franchise Rule, the Commission should issue another notice in the Federal Register, release a statement of basis and purpose, and announce the effective date of new Rule.

III. PROCEDURE

A. JURISDICTION

Many cases during the Survey period analyzed the traditional arguments that defendants assert to contest personal jurisdiction—no minimum contacts exist for Texas courts to obtain personal jurisdiction. In these cases, the Texas long-arm statute and federal due process requirements were applied. The ultimate question was whether sufficient contacts were established by which the defendant purposefully availed itself of the privilege of conducting activities within Texas, thus invoking the benefits and protections of Texas laws. The Austin Court of Appeals in *Johnson v. Schlotzsky's, Inc.*, however, was among the few that went beyond this conventional analysis.

In *Johnson v. Schlotzsky's, Inc.*,²² the appellate court affirmed the district court's denial of a franchisee's request for special appearance and severance of contract and tort claims. In this case, Schlotzsky's, Inc. and its chief executive officer John C. Wooley (collectively, Schlotzsky's) sued Jeff Johnson for business disparagement, defamation, conspiracy, and breach of confidentiality agreements. This action arose when Johnson, a franchisee and area developer for Schlotzsky's for seventeen years, allegedly conveyed confidential and defamatory information to "Yahoo! Finance BUNZ Message Board" messengers. Johnson filed a special appearance with respect to the tort claims alleging that Texas courts did not have specific or general jurisdiction for the tort claims. The district court held, and the appellate court affirmed, that the tort and contract claims were not severable and that the Texas courts, therefore, had personal jurisdiction over all claims.²³

Schlotzsky's is a publicly traded franchise restaurant chain with locations throughout the United States, with its corporate headquarters in Austin, Texas. Over seventeen years, Schlotzsky's and Johnson entered into five agreements—two franchise agreements, an area developer agreement, a management agreement, and a unit development agree-

21. Report, *supra* note 6, at 249; Franchise Rule, 64 Fed. Reg. at 57,322.

22. *Johnson v. Schlotzsky's, Inc.*, No. 03-03-00468-CV, 2003 WL 22964291, at *5 (Tex. App.—Austin Dec. 18, 2003, no pet.).

23. *Id.*

ment. The third agreement, the area developer agreement, provided that all disputes arising out of the agreement would be arbitrated in Austin. As a franchisee, Johnson sent monthly royalty payments to Schlotzsky's corporate headquarters in Austin, and as an area developer, Johnson received a check from Schlotzsky's Austin headquarters for each franchise that he sold, as well as monthly royalty checks for a percentage of sales.²⁴

After over ten years of Johnson's business relationship with Schlotzsky's, Schlotzsky's began to implement changes to its policies and business methods, which Johnson opposed. Johnson, therefore, initiated an arbitration proceeding in Austin against Schlotzsky's under his area developer agreement. By a settlement agreement, the parties settled the arbitration and litigation in September 2001. This settlement agreement contained a confidentiality clause "forbidding either party from disclosing the terms of the settlement and anything said and exchanged in the negotiations leading up to the settlement." When Johnson's alleged statements were posted on an internet message board, this litigation ensued based on breach of the settlement and confidentiality agreement. Because Texas law governed the settlement agreement and included a forum-selection clause placing venue in Travis County, Texas, Johnson did not contest the court's jurisdiction for breach of the confidentiality claim based on the contract. Johnson did contest jurisdiction over the tort claims, alleging that the claims were severable and no jurisdiction existed. The court rejected this argument.²⁵

The court said that a claim was properly severable if: (1) the controversy involved more than one cause of action; (2) the severed claim was one that would be proper subject of a lawsuit if independently asserted; and (3) the severed claim was not so interwoven with the remaining action that they involved the same facts and issues. Furthermore, the controlling reasons for a severance were to do justice and to avoid prejudice and further inconvenience. Although Johnson met the first two requirements of severability, he failed to meet the third requirement because the tort claims were interwoven with the contract claim. Moreover, the contract and tort claims involved the same facts, arose out of a single course of conduct, and involved the same issues. Therefore, justice would be better served by enabling a single fact-finder to consider the contractual relationship of the parties, the allegedly tortious conduct, and the interplay between the two.²⁶

In addition, the *Schlotzsky's* court held that independent of the severance issue, the district court would still have personal jurisdiction over Johnson because of his Texas contacts. To establish personal jurisdiction over a nonresident defendant, a plaintiff must show that the defendant falls within the reach of the Texas long-arm statute. The long-arm statute reaches as far as the federal constitutional requirement of due process

24. *Id.* at *1.

25. *Id.* at *2.

26. *Id.* at *3.

will permit. The appellate court affirmed that a Texas court may assert personal jurisdiction over actions that are related to the defendant's contacts with the state, as long as the contacts stem from the defendant's purposeful conduct rather than from the plaintiff's unilateral activity, such that the defendant "should reasonably anticipate being haled into court" in Texas to defend the claims.²⁷

Furthermore, the court held that a defendant's contacts with a forum could give rise to either specific or general jurisdiction. It held that for a court to exercise specific jurisdiction over a non-resident defendant, two requirements must be met: (1) the defendant's contacts with the forum must be purposeful, and (2) the cause of action must arise from or relate to those contacts. Most importantly, the exercise of personal jurisdiction must not offend "traditional notions of fair play and substantial justice."²⁸

Although Johnson challenged the court's exercise of jurisdiction based on the tort claims, neither the district nor appellate court analyzed jurisdiction based on the Internet bulletin messages—the subject of the tort claims. Instead, the appellate court specifically focused on Johnson's business relationship and contacts with Schlotsky's as a franchisee and area developer. The court held that the record was clear that Johnson's contacts with Texas were purposeful, thereby satisfying the first requirement of exercising specific jurisdiction over a non-resident defendant. Likewise, the court held that the tort claims arose from or related to those contacts since the tort claims would likely not exist but for Johnson's purposeful contacts with Texas, especially the settlement agreement.²⁹

Finally, the appellate court considered whether the exercise of personal jurisdiction would offend traditional notions of fair play and substantial justice. Texas courts consider five factors when making this determination: (1) the burden on the defendant; (2) the interests of the forum state in adjudicating the dispute; (3) the plaintiff's interest in obtaining convenient and effective relief; (4) the interstate judicial system's interest in obtaining the most efficient resolution of controversies; and (5) the shared interest of the several states in furthering fundamental substantive social policies. Considering these factors, the court held that because Johnson had already submitted to personal jurisdiction with respect to the contract claim, and because the contract and tort claims were interwoven, these factors weighed in favor of the assumption of jurisdiction over Johnson.³⁰

B. CHOICE OF LAW

With franchise relationships extending across state and international boundaries, it is important to consider forum selection and choice of law provisions for dispute resolution. Whether choice of law clauses are con-

27. *Id.*

28. *Id.* at *4 (citing *Int'l Shoe Co. v. Wash.*, 326 U.S. 310, 316 (1945)).

29. *Id.*

30. *Id.*

strued narrowly or broadly can greatly change the outcome of an entire case. Federal and Texas courts generally enforce and presume valid choice of law provisions. The first case illustrates the construction of a choice of law clause and how the result would be the same whether the court enforced the clause or not. A later case discusses the effect if the contractual choice of law provision fails.

In *El Pollo Loco, S.A. de C.V. v. El Pollo Loco, Inc.*,³¹ the district court analyzed the applicable law provided in the parties' dispute resolution clause of their intellectual property acquisition agreement (the "Agreement"). In the defendants' motion to dismiss, they urged the district court to dismiss all the plaintiff's claims for failing to state a claim under the applicable law. El Pollo Loco, the plaintiff, was a Mexican corporation who owned the rights in Mexico to the El Pollo Loco trademarks, trade names, copyrights, trade secrets, trade practices, and the right to a number of franchise and license agreements with Mexican franchisees.³² Plaintiff agreed to transfer to defendant El Pollo Loco, Inc., a United States corporation, all its rights to the intellectual property in exchange for an exclusive, royalty-free license within specified Mexican territories along with other franchise-related benefits. Although the Agreement contained a forum selection clause designating that disputes were to be argued in the Southern District of Texas and a choice of law clause selecting Mexican law to govern the disputes, the plaintiff asserted tort and contract claims, referring only to Texas law, and that was the basis for the defendant's motion to dismiss.³³ The dispute resolution clause stated:

All disputes which may arise in connection with the performance of this Agreement, which cannot be resolved by means of negotiation, will be resolved by the United States District Court for the Southern District of Texas, Laredo Division. Governing laws shall be those of Mexico. EPL-USA expressly waives any rights under the laws of the USA which may be in conflict with this provision.³⁴

While the defendant argued that Mexican law should govern all the plaintiff's claims since they "arise in connection with" the Agreement, the plaintiff argued that Texas law should apply to the contract claims without any justification. In the alternative, the plaintiff contended that the choice of law provision should be narrowly construed so that, even if the contract claims applied Mexican law, the tort claims would apply Texas law. The district court disagreed.³⁵

The district court followed the United States Supreme Court's rule that "choice of law clauses were presumptively valid, and American courts [should] enforce such clauses in the interests of international comity and

31. *El Pollo Loco, S.A. de C.V. v. El Pollo Loco, Inc.*, 344 F. Supp. 2d 986 (S.D. Tex. 2004).

32. *Id.* at 987.

33. *Id.* at 987-88.

34. *Id.* at 988.

35. *Id.*

out of deference to the integrity and proficiency of foreign courts.”³⁶ Moreover, Texas choice of law principles gave effect to choice of law clauses if the law chosen by the parties had a reasonable relationship with the parties and the chosen state, and the law of the chosen state was not contrary to the state’s fundamental policy. Therefore, the district court held that the choice of law clause was valid.³⁷

Although the clause was held valid and plainly governed the contract claims, the district court noted that it was not equally clear whether the clause applied to the tort claims. The district court considered the construction of choice of law provisions in a few Fifth Circuit cases. In *Benchmark Electronics, Inc. v. J.M. Huber Corp.*,³⁸ the Fifth Circuit narrowly construed a choice of law provision to apply only to contract claims and not to the tort claims because the clause stated that the “[a]greement shall be governed by, and construed in accordance with, the internal laws of New York.” Likewise, in *Caton v. Leach Corp.*,³⁹ the Fifth Circuit did not apply the choice of law to the alleged tort claims when the clause stated that the “[a]greement shall be construed under the laws of the State of California.” The district court recognized, however, that the phrase “*all disputes* which may arise in connection with the performance of this Agreement” was broader than the choice of law provisions at issue in *Benchmark* or *Caton*. The district court held that the choice of law clause applied to the plaintiff’s tort claims as well as its contract claims.⁴⁰

The district court went further to show that, even if the choice of law clause did not apply to the tort claims, the application of Texas choice of law rules would produce the same result—Mexican law would govern the tort claims. Texas courts use the Restatement’s “most significant relationship” test to decide choice of law. The district court concluded that most of the parties’ actions and transactions arising from the Agreement related directly to Mexico. The parties, as the district court noted, had very minimal ties to Texas. Therefore, application of the “most significant relationship” test required that Mexican law govern the plaintiff’s tort claims.⁴¹

Just as the district court in *El Pollo Loco* reasoned that the choice of law clause must have a reasonable relationship with the parties and chosen state, the Dallas Court of Appeals in *SAVA Gumarska In Kemijska Industrial D.D. v. Advanced Polymer Sciences, Inc.*⁴² applied the same theory. Nevertheless, the result was completely different. In *SAVA*, *SAVA* and *APS* entered into two agreements—the company formation agreement and the equipment agreement—providing for the formation and ownership of *SAVA AP*, a new Slovenian stock company. After mu-

36. *Id.*

37. *Id.* at 988-89.

38. 343 F.3d 719, 726 (5th Cir. 2003).

39. 896 F.2d 939, 943 (5th Cir. 1990).

40. *Id.* at 942-43.

41. *Id.* at 943.

42. 128 S.W.3d 304 (Tex. App.—Dallas 2004, no pet. h.).

tual problems with various aspects of the transaction and SAVA AP becoming insolvent, APS filed claims against SAVA for breach of the equipment agreement, in which SAVA counterclaimed for breach of the equipment agreement, company formation agreement, and agreements between SAVA AP and APS. The appellate court analyzed which law to apply to the transactions at issue in this case.⁴³

Although the equipment agreement provided that the laws of England would apply to any disputes, English law had no relation to this transaction and neither the trial nor appellate court would apply such law. Because the choice of law clause did not bear a "reasonable relationship" to the chosen state and therefore failed, the appellate court affirmed that Texas would apply the law of the state or nation with the most significant relationship to the transaction and the parties. As a result, the court applied Texas law to all the issues presented.⁴⁴

C. FORUM SELECTION

Although not specifically related to "franchise" law, the Texas Supreme Court last year confirmed the enforceability of forum selection clauses, an issue important to franchises and dealerships. In *In re AIU Insurance Co.*,⁴⁵ the Texas Supreme Court analyzed the enforceability of forum selection clauses based on *Bremen v. Zapata Off-Shore Co.*⁴⁶ and *Carnival Cruise Lines, Inc. v. Shute*⁴⁷ precedents. This was the first time the Texas Supreme Court addressed the validity of this type of forum-selection clause, while dealing with issues of convenience, Texas statutory provisions, and the "public interest" of litigating in Texas.⁴⁸

Louis Dreyfus Corporation obtained \$70 million of pollution liability coverage for itself and its subsidiaries from AIU Insurance Company. At the time the policy was issued, AIU was a New York corporation with its principal place of business in New York. The insurance policy contained a forum-selection clause in which the insured and insurer agreed that all disputes would be resolved in the State of New York. Louis Dreyfus Corporation's subsidiary, Louis Dreyfus Natural Gas Corporation ("LDNGC"), was listed as an insured on the AIU policy. A few months after the policy issued, LDNGC merged with American Exploration Company, which was based in Hidalgo County, Texas. About a year and a half after the policy became effective, LDNGC was added as a defendant in a suit in Hidalgo County in which the plaintiff alleged that LDNGC had contaminated the air, soil, and ground water. AIU provided a defense under a reservation of rights and disputed coverage. LDNGC sued AIU in Hidalgo County seeking a declaratory judgment

43. *Id.* at 310-13.

44. *Id.* at 314.

45. 148 S.W.3d 109 (Tex. 2004).

46. 407 U.S. 1 (1972).

47. 499 U.S. 585 (1991).

48. *In re AIU Ins. Co.*, 148 S.W.3d at 109.

that the environmental contamination claims against it were covered. AIU filed a motion to dismiss based on the insurance policy's forum-selection clause. The Hidalgo County trial court denied AIU's motion to dismiss, and the court of appeals denied mandamus relief. The Texas Supreme Court granted the petition and issued a writ of mandamus.⁴⁹

At one time, American courts disfavored forum-selection clauses because such clauses were viewed as "ousting" a court of jurisdiction. In 1972, however, the United States Supreme Court held in *Bremen v. Zapata Off-Shore Co.* that international forum-selection clauses should be given full effect, absent fraud, undue influence, or overwhelming bargaining power.⁵⁰ Subsequently, in *Carnival Cruise, Inc. v. Shute*, the U.S. Supreme Court enforced a clause that selected Florida as the situs of any litigation when the plaintiff sued in the state of Washington.⁵¹ Moreover, the Texas Supreme Court noted that since these two U.S. Supreme Court cases, five Texas appellate courts have enforced forum-selection clauses that provided that litigation must be brought in a particular state.⁵²

LDNGC urged the supreme court that the *Bremen* exceptions applied to a forum-selection clause (1) upon a "strong showing" or (2) a showing that the enforcement would be unreasonable and unjustly applied in the instant case. Specifically, LDNGC gave three reasons why the supreme court should set aside the forum-selection clause. First, LDNGC contended that many, if not most, potential witnesses regarding coverage issues were in Texas. Second, Texas Insurance Code Article 21.42 applied and required that Texas law govern. Finally, LDNGC argued that Texas had a strong public interest in having the coverage issues litigated in Texas because insurance proceeds "could be used to benefit the health and welfare of the citizens and landowners of Hidalgo County, Texas," and the substantial amount of insurance available under the policy "is also likely to dissipate any potential adverse financial effects on" LDNGC's successor, who had its offices in Houston and employed a large number of people in Texas. The supreme court rejected all three arguments.⁵³

On LDNGC's inconvenience argument, the supreme court analyzed whether LDNGC had established that trial in the contractual forum would be so gravely difficult and inconvenient that LDNGC would, for all practical purposes, be deprived of its day in court. The supreme court held that LDNGC did not show how litigating in New York would essen-

49. *Id.* at 110-12.

50. *Bremen*, 407 U.S. at 1.

51. *Shute*, 499 U.S. at 585.

52. *In re AIU Ins. Co.*, 148 S.W.3d at 109. The five Texas cases include: *My Café-CCC, Ltd. v. Lunchstop, Inc.*, 107 S.W.3d 860, 865-867 (Tex. App.—Dallas 2003, no pet.); *CMS Partners, Ltd. v. Plumrose USA, Inc.*, 101 S.W.3d 730, 734-736 (Tex. App.—Texarkana 2003, no pet.); *Holeman v. Nat'l Bus. Inst., Inc.*, 94 S.W.3d 91, 101-103 (Tex. App.—Houston [14th Dist.] 2002, pet. denied); *Barnett v. Network Solutions, Inc.*, 38 S.W.3d 200, 203-205 (Tex. App.—Eastland 2001, pet. denied); *Abacan Tech. Servs. Ltd. v. Global Marine Int'l Servs. Corp.*, 994 S.W.2d 839, 843-845 (Tex. App.—Houston [1st Dist.] 1999, no pet.).

53. *In re AIU Ins. Co.*, 148 S.W.3d at 112-13.

tially deprive it of its day in court. Furthermore, the supreme court noted how the U.S. Supreme Court refined its analysis of *Bremen* in *Carnival Cruise Lines*. In *Carnival Cruise Lines*, a passenger sued Carnival Cruise Lines after she sustained personal injuries on the cruise. Although her printed tickets contained a forum-selection clause for any litigation to be brought in Florida, the passenger sued in the State of Washington. The U.S. Supreme Court held that Florida was not a "remote alien forum," nor was there any indication that Carnival Cruise Lines set Florida as the forum as a means of discouraging cruise passengers from pursuing legitimate claims. The Texas Supreme Court analogously held that New York was not a remote alien forum and there was no indication that AIU or LDNGC chose New York as a means of discouraging claims. The supreme court further held that there was no evidence of fraud or overreaching.⁵⁴

After noting that the Texas Insurance Code did not require the suit to be brought or maintained in Texas, the supreme court firmly rejected LDNGC's argument that the insurance proceeds would benefit Texas businesses. The supreme court held that "not only does this reflect something of a provincial attitude regarding the fairness of other tribunals, a notion rejected by the U.S. Supreme Court in *Bremen*, LDNGC's argument blatantly suggests that the tribunal should consider, consciously or unconsciously, the benefits to the local community in deciding whether there is insurance coverage."⁵⁵ The supreme court held that this argument was highly offensive to a system of justice based on the rule of law and gave fodder to those who have in the past questioned the fairness of Texas courts. The supreme court "categorically" rejected this argument.⁵⁶

In addition to arguing that the forum-selection clause should be set aside, LDNGC presented several reasons why mandamus relief was unavailable. First, LDNGC contended that AIU had an adequate remedy at law. The supreme court reasoned that it had granted mandamus relief to enforce another type of forum-selection clause—an arbitration agreement—which should be analyzed in the same manner. LDNGC argued that the supreme court should treat a forum-selection clause requiring litigation to be brought in another state different from arbitration agreements; it argued that (1) requiring the parties to proceed to trial in Texas and then enforcing the forum-selection clause on appeal did not make an appellate remedy inadequate, and (2) AIU might prevail in a trial in Texas and that the mere possibility of a waste of judicial resources if AIU did not prevail would not render an appellate remedy inadequate. Nevertheless, the supreme court rejected both of these arguments and concluded that an appeal following a trial would be an inadequate remedy.⁵⁷

54. *Id.* at 113-114.

55. *Id.* at 114.

56. *Id.*

57. *Id.* at 115 (noting that the supreme court stated that these same considerations were presented in *Jack B. Anglin Co., Inc. v. Tipps*, where the supreme court similarly held

The supreme court also noted that subjecting a party to trial in a forum other than that agreed upon and requiring an appeal to vindicate the rights granted in a forum-selection clause was “clear harassment” with no benefit to either the individual case or the judicial system as a whole.⁵⁸ The *AIU* court held that only the breaching party benefits from the breach of a forum selection clause; that party hopes that its adversary will weary or avoid the cost of protracted litigation and settle when the adversary would not otherwise have done so. Furthermore, the supreme court held that by insisting that the case proceed in a forum other than that agreed upon, the breaching party would be adding a layer of expense that would otherwise not exist, and the breaching party may be inclined to protract proceedings to encourage a favorable settlement. Consequently, the supreme court concluded that a trial in a forum other than that contractually agreed upon would be a meaningless waste of judicial resources, the error would not be harmless, and the forum-selection clause was enforceable by mandamus.⁵⁹

D. ARBITRATION

Parties often contract to resolve any future disputes through arbitration. In *Beyond the Arches*, a McDonald’s franchisee petitioned the Beaumont Court of Appeals for mandamus relief to enforce an arbitration agreement with its employee.⁶⁰ The franchisee’s employee sued for negligence when she injured her back at work. The franchisee filed a motion to compel arbitration pursuant to a dispute resolution agreement that the employee allegedly signed. The appellate court reasoned that a party seeking to compel arbitration must first establish that an arbitration agreement exists. The appellate court held that the franchisee did not meet its burden of establishing a “meeting of the minds,” consent to the terms, and acceptance of the terms in strict compliance with the arbitration agreement terms. The franchisee argued that at the time of employment, all employees were given a copy of the dispute resolution program, and it maintained that the employee could not have signed the form without being presented with a copy of the program. The franchisee, however, did not present evidence that the employee in fact signed the form.⁶¹

Furthermore, the appellate court held that the employee did not ratify the arbitration agreement by accepting the franchisee’s benefits or by allowing the franchisee to pay the medical expenses. The appellate court reasoned that, before the acceptance of benefits could be said to trigger estoppel or demonstrate ratification, it must be shown that the benefits

that an appeal based on an arbitration clause following a trial would be an inadequate remedy). See *Jack B. Anglin Co., Inc. v. Tipps*, 842 S.W.2d 266, 272-273 (Tex. 1992).

58. *In re AIU Ins. Co.*, 148 S.W.3d at 117.

59. *Id.* at 118.

60. *In re Beyond the Arches, Inc.*, No. 09-04-126 CV, 2004 WL 1699900 (Tex. App.—Beaumont Jul. 29, 2004, no pet. h.).

61. *Id.* at *1-3.

were accepted with knowledge of all material facts. Here, the employee did not accept the employer's payment of her work-related accident benefits in recognition of the arbitration agreement. Accordingly, the petition for writ of mandamus was denied.⁶²

In *In re Wood*, the Texas Supreme Court considered whether an arbitrator or a court should rule on class certification issues when the contracts at issue committed all disputes arising out of the agreement to the arbitrator.⁶³ The supreme court held that such authority resided with the arbitrator. Two days before the appellate court directed the trial court to determine whether to certify the class, the United States Supreme Court held that "where parties agreed to submit all disputes to an arbitrator under the Federal Arbitration Act, issues of class arbitration are for the arbitrator to decide."⁶⁴ Contrary to the appellate court's decision that *Green Tree*⁶⁵ was inapplicable, the Texas Supreme Court reasoned that *Green Tree* was directly on point.⁶⁶

In *Green Tree*, the U.S. Supreme Court refused to interpret the contract and rule whether the contract itself expressly allowed or forbade class arbitration. Instead, the Supreme Court held that, as a question of contract interpretation, the issue of class arbitrability had been committed to the arbitrator because the dispute related to the contract. The Supreme Court concluded that the parties agreed to have an arbitrator, not a judge, answer the relevant question. Likewise, the *Wood* court held that an arbitrator should decide whether to certify this class because the underlying suit was based on contracts with arbitration clauses that each of the over 2,000 plaintiffs entered into with the defendant.⁶⁷

The Texas Supreme Court also rejected the defendant's attempt to escape *Green Tree's* application by arguing that the American Arbitration Association ("AAA"), at the time this lawsuit was filed, did not have rules for class arbitration similar to the rules the Federal Arbitration Act provided. Since the lawsuit was filed, the AAA had published such rules. The supreme court rejected the defendant's argument that the rule could not be effective because it was not in effect when the lawsuit was filed, the date when the trial court referred the case to arbitration, or the date arbitration was initiated. The supreme court held that another plausible interpretation of the "rules in effect" language was the rules in effect when the arbitration actually began. Therefore, the supreme court maintained that the appellate court erred in directing the trial court to determine class certification since such authority lay with the arbitrator.⁶⁸

62. *Id.* at *4-5.

63. *In re Wood*, 140 S.W.3d 367 (Tex. 2004).

64. *Green Tree Fin. Co. v. Bazzle*, 539 U.S. 444, 451-52 (2003).

65. *Id.*

66. *In re Wood*, 140 S.W.3d at 369.

67. *Id.* at 368.

68. *Id.* at 369.

E. JURY WAIVER PROVISIONS

Personal, constitutional rights, such as trial by jury, access to the courts, and due process of law, have often been argued to be non-waivable. During the Survey period, however, the Texas Supreme Court determined whether a pre-suit waiver of trial by jury was enforceable and fit for mandamus review, an issue of first impression for the court. The supreme court held that (1) jury waivers, in general, were enforceable; (2) the specific waiver in the instant case was enforceable; and (3) the enforceability of a jury waiver was appropriate for mandamus review.⁶⁹

In *In re Prudential Insurance Co. of America*, Francesco and Jane Secchi and their limited partnership (collectively, the "Secchis") owned and operated two Dallas restaurants and had recently executed a lease to open a third restaurant.⁷⁰ In connection with the lease, the Secchis personally guaranteed the lease as Prudential insisted. The Secchis sued Prudential Insurance Company of America, claiming, in part, that it was impossible to do business on the premises because of a persistent sewage odor. When the trial court notified the parties that a date for a non-jury trial had been set, the Secchis filed a jury demand that the trial court subsequently granted. Although the Secchis paid the required fee according to Texas Rule of Civil Procedure 216, Prudential moved to quash the jury demand based on the jury waiver in the lease. Specifically, the lease language stated that, "Tenant and Landlord both waive a trial by jury of any or all issues arising in any action or proceeding between the parties hereto or their successors, under or connected with this Lease, or any of its provisions." The Secchis responded and alleged that contractual jury waivers in general, and the waiver in the lease in particular, were unenforceable. The supreme court addressed each of the arguments the Secchis asserted and rejected all of them.⁷¹

First, the supreme court addressed whether contractual jury waivers in general were enforceable. The supreme court reasoned that personal rights provided in the Texas Constitution could be waived, at least under certain conditions. Furthermore, the Secchis' argument that Rule 216 prescribes the only way in which a trial by jury can be waived was completely rejected. The supreme court held that the Rule's express language contained prerequisites to a jury trial, not guarantees of one. Also, the supreme court considered the Secchis' argument that an agreement to waive trial by jury was contrary to public policy because to allow such waivers gave parties the power to alter the fundamental nature of the civil justice system by private agreement. The supreme court rejected this argument.⁷²

The supreme court reasoned that parties already have power to agree to important aspects of how prospective disputes will be resolved, such

69. *In re Prudential Ins. Co. of Am.*, 148 S.W.3d 124 (Tex. 2004).

70. *Id.* at 127.

71. *Id.* at 124, 127-29.

72. *Id.* at 130-31.

that they can decide that the law of a certain jurisdiction will apply, designate the forum in which future litigation will be conducted, and waive in personam jurisdiction. Most contrary to the Secchis' argument is that parties can agree to opt out of the civil justice system altogether and submit future disputes to arbitration. Therefore, the supreme court denied the Secchis' public policy argument because public policy that permits parties to waive trial altogether surely does not forbid waiver of trial by jury.⁷³

When analyzing whether the jury waiver was enforceable in general, the supreme court noted the fundamental principle that a waiver of constitutional rights must be voluntary, knowing, and intelligent with full awareness of the legal consequences. Moreover, the supreme court noted that if parties were willing to agree to a non-jury trial, it was preferable to enforce that agreement rather than leave them with arbitration as their only enforceable option. By agreeing to arbitration, parties waived not only their right to trial by jury but also their right to appeal, whereas by agreeing to waive only the former right, they took advantage of the reduced expense and delay of a bench trial, avoided the expense of arbitration, and retained their right to appeal.⁷⁴

Second, the supreme court then applied this general law to the specific facts of this case. The supreme court initially held that Secchis' contention that the waiver was not voluntary, knowing, and intelligent was unfounded. To start with, the waiver's language was crystal clear; although it was near the end of a lengthy document, it was not printed in small type or hidden in lengthy text. Next, although the caption "jury waiver" instead of "jury trial" might have been clearer, the supreme court did not agree that the caption would have reasonably diverted the Secchis' attention or misled them into thinking that the provision meant the opposite of what it clearly said. Also, as with most contract responsibilities, the Secchis were charged with knowledge of all of the lease provisions even though they did not read the "jury trial" paragraph.⁷⁵

Finally, the supreme court held that the jury waiver was enforceable even if Prudential allegedly fraudulently induced the Secchis to enter into the lease. To hold otherwise would entirely defeat the purpose of such jury waiver and related provisions—to control resolution of future disputes.⁷⁶

Lastly, the Secchis argued that because the guaranty did not contain a waiver, the waiver could not be enforced against them. The supreme court disagreed. The supreme court held that the guaranty incorporated by reference the jury waiver in the lease because the guaranty "plainly [referred] to another writing."⁷⁷

73. *Id.* at 131.

74. *Id.* at 132.

75. *Id.* at 133-34.

76. *Id.* at 133-35.

77. *Id.* at 135.

After holding that the jury waiver was enforceable, the supreme court considered, as it did in *In re AIU Ins. Co.*, whether mandamus relief was proper. All of the above analysis only established that the first prong was met—whether the trial court clearly abused its discretion. The second prong—whether the relator has shown that it had no adequate remedy by appeal—similarly required detailed analysis. The principle behind mandamus review is that it may be essential to preserve important substantive and procedural rights from impairment or loss, allow the appellate courts to give needed and helpful discretion to the law that would otherwise prove elusive in appeals from final judgments, and spare private parties and the public the time and money utterly wasted enduring eventual reversal of improperly conducted proceedings. The supreme court held that if Prudential were to obtain judgment on a favorable jury verdict, it could not appeal, and its contractual right would be lost forever. On the other hand, if Prudential suffered judgment on an unfavorable verdict, Prudential could not obtain reversal for the incorrect denial of its contractual right “unless the court of appeals concludes that the error complained of . . . probably caused the rendition of an improper judgment.”⁷⁸ Accordingly, the supreme court held that to deny Prudential enforcement of the jury waiver by mandamus was to deny it any remedy at all; the supreme court granted mandamus relief.⁷⁹

F. REMOVAL

In *Kardell v. Century 21 Real Estate Corp.*, defendants Century Real Estate Corporation (“Century 21”) and Lowery Nabb filed a joint notice of removal on June 14, 2004. The plaintiff, Patricia Kardell, opposed and filed a motion to remand to state court claiming that there was no diversity jurisdiction as a result of the joinder of Texas resident Nabb as a defendant.⁸⁰

The underlying facts show that Kardell entered into a franchise agreement with Century 21 in 1999. In 2002, Kardell attempted to sell her real property and her Century 21 franchise to Stephen B. Hill, subject to the franchise agreement’s provision that the franchisee had to obtain the franchisor’s consent, which could not be unreasonably withheld. Following her agreement with Hill, Kardell informed Nabb, Century 21’s regional service director, of the impending franchise sale. In September 2002, Nabb informed Kardell that he could not assist her with the assignment and that she would instead have to work it out with the Century 21 managers. The franchise agreement that Century 21 subsequently prepared required Hill to accept a ten-year franchise agreement rather than the two years remaining on the agreement with Kardell. As a result of this condition, Hill refused to purchase Kardell’s business. Kardell then

78. *Id.* at 139-40.

79. *Id.*

80. *Kardell v. Century 21 Real Estate Corp.*, No. SA-04-CA-510-RF, 2004 WL 2550591, at *1-2 (W.D. Tex. Nov. 1, 2004).

sued Century 21 and Nabb for breach of contract and tortious interference with an existing contract.⁸¹

The district court analyzed whether Nabb was improperly joined to defeat diversity jurisdiction to decide whether the defendants were entitled to maintain the action in federal court. While suits arising under federal law are removable irrespective of the citizenship of the parties, all other suits are removable “only if none of the parties in interest *properly* joined and served as defendants is a citizen of the State in which such action is brought.”⁸² In this case, Nabb was a Texas resident; the defendants, therefore, had the heavy burden of proving that Nabb had been improperly joined to defeat remand to state court.

The district court held that there were two ways to establish improper joinder: (1) actual fraud in the pleading of jurisdictional facts, or (2) inability of the plaintiff to establish a cause of action against the non-diverse party in state court. Fraudulent or improper joinder will be established if proven that there is no reasonable basis for predicting that the plaintiff might be able to recover against an in-state defendant. To prove whether a reasonable basis for recovery exists, the court has two ways to resolve this issue: (1) the court can conduct a Rule 12(b)(6)-type analysis or (2) the court can pierce the pleadings and conduct a summary inquiry—an approach appropriate only when a plaintiff has stated a claim but has misstated or omitted discrete facts that would determine the propriety of joinder. The defendants did not meet their burden.⁸³

After analyzing the elements of tortious interference with an existing contract (since this was the only claim alleged against Nabb), the district court held that because there was a possibility that Kardell had set forth a valid cause of action against Nabb, the case was remanded to state court.⁸⁴

IV. THE FRANCHISE RELATIONSHIP, TERMINATION AND NON-RENEWAL

A. THE FRANCHISE RELATIONSHIP

While there are a number of state and federal laws that specifically regulate the franchisee-franchisor relationship, *Shell Oil Co. v. HRN, Inc.* demonstrates that the unique nature of the franchisee-franchisor relationship does not preclude application of traditional commercial laws, such as the Uniform Commercial Code (“UCC”).⁸⁵

In *Shell Oil Co. v. HRN, Inc.*, several hundred Shell dealers who leased Shell service stations and purchased gasoline from Shell under dealer agreements (the “Dealers”) filed suit against Shell alleging that Shell violated UCC section 2-305(2) based on the manner in which Shell set the

81. *Id.*

82. *Id.* at *1 (citing 28 U.S.C. § 1441(b) (2002)) (emphasis in original).

83. *Id.* at *2.

84. *Id.* at *3.

85. *Shell Oil Co. v. HRN, Inc.*, 144 S.W.3d 429 (Tex. 2004).

prices the Dealers paid for Shell gasoline.⁸⁶ The Dealers alleged that Shell set prices arbitrarily high in order to drive the Dealers out of business. Shell argued that the Dealers' claims failed as a matter of law because there was evidence that Shell's Dealer price was commercially reasonable, regardless of the effect that the price may have had on the Dealers' profit margins.⁸⁷

In order to evaluate the Dealers' claims, the Texas Supreme Court felt it was necessary to understand Shell's gasoline distribution network. Shell distributed gasoline through three classes of trade: (1) through the Dealers who operated as Shell franchisees, (2) through Shell company-owned stores, and (3) through "Jobbers" who purchased gasoline from Shell and sold that gasoline to either Dealers or independent service stations.⁸⁸ The price Shell charged depended on what class of trade the purchaser participated in. Dealers paid the dealer tank-wagon price ("DTW"), while Jobbers paid an off-the-rack price ("OTR"), which was lower than the DTW price. Moreover, if a Jobber purchased gasoline at the OTR price and then sold that gasoline to a Dealer, the Jobber was retroactively charged the DTW price. The Dealers claimed that Shell set the DTW price higher than the OTR price in bad faith to drive the Dealers out of business, and convert the Dealers' stores into more profitable Shell company owned stores.⁸⁹

The Texas Supreme Court analyzed the Dealers' claims under the UCC. The Dealer contracts were open price term contracts, and under section 2-305(b) of the UCC, the seller may set the price to be charged under an open price term contract, but must do so in good faith.⁹⁰ The supreme court held that good faith under 2-305 meant a commercially reasonable and non-discriminatory price.⁹¹ A commercially reasonable price was one that was within the range of prices charged by other participants in the market.⁹² Further, a non-discriminatory price was one that was applied equally to similarly situated purchasers—the same members of a class of trade in a particular market.⁹³

Applying these standards to the Dealers, the supreme court held that Shell did not breach the UCC's duty of good faith.⁹⁴ The court noted that Shell did not discriminate among Dealers in a particular market, and that Shell's price was within the range of DTW prices charged by other refiners.⁹⁵ The fact that the DTW price was higher than the OTR price did not persuade the court that Shell had acted in bad faith. The court stated that "[w]e cannot agree that a relatively high, yet commercially reasona-

86. *Id.* at 431.

87. *Id.* at 432.

88. *Id.* at 431.

89. *Id.* at 432.

90. *Id.* at 432-33.

91. *Id.* at 433.

92. *Id.* at 434.

93. *Id.* at 436.

94. *Id.* at 437.

95. *Id.*

ble, price is evidence of bad faith. A good-faith price under section 2-305 is not synonymous with a fair market price or the lowest price available."⁹⁶ As a result, the Texas Supreme Court rendered judgment in favor of Shell.

Also of note is the supreme court's rejection of the Dealers' argument that the fact that the Dealers were required to purchase only Shell gasoline was relevant to the determination that Shell had acted in bad faith. The supreme court stated that the Dealers were only "captive" buyers of Shell products as a result of their own decision to become Shell-branded franchisees.⁹⁷ Therefore, the "captivity" the Dealers complained of was the "normal case" of a long-term franchisee and was not relevant to determining whether Shell acted in bad faith in setting the price of gasoline.⁹⁸

B. THE FAILURE TO PERFORM

The court in *Hildreth v. Merle Norman Cosmetics, Inc.*⁹⁹ construed a franchise agreement as a matter of law in order to determine that the franchisee failed to perform under the franchise agreement, and therefore, could not maintain a cause of action for breach of contract against the franchisor.

Hildreth operated a Merle Norman franchise.¹⁰⁰ She successfully operated the franchise for several years when her landlord sold the building where the franchise was located, which required Hildreth to relocate her franchise. Before she could relocate the franchise, however, she had to obtain written approval from the franchisor. Hildreth requested approval, and Merle Norman orally agreed to provide written approval to relocate as soon as Hildreth brought her account with Merle Norman current.¹⁰¹ Hildreth purportedly mailed payment to Merle Norman's corporate office on three separate occasions, but payment was never received. Therefore, Merle Norman never provided the written approval to relocate. As a result, Hildreth was forced to close her franchise. Hildreth then sued Merle Norman alleging that it breached the franchise agreement and the duty of good faith and fair dealing by failing to provide written consent to relocate.¹⁰²

In order to assert a claim for breach of contract, a plaintiff must show: (1) the existence of a valid contract, (2) performance or tendered performance by the plaintiff, (3) breach of the contract by the defendant, and (4) damages resulting from the breach.¹⁰³ The court focused on

96. *Id.*

97. *Id.* at 438.

98. *Id.*

99. *Hildreth v. Merle Norman Cosmetics, Inc.*, No. 08-02-00402-CV, 2004 WL 736991 (Tex. App.—El Paso Apr. 6, 2004, no pet. h.).

100. *Id.* at *1.

101. *Id.*

102. *Id.*

103. *Id.* at *2.

whether Hildreth performed under the franchise agreement.

Under the franchise agreement, Hildreth was required to operate the franchise in a businesslike manner while keeping the store open “at all hours regularly kept by other retail establishments in [her] neighborhood or area”¹⁰⁴ Despite this obligation, Hildreth only opened her store for one day a week. Thus, the court had to determine whether keeping the store open for only one day per week constituted performance that enabled Hildreth to satisfy a material element of her breach of contract claim.

The court applied the traditional rules of contract construction and held that the franchise agreement unambiguously defined the franchisee’s performance obligations and required Hildreth to keep her store open for five days per week—the same number of days that other retail establishments in her neighborhood remained open.¹⁰⁵ Because Hildreth had not kept her store open five days per week, the court of appeals held that she had not substantially performed her obligations under the franchise agreement. As a result, the court of appeals affirmed the summary judgment in favor of Merle Norman because Hildreth could not prove that she had substantially performed her obligations under the franchise agreement.¹⁰⁶

An interesting facet of the court of appeal’s analysis is that by focusing on whether Hildreth performed by keeping her store open for the same number of days as other stores in her neighborhood, the court was able to side-step the issue of whether mailing the payment to Merle Norman constituted tendering performance, which presumably would have entitled Hildreth to obtain written approval to relocate.

C. TERMINATION AND NON-RENEWAL

Although Texas does not have statutory franchise relationship laws, there are other federal statutes, in addition to the Franchise Rule discussed earlier, that impact certain types of franchisee-franchisor relationships. One example is the Petroleum Marketing Practices Act (the “PMPA”), which governs the termination and non-renewal of petroleum franchise relationships.¹⁰⁷ In *Sun Chase Enterprises, Inc. v. Swati Enterprises, Inc.*,¹⁰⁸ the court held that the PMPA does not govern all aspects of a petroleum franchise relationship, and therefore, did not preempt a cause of action for tortious interference with a prospective contract to purchase petroleum products from suppliers other than the franchisor.

Sun Chase Enterprises, Inc. (“SCE”) operated several gas stations under a franchise agreement with the defendant Swati Enterprises, Inc.

104. *Id.* at *3.

105. *Id.*

106. *Id.* at *4.

107. 15 U.S.C. § 2801 (2000).

108. 143 S.W.3d 902, 906 (Tex. App.—Beaumont 2004, no pet. h.).

(“Swati”).¹⁰⁹ The franchise agreement obligated SCE to brand its stores as Chevron stations and sell only Chevron products, but SCE was permitted to purchase those products from suppliers other than Swati.¹¹⁰ At some point, the business relationship between SCE and Swati became acrimonious, and SCE attempted to purchase Chevron products from suppliers other than Swati.¹¹¹ In response, Swati sent letters to those suppliers stating that Swati had a contractual agreement with SCE, and would take all appropriate legal action to protect Swati’s rights under that agreement. Eventually, Swati terminated the franchise agreements, and SCE filed suit for tortious interference with a prospective business relationship but did not make a claim for wrongful termination or non-renewal of the franchise agreement. Swati argued that the PMPA preempted SCE’s state law tort claims and moved to dismiss the case.¹¹²

The court of appeals noted that federal courts take two approaches in interpreting the PMPA. Some courts take a restrictive view and hold that the PMPA only preempts state laws that regulate the grounds and procedures regarding termination of a petroleum franchise and the notification requirements for termination.¹¹³ On the other hand, some federal courts take an expansive view of the PMPA and hold that the PMPA preempts any state law action that arises out of, or is incident to, the termination of a petroleum franchise.¹¹⁴

Ultimately, the court held that the PMPA did not preempt SCE’s tortious interference claims under either view because those claims related to Swati’s attempts to “protect” his contractual relationship rather than Swati’s termination of the franchise agreements. “We hold only that a state law claim for tortious interference with prospective business relations is not preempted by the PMPA where the state law claim is not an incident of the termination or non-renewal of the franchise.”¹¹⁵

V. STATUTORY CLAIMS

A. THE TEXAS DECEPTIVE TRADE PRACTICES—CONSUMER PROTECTION ACT

In round two of *Texas Taco Cabana L.P. v. Taco Cabana of New Mexico, Inc.*,¹¹⁶ the court considered cross motions for summary judgment. Franchisees filed a counter-claim alleging that franchisors committed un-

109. *Id.* at 903.

110. *Id.*

111. *Id.* at 904.

112. *Id.* at 904-05.

113. *Id.* at 905.

114. *Id.*

115. *Id.* at 906.

116. *Tex. Taco Cabana L.P. v. Taco Cabana of N.M., Inc.*, No. Civ. A. SA-02-CV-1209, 2004 WL 2106527, at *1 (W.D. Tex. Sept. 20, 2004). For round one, see *Tex. Taco Cabana L.P. v. Taco Cabana of N.M., Inc.*, 304 F. Supp. 2d 903, 906 (W.D. Tex. 2003) (explaining the court’s rulings on motion to dismiss). For a thorough discussion of round one, see Deborah S. Coldwell et al., *Franchise Law*, 57 SMU L. REV. 1055-57 (2004).

fair and unconscionable acts in violation of the Texas Deceptive Trade Practices—Consumer Protection Act (“DTPA”).¹¹⁷ In the DTPA claim, the franchisees alleged that the franchisors refused to cooperate in development under an amendment to one of their franchise agreements, falsely claimed that a development agreement did not exist, refused to acknowledge franchisees’ continuing development rights, defaulted under a license agreement and threatened to terminate a license agreement.¹¹⁸ The court disagreed, however, and held that a disagreement over the interpretation of a contract was not actionable under the DTPA.¹¹⁹ Therefore, franchisors were not liable under the DTPA for refusing to cooperate in the development of additional Taco Cabanas or for allegedly being in default under their agreements.¹²⁰ These issues only dealt with contractual interpretation and did not support claims under the DTPA.¹²¹

The franchisees’ claim that the franchisors acted unconscionably by falsely claiming that a development agreement did not exist also failed.¹²² The court agreed that “false statements of fact regarding a party’s rights under an agreement are sufficient to support a violation of the DTPA.”¹²³ According to the court, however, the franchisees failed to provide any evidence that franchisors actually denied the existence of the development agreement other than in their initial complaint. The franchisors later amended the complaint and admitted the existence of the development agreement. The franchisees also failed to allege any damages that could have arisen from the franchisors’ denial of the existence of the development agreement.¹²⁴ The court granted the franchisors’ motion for summary judgment on the franchisees’ counter-claim.¹²⁵

In *Carousel’s Creamery, LLC v. Marble Slab Creamery, Inc.*,¹²⁶ franchisee Carousel’s Creamery (“Carousel’s Creamery”) sued franchisor Marble Slab (“Marble Slab”) for violations of the DTPA, negligent misrepresentation, and fraud. Marble Slab filed a counterclaim alleging breach of contract.

After a jury trial, the court granted Marble Slab’s motion for directed verdict on the negligent misrepresentation claim, but denied the motion on the fraud and DTPA claims.¹²⁷ To prevail on its DTPA claim, Carousel’s Creamery was required to prove that “(1) Carousel’s Creamery was a consumer of Marble Slab’s goods or services; (2) Marble Slab commit-

117. *Tex. Taco Cabana*, 2004 WL 2106527, at *1.

118. *Id.* at *9.

119. *Id.* (citing *Crim Truck & Tractor Co. v. Navistar Int’l Transp. Corp.*, 823 S.W.2d 591, 596 (Tex. 1992); *Enter-Laredo Assoc. v. Hachar’s, Inc.*, 839 S.W.2d 822, 828-29 (Tex. App.—San Antonio 1992, writ denied)).

120. *Tex. Taco Cabana*, 2004 WL 2106527, at *9.

121. *Id.*

122. *Id.*

123. *Id.* (citing *Leal v. Furniture Barns, Inc.*, 571 S.W.2d 864, 865 (Tex. 1978)).

124. *Id.*

125. *Id.*

126. 134 S.W.3d 385, 390 (Tex. App.—Houston [1st Dist.] 2004, pet. granted).

127. *Id.*

ted one of the false, misleading or deceptive acts enumerated under section 17.46(b) of the DTPA, breached an express or implied warranty, or engaged in an unconscionable action or course of action; and (3) these acts were the producing cause of Carousel's Creamery's actual damages."¹²⁸ To satisfy the producing cause requirement of the third factor, Carousel's Creamery needed to show that the acts were both a cause-in-fact and a "substantial factor" in causing the injuries.¹²⁹ At the trial court level, the jury found in favor of the franchisor and against Carousel's Creamery on its fraud and DTPA claims.¹³⁰ The appellate court found that there was substantial evidence to support the finding that Marble Slab's representations were neither a cause-in-fact nor a "substantial factor" in causing Carousel's Creamery's injuries, and therefore, Carousel's Creamery was unable to recover on its DTPA and fraud claims.¹³¹

VI. COMMON-LAW CLAIMS

A. FRAUD AND MISREPRESENTATION

Plaintiffs have increasingly begun to assert both contract and fraud causes of action in order to recover punitive damages that are often significantly greater than the benefit-of-the-bargain damages available under a pure contract claim. The tendency to assert each of the above causes of action has given rise to the law of "contorts." Although a fundamental difference exists between the law of contracts and the law of torts, Texas courts have struggled to enunciate a bright line distinction between the two. As the Texas Supreme Court stated, "courts and commentators have struggled to clarify the boundary between contract claims and other causes of action."¹³²

In one of the watershed opinions in this area of the law, the Texas Supreme Court, in *Haase v. Glazner*,¹³³ held that a plaintiff could not assert a fraudulent inducement claim in the absence of a contract and, to the extent a plaintiff sought to recover benefit-of-the-bargain damages related to a contract that was unenforceable under the Statute of Frauds, the Statute barred the fraud claim.¹³⁴ The Fourteenth District Court of Appeals in Houston recently revisited this issue in *McMillan v. International Brands, Ltd.* The court held that the plaintiff could not recover benefit-of-the-bargain damages because the alleged contract to purchase a distributorship was unenforceable under the Statute of Frauds.¹³⁵

128. *Id.* at 399 (citing *Brown v. Bank of Galveston*, Nat. Ass'n, 963 S.W.2d 511, 513 (Tex. 1998)).

129. *Id.* (citing *Brown*, 963 S.W.2d at 514).

130. *Id.* at 390.

131. *Id.* at 402-03.

132. *Crawford v. Ace Sign, Inc.*, 917 S.W.2d 12, 13 (Tex. 1996) (citing William Powers, Jr., *Border Wars*, 72 TEX. L. REV. 1209, 1209 (1994)).

133. 62 S.W.3d 795, 800 (Tex. 2001).

134. *Id.*

135. *McMillan v. Hillman Int'l Brands, Ltd.*, No. 14-03-01392-CV, 2004 WL 1660760, at *1 (Tex. App.—Houston [14th Dist.] July 27, 2004, pet. denied).

In *McMillan*, William J. McMillan (“McMillan”), an employee of Hillman International Brands, Ltd. (“Hillman”), approached Hillman executives about the possibility of buying Hillman and maintaining its distributorship business with its current employees. After several weeks of discussions, McMillan, Hillman’s chief executive officer, and other Hillman executives signed a letter directed to Hillman employees stating that Hillman would be sold to McMillan. For undisclosed reasons, however, the sale of Hillman to McMillan was never consummated.¹³⁶ When Hillman was eventually sold to a third party for the sum of \$38.5 million, McMillan filed suit alleging that Hillman representatives made fraudulent representations regarding their intent to sell Hillman to McMillan and that the letter constituted a valid contract for sale under the Statute of Frauds.

The court rejected both of McMillan’s arguments and upheld the trial court’s judgment for Hillman on all counts.¹³⁷ After examining the evidence, the court of appeals agreed with the trial court that the letter was nothing more than an agreement to negotiate.¹³⁸ More specifically, the court of appeals held that because the letter failed to define the property and assets being sold and failed to specify the price to be paid, the letter lacked material terms, and therefore, was not an enforceable contract under the Statute of Frauds. As a result, McMillan was not entitled to benefit-of-the-bargain damages. Relying on *Haase v. Glazner*, the court held that, in the absence of an enforceable contract, a plaintiff’s claims cannot survive summary judgment when benefit-of-the-bargain damages are sought.¹³⁹

Furthermore, because the court of appeals characterized the letter as a future promise to negotiate the sale of the distributorship to McMillan, the court held that the letter could not form the basis of a cause of action for fraud in the absence of any evidence that the future “promise” was made with the intent to deceive and with no intent to perform. Because McMillan failed to introduce any evidence that Hillman representatives did not intend to sell Hillman to McMillan at the time the letter was written, the court of appeals rejected McMillan’s fraud claim. Therefore, just as in *Haase*, the court of appeals refused to allow a plaintiff to use a fraud claim to enforce an unenforceable contract.¹⁴⁰

*Carousel’s Creamery, L.L.C. v. Marble Slab Creamery, Inc.*¹⁴¹ exemplifies how Texas common-law tort claims can be used to regulate franchisors in Texas similar to how other states and the federal government regulate franchisors by statute. Carousel’s Creamery acquired several Marble Slab Creamery franchises. After a period of operating losses, Carousel’s Creamery sued Marble Slab claiming that Marble Slab made

136. *Id.* at *2.

137. *Id.* at *4.

138. *Id.*

139. *Id.*

140. *Id.*

141. 134 S.W.3d 385 (Tex. App.—Houston [1st Dist.] 2004, pet. granted).

material misrepresentations in its Uniform Franchise Operating Circular ("UFOC").¹⁴² Specifically, Carousel's Creamery said that Marble Slab intentionally used a company owned store that did not have labor costs and that generated substantial revenue from catering corporate events, rather than from in-store sales, as the "model store" in the UFOC "in order to dramatically improve the financial results that could be portrayed in the UFOC."¹⁴³ Carousel's Creamery alleged that by so doing, Marble Slab's UFOC artificially inflated franchise income and profits, which led Carousel's Creamery to acquire franchises that it would not have acquired had Marble Slab fully and accurately disclosed the profitability of its franchises.¹⁴⁴ As a result, Carousel's Creamery filed suit against Marble Slab for negligent misrepresentation, fraud, and violation of the DTPA.¹⁴⁵

With respect to the negligent misrepresentation claim, the court of appeals noted that the UFOC (1) failed to state that the "model store" was a company-owned store that had substantially lower labor and freight costs than a typical franchise, (2) did not disclose the percent of revenue the "model store" generated from catering services, and (3) failed to disclose the overall turnover rate for Marble Slab franchisees.¹⁴⁶ The court held that all of this information directly affected Carousel's Creamery's bottom line and materially influenced Carousel's Creamery's decision to invest in the Marble Slab company.¹⁴⁷

Moreover, the court held that Carousel's Creamery justifiably relied on the representations in the UFOC, notwithstanding the fact that the franchise agreement contained a non-reliance and merger clause.¹⁴⁸ The court noted that the Federal Trade Commission's rules and regulations governing franchisor-franchisee relationships require that information in UFOCs be truthful, accurate, and concise.¹⁴⁹ Further, a Marble Slab representative testified that if information is contained in a UFOC, a franchisee may rely on it.¹⁵⁰ Therefore, the court held that Carousel's Creamery was justified in expecting the information in the UFOC to be accurate and not misleading.¹⁵¹

Because the information was misleading, and because Carousel's Creamery was justified in relying on that information, the court of appeals held that the trial court erred in granting Marble Slab a directed verdict on Carousel's Creamery's negligent misrepresentation claim and reversed that portion of the trial court's judgment.¹⁵²

142. *Id.* at 391.

143. *Id.*

144. *Id.*

145. *Id.* at 390; *see supra* notes 93-108 and accompanying text.

146. *Id.* at 391.

147. *Id.* at 391-92.

148. *Id.* at 394.

149. *Id.* at 391.

150. *Id.* at 392.

151. *Id.*

152. *Id.* at 394.

As discussed earlier at Section V, Subsection A., the court of appeals upheld the trial court's judgment in favor of Marble Slab on Carousel's Creamery's fraud and DTPA claims. Although Carousel's Creamery's fraud and DTPA claims were grounded on many of the same facts as its negligent misrepresentation claim, the court held that there was substantial evidence to support the jury's finding that Carousel's Creamery could not establish the causation elements of its fraud and DTPA claims.¹⁵³

More specifically, the court of appeals held that there was significant evidence to support the jury's finding that Carousel's Creamery's failure to adequately investigate its investment decision was the cause of its injuries, rather than Marble Slab's failure to make full and complete disclosures in the UFOC.¹⁵⁴ In reaching this decision, the court relied on testimony from franchising experts and certified public accounts who testified that it was "silly, foolish, and improper" for Carousel's Creamery to rely only on the UFOC, fail to read the franchise agreements, fail to review detailed financial statements, and fail to consult with an attorney before investing in the Marble Slab franchise system.¹⁵⁵

Although the appellate court's findings appear to be inconsistent at first glance, a closer examination reveals that they are not. The court's analysis of Carousel's Creamery's negligent misrepresentation claim focused on whether Marble Slab violated its statutory duty to make truthful and accurate statements in the UFOC.¹⁵⁶ Because (1) all of the statements in the UFOC were untruthful and inaccurate and (2) Marble Slab had a statutory duty to make truthful and accurate disclosures, the court of appeals held that Carousel's Creamery presented a viable claim for negligent misrepresentation.¹⁵⁷

On the other hand, Carousel's Creamery's fraud and DTPA claims essentially alleged that Marble Slab's misstatements in its UFOC were the cause of all of Carousel's Creamery's financial difficulties. The court of appeals, however, held that it was Carousel's Creamery's failure to investigate its investment decision and its flawed accounting practices, not Marble Slab's UFOC, that caused Carousel's Creamery's financial downfall.¹⁵⁸ Thus, the court of appeals allowed Carousel's Creamery to maintain a cause of action against Marble Slab for failing to make adequate disclosures in the UFOC in accordance with federal law, but refused to allow Carousel's Creamery to argue that the failure to make those disclosures rose to the level of fraud or a violation of the DTPA.

153. *Id.* at 402-03.

154. *Id.* at 400.

155. *Id.* at 402. The court of appeals also noted that Carousel's Creamery engaged in questionable accounting practices during the operation of its franchises. *Id.* at 400-01.

156. *Id.* at 391.

157. *Id.*

158. *Id.* at 402-03.

B. VICARIOUS LIABILITY

Because many franchise operations center around the food service industry, recent lawsuits claiming various “fast-food” restaurants were liable for their patrons’ alleged weight gain set off alarms at the headquarters of many food service franchisors. Apparently, the lawsuits also set off alarms in the Texas House of Representatives and served as the motivation behind House Bill 107.

House Bill 107, introduced on November 10, 2004, by Rep. Corbin Van Arsdale, provides that no person may bring a state court civil action in the State of Texas against a manufacturer or seller of food or a trade association arising out of or related to an injury resulting from an “individual’s consumption of a food and weight gain, obesity, or any health condition that is associated with an individual’s weight gain or obesity.”¹⁵⁹ If enacted, House Bill 107 would shield franchisors from civil liability arising out of a patron’s alleged weight gain or other health conditions purportedly resulting from the consumption of food at a franchised restaurant.

It should also be noted that House Bill 107 specifically provides that it would not prevent a person from bringing an action based on either (1) a willful violation of a federal or state statute where such violation is the proximate cause of an injury related to an individual’s weight gain, obesity, or any health condition that is associated with an individual’s weight gain or obesity; or (2) a breach of an express contract or express warranty in connection with the purchase of a food.¹⁶⁰

In a significant case for franchisors, the San Antonio Court of Appeals recently confirmed that a franchisor’s right to terminate or suspend the franchisee’s operations for failure to comply with a franchise agreement’s minimum operational standards was not enough, standing alone, to subject the franchisor to vicarious liability for the franchisee’s alleged negligence.

In *Fitz v. Days Inn Worldwide, Inc.*,¹⁶¹ Fitz was hit by a tractor trailer as the truck turned into a Days Inn parking lot. Fitz suffered significant injuries and sued the truck driver, the owner of the tractor trailer, the franchisee, and the franchisor—Days Inn Worldwide, Inc. (“DIW”).¹⁶² DIW obtained summary judgment on the ground that it had not exercised sufficient control over its independent contractor franchisee to be subject to vicarious liability for the franchisee’s negligence.¹⁶³ Fitz appealed.

The court of appeals examined the relevant standards for determining whether a general contractor can be liable for the torts of its independent contractor. A general contractor is liable for the torts of its independent contractor when the general contractor retains the right to control the

159. Tex. H.B. 107, 79th Leg., R.S. (2005).

160. *Id.*

161. 147 S.W.3d 467 (Tex. App.—San Antonio 2004, pet. denied).

162. *Id.* at 469-70.

163. *Id.* at 470.

allegedly negligent activity.¹⁶⁴ Control could be established in two ways: (1) by evidence of a contractual agreement that assigned the premises owner the right to control the activity; or (2) in the absence of a contractual agreement, by evidence that the owner of the premises exercised actual control over the manner in which the independent contractor's work was performed.¹⁶⁵ Fitz argued that DIW had contractual and actual control over the franchisee.

As the basis for establishing contractual control, Fitz pointed out that the franchise agreements spelled out minimum standards that the franchisee had to satisfy in order to continue operating as a DIW.¹⁶⁶ Fitz argued that DIW's right to suspend or terminate the franchise agreements for the failure to satisfy the minimum standards gave DIW contractual control over the franchisee.

The court of appeals disagreed. The court of appeals first noted that the franchise agreements explicitly stated that the franchisee was an independent contractor.¹⁶⁷ The court then distinguished between the right to set minimum standards and the right to exercise control. For a general contractor to have control over an independent contractor, the general contractor must have the right to control the means, methods, and details of the independent contractor's work.¹⁶⁸ While the franchise agreements granted DIW the right to set the standards or goals that the franchisee had to meet, the franchise agreements did not explicitly grant DIW the right to control *how* the franchisee met those standards.¹⁶⁹ Therefore, the court of appeals held that the franchise agreements did not grant DIW contractual control over the franchisee.¹⁷⁰ Similarly, the court of appeals held that the franchisee's ability to suspend or terminate the franchisee's operations for failure to comply with the franchise agreement's minimum standards was not a sufficient level of actual control to subject the franchisor to vicarious liability.¹⁷¹

Finally, Fitz argued that DIW exercised actual control over the franchisee because DIW had the right to inspect the premises and require the franchisee to operate the franchise in accordance with the franchise agreement.¹⁷² The court of appeals held that the right to inspect the premises and to require compliance with the franchise agreements was insufficient control to subject DIW to vicarious liability because there was no evidence that, in requiring compliance with the franchise agreements, DIW controlled the franchisee's "method of work or its operative

164. *Id.* at 471 (citing *Risner v. McDonald Corp.*, 18 S.W.3d 903, 906 (Tex. App.—Beaumont 2000, pet. denied)).

165. *Id.*

166. *Id.* at 472.

167. *Id.* at 473.

168. *Id.* at 472.

169. *Id.*

170. *Id.* at 473.

171. *Id.*

172. *Id.*

detail.”¹⁷³ As a result, the court of appeals upheld the trial court’s grant of summary judgment in favor of DIW.

C. TORTIOUS INTERFERENCE

*COC Services, Ltd. v. CompUSA, Inc.*¹⁷⁴ involved the alleged tortious interference with a proposed master franchise agreement (“MFA”). COC Services, Ltd. (“COC”) hoped to franchise CompUSA retail centers throughout Mexico. After a period of negotiations with CompUSA, COC obtained a succession of three letters of intent from CompUSA, which granted COC the exclusive right to identify and submit candidates to become CompUSA franchisees in Mexico. Under the third letter of intent, COC identified the Carso Group, a prominent Mexican business enterprise, as a potential franchisee.¹⁷⁵

Although initial negotiations among COC, the Carso Group, and CompUSA appeared promising, talks broke down in late September of 1999, and the Carso Group stopped communicating with COC.¹⁷⁶ The Carso Group, however, continued negotiating directly with CompUSA regarding franchising opportunities in Mexico. Following a meeting of the CompUSA board of directors in November of 1999, the Dallas media reported that CompUSA was speaking with the Carso Group regarding franchising opportunities in Mexico. COC asked CompUSA about the negotiations with the Carso Group, and CompUSA assured COC that the press reports were referring to the proposed deal among COC, the Carso Group, and CompUSA when, in fact, CompUSA began negotiating the sale of CompUSA to the Carso Group. It soon became apparent to COC that the Carso Group no longer had any interest in becoming a CompUSA franchise under COC’s MFA.¹⁷⁷

Although COC eventually identified another potential franchisee, the third letter of intent expired and CompUSA refused to renew the letter and did not approve the franchisee. Shortly thereafter, the Carso Group purchased CompUSA and COC filed suit for, *inter alia*, tortious interference with the MFA and tortious interference with a prospective business relationship.¹⁷⁸

1. *Tortious Interference with the MFA*

To prevail on a cause of action for tortious interference, the plaintiff must show: (1) the existence of a contract subject to interference; (2) a willful and intentional act of interference; (3) proximate cause; and (4) actual damage or loss occurred.¹⁷⁹ The Dallas Court of Appeals held that

173. *Id.* at 474.

174. 150 S.W.3d 654, 660 (Tex. App.—Dallas 2004, pet. filed).

175. *Id.* at 661.

176. *Id.*

177. *Id.* at 660-62.

178. *Id.* at 660.

179. *Id.* at 670 (citing *Browning-Ferris, Inc. v. Reyna*, 865 S.W.2d 925, 926 (Tex. 1993)).

COC failed to establish the existence of a contract subject to interference.

As an initial matter, the court of appeals pointed out that the parties never signed the MFA and the letters of intent stated that COC had to identify and CompUSA had to approve a franchisee, and the MFA and a license agreement had to be signed before the MFA would become binding.¹⁸⁰ None of these events occurred. Therefore, the MFA was unenforceable.

The court of appeals also noted that the MFA was unenforceable because it lacked a material term.¹⁸¹ Specifically, the MFA failed to establish the minimum sales volume for the franchised stores and the number of stores COC had to open during the effective dates of the MFA. As a result, the court of appeals held that COC's claim for tortious interference failed as a matter of law because COC could not establish that it had a valid contract subject to interference.¹⁸²

2. *Tortious Interference with Prospective Business Relationships*

COC also argued that CompUSA and its CEO tortiously interfered with COC's prospective business relationship with the Carso Group by secretly negotiating for franchises and other business opportunities with the Carso Group during the effective dates of the final letter of intent.¹⁸³

To prevail on a cause of action for interference with a prospective business relationship, the plaintiff must prove that the defendant engaged in some conduct that was independently tortious or unlawful.¹⁸⁴ It is not enough that the defendant's conduct was "sharp" or "unfair"; to be actionable the conduct must be independently unlawful.¹⁸⁵ Furthermore, the unlawful conduct must have been a substantial factor in causing the injury, without which the harm would not have occurred.¹⁸⁶

After it became apparent that talks between COC and the Carso Group had broken down, COC asked CompUSA for assistance in jump-starting negotiations.¹⁸⁷ At that time, CompUSA suggested that COC send the Carso Group a letter stating the COC had begun negotiating with another possible franchisee. CompUSA also denied that it was engaged in direct negotiations with the Carso Group when, in fact, CompUSA was discussing franchising possibilities and other deals with the Carso Group.¹⁸⁸ COC argued that CompUSA's statement denying that it had been negotiating with the Carso Group was false and COC relied on that statement to its detriment. The court of appeals held that because the talks between COC and the Carso Group broke down in September,

180. *Id.* at 663.

181. *Id.* at 664.

182. *Id.* at 665.

183. *Id.* at 679.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.* at 680.

188. *Id.*

and the false statement allegedly made by CompUSA did not occur until October, there was no evidence that COC would have entered into an agreement with the Carso Group had COC not sent the letter regarding other possible franchisees.¹⁸⁹

The court reasonably concluded that instructing COC to send the letter to the Carso Group was not the "but for" cause of the break down in talks between COC and the Carso Group. The court of appeals, however, failed to address whether and to what extent CompUSA's direct negotiations with the Carso Group during the effective dates of the letter of intent constituted a breach of the letter of intent and could be viewed as independently unlawful. Given that the jury initially found that CompUSA committed tortious interference with a prospective business relationship, franchisors would be well advised to tread carefully when engaging in business negotiations with an entity conducting business within an exclusive territory under a MFA or letter of intent contemplating the execution of a MFA.

VII. REMEDIES: LIMITATION OF DAMAGES

As discussed in *COC Services, Ltd.*, CompUSA and COC entered into negotiations for a MFA to establish CompUSA stores in Mexico. Also involved in this transaction were the Carso defendants, an enterprise that conducted numerous businesses in Mexico. Starting in 1997, COC obtained three consecutive letters of intent from CompUSA, granting the right to submit candidates to participate in a potential MFA for all of Mexico. On COC's fourth letter of intent, it attached a form of a MFA and a form of a license agreement, both of which would be subject to CompUSA's approval. After several extensions, neither the MFA nor the licensee agreement was executed.¹⁹⁰

In the midst of negotiations between CompUSA and COC, the Carso defendants acquired stock in CompUSA. Eventually, they acquired fifteen percent of the stock and became involved in the negotiations with the prospective franchise deal between CompUSA and COC. According to COC, the Carso defendants made a "handshake deal" with COC to form a joint venture during a meeting between the parties. The Carso defendants later decided to reject the deal, and they ultimately acquired CompUSA. COC consequently sued CompUSA and the Carso defendants for breach of contract and tortious interference with an existing contract. A jury found for COC; COC was awarded \$90 million in damages for lost profits and \$270 million in punitive damages from CompUSA, and \$31.5 million in actual damages and \$90 million in punitive damages from the Carso defendants. The trial court granted judgment notwithstanding the verdict in favor of CompUSA, which COC appealed.¹⁹¹

189. *Id.*

190. *Id.* at 661.

191. *Id.* at 661-62.

The appellate court held that the damages-limiting provision in the MFA prevented COC from recovering lost-profits damages from CompUSA, assuming the MFA itself was binding and enforceable. In the MFA, the damages-limiting provision provided that “Franchisor, Master Franchisee and the controlling principles of Master Franchisee hereby waive any right to or claim of any punitive, exemplary, incidental, indirect, special, consequential or other damages (including, without limitation, loss of profits).”¹⁹²

COC argued that CompUSA’s statement in its affirmative defense did not give COC notice that the provision limiting damages would be a basic issue in the suit. CompUSA’s affirmative defense plead that “Plaintiff’s claims are barred . . . by the language of the putative agreements relied upon by Plaintiff.” The appellate court held that because Texas follows the “fair notice” standard, and COC did not specially except to that statement, COC contractually waived its right to lost-profit damage under the unambiguous damages-limitation provision.¹⁹³

192. *Id.* at 677.

193. *Id.* at 677-78 (noting that the purpose of the fair notice rule is to give the opposing party adequate notice of the facts to enable the opposing party to prepare a defense and to know what testimony would be relevant for trial).

