

CHAPTER 5

The Franchisor-Franchisee Relationship

Since World War II, franchising has become a growth industry, both in the United States and internationally. As of 2005, there were over 900,000 franchised locations in the United States, providing 11 million direct jobs and generating \$880 billion in direct economic output.¹ Many types of businesses use franchise systems, including automobile dealerships, gasoline stations, convenience stores, soft drink bottlers, travel agencies, restaurants, car rental agencies, pet stores, cleaning services, hair salons, tax preparation services, tutoring services, and day care centers. Although no definitive recent statistics exist, analysts generally agree that 35 percent to 40 percent of retail sales occurs through franchised businesses.² This chapter addresses legal issues that are specific to the franchisor-franchisee relationship.

Overview

The term *franchise* refers to a contractual relationship where one party (the *franchisor*) licenses another party (the *franchisee*) to use the franchisor's trade name, trademarks, copyrights, and other property in the distribution and sale of goods or services in accordance with established practices and standards. "Franchise" is used to refer both to the contractual agreement between the franchisor and the franchisee and to the franchise outlet itself.

Both the franchisor and the franchisee can obtain significant benefits from a well-conducted franchise relationship. The franchisee receives the opportunity to start and own a business, even though the franchisee may have limited capital and/or experience. The franchisee also obtains access to the franchisor's goodwill, training, and supervision, as well as access to product supplies and marketing expertise generally available only to larger business concerns. The franchisor receives the influx of the franchisee's capital (which facilitates expansion), a larger asset base, enhanced goodwill generated by the franchisee's business efforts, and access to a known distribution network.

The franchise system poses risks for both parties as well, however. The franchisor must work to ensure consistent quality and operational standards throughout the franchise system, which can be both costly and difficult. The franchisee, on the other hand,

¹See *Economic Impact of Franchised Business*, vol. 2, available on the Web site of the International Franchise Association, a franchising advocacy group, at www.franchise.org. For general information franchise industry trends and statistics, see Goizueta Business School's site at <http://business.library.emory.edu/info/franchising/trends.html#tats>

²See Francine Lafontaine, "Myths and Strengths of Franchising," *Financial Times*, Mastering Strategies Series, November 22, 1999, reprinted in *Mastering Strategy: The Complete MBA Companion in Strategy* (London: FT Prentice Hall, 2000), 140–45.

must guard against abuses by the franchisor of its generally superior knowledge of the business and market power.

As discussed later in this chapter, the federal government, acting through the Federal Trade Commission (FTC), regulates only limited aspects of the franchise relationship—primarily issues relating to disclosure.³ Most regulation of the franchise relationship occurs at the state level.

Some municipalities have, in recent years, sought to restrict or limit the location of franchised businesses through local ordinances, fearing that such “formula” businesses may detract from the local character or may damage local businesses. Ordinances that attempt to block franchises from entering local markets may well be unconstitutional under the Commerce Clause of the U.S. Constitution.

◀ See Discussion Case 5.1.

Types of Franchises

There are two primary categories of franchises: *product and trade name franchises* and *business format franchises*. In a *product and trade name franchise*, the franchisor licenses a franchisee to sell its product, either exclusively or with other products. The franchisee often has the exclusive right to sell the product in a designated area or territory. These franchises essentially function as a distribution system for the franchisor’s goods. Automobile dealerships and beer distributorships, for example, fall within this category.

In a *business format franchise*, the franchisee operates a business under the franchisor’s trade name and is identified as a member of a select group of persons who deal in this particular good or service. The franchisor sells a “way of doing business” to the franchisee in exchange for royalties and fixed fees. Generally, the franchisee must follow a standardized or prescribed format as to methods of operation, including things such as use of trade or service marks, site selection, design of the facility, hours of business, and qualifications and training of employees. Fast-food restaurants, hotels, and rental services are generally set up as business format franchises.

Definition of a “Franchise”

It is often difficult to distinguish between a franchise and other forms of branded distribution. The label that the parties attach to their relationship does not necessarily control. In many states, “franchise” is defined statutorily. The Illinois Franchise Disclosure Act is typical:

- (1) “Franchise” means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:
 - (a) a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services, under a marketing plan or system prescribed or suggested in substantial part by a franchisor; and
 - (b) the operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and

³For information on the FTC’s role in franchise regulation, see www.ftc.gov/bcp/menus/business/franchise.shtm

- (c) the person granted the right to engage in such business is required to pay, directly or indirectly, a franchise fee of \$500 or more⁴

Most state statutes and the federal amended Franchise Disclosure Rule (discussed below) provide that, in order for a franchise relationship to exist, there must be a contract or agreement, either express or implied, oral or written, that meets three requirements:

1. *Use of mark.* The franchisee must receive a license to use the franchisor's trade or service mark, trade name, logotype, advertising, or other commercial symbol in connection with the sale or distribution of goods or services.
2. *Assistance to or control over franchisee's operations.* The franchisor must somehow assist or control the franchisee's operations, usually through the provision of a marketing plan or system prescribed in total or substantial part by the franchisor. Under the amended Franchise Disclosure Rule, significant types of *control* can take many forms:
 - site approval for unestablished businesses;
 - site design or appearance requirements;
 - hours of operations;
 - production techniques;
 - accounting practices;
 - personnel policies;
 - promotional campaigns requiring franchisee participation or financial contribution;
 - restrictions on customers; and
 - locale or area of operation.⁵

Under the amended Rule, significant types of *assistance* include:

- providing formal sales, repair, or business training programs;
 - establishing accounting systems;
 - furnishing management, marketing, or personnel advice;
 - selecting site locations;
 - furnishing systemwide networks and websites; and
 - furnishing a detailed operating manual.⁶
3. *Franchise fee.* Under most (though not all) state franchise statutes, a franchise relationship does not exist in the absence of a payment of a "franchise fee." This requirement is easily met, however, as most state statutes define a franchise fee as any payment above a minimal amount (usually \$500) required for the right to enter into the franchise business (excluding purchases or leases of real property and purchases of goods at bona fide wholesale prices). It does not matter whether the parties have labeled the payment a "franchise fee" or not.

Thus, business arrangements such as licenses, joint ventures, strategic alliances, distribution agreements, dealer or sales agent agreements, and subcontractor agreements may potentially be regulated as franchises, even if the parties did not contemplate a franchise relationship (see Case Illustration 5.1).

To avoid the inadvertent creation of a franchise, a supplier or manufacturer should be careful about licensing others to use its marks, should exercise restraint in providing assistance to or control over a distributor's business, and should not require any payment from its dealers above a bona fide wholesale price. A more extensive (but often impractical) strategy is for the supplier or manufacturer to use its own sales force and retail outlets and avoid the use of dealers altogether.

⁴815 Ill. Comp. Stat. 705/3 (2007).

⁵See www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf

⁶*Id.*

CASE ILLUSTRATION 5.1

**JEROME-DUNCAN, INC. v. AUTO-BY-TEL, LLC,
989 F. SUPP. 838 (E.D. MICH. 1997), AFF'D, 176 F.3D 904
(6TH CIR. 1999)**

FACTS Jerome-Duncan, Inc. (JDI), a Ford dealership, entered into a five-year contract with Auto-by-Tel (ABT), which operated an Internet site, through which it referred potential customers to car dealers. Under the contract, JDI was to be the exclusive dealer to which ABT would refer potential Ford customers in a four-county area. Either party could terminate the contract on 30 days' notice. After JDI refused ABT's request to renegotiate the contractual terms, ABT gave notice that it was terminating the contract. JDI sued, claiming that the contract was a "franchise agreement" under the Michigan Franchise Investment Law (MFIL) and therefore could not be terminated without good cause, despite the express termination provision.

DECISION The trial court noted that the policy behind the MFIL was to remedy perceived abuses by large franchisors against unsophisticated investor franchisees. JDI, which was the largest Ford dealership in the metro Detroit area and which had annual sales in excess of \$130 million, was not the type of franchisee that the MFIL was intended to protect.

Moreover, the MFIL defines a "franchise agreement" as one in which: (1) the franchisee is subject to a marketing plan or system prescribed in substantial part by the franchisor; (2) the franchisee is allowed to use the mark, trade name, or other commercial symbol of the franchisor; and (3) the franchisee is required to pay a franchise fee.

The trial court found that neither of the first two requirements had been met. First, JDI attempted to classify ABT's website as a "virtual dealership" and argued that JDI thus operated an ABT "virtual dealership" franchise. JDI pointed to the specific guidelines given by ABT regarding customer contacts, the training provided by ABT to a JDI executive who was to serve as the "ABT representative," and the limited territory that it received from ABT. The trial court rejected this argument, finding that because JDI was

selling Ford products, not ABT goods or services, it was not operating under a "marketing plan prescribed by a franchisor."

Second, JDI was not engaged in distributing goods or services substantially associated with the mark of ABT. Although ABT required JDI to place the ABT logo on certain print advertisements, place an "authorized Auto-by-Tel dealer" sign in its showroom, use the ABT logo on business cards, and assign titles such as "Auto-by-Tel manager" to its employees, the court found that JDI's sales were still primarily associated with the Ford mark borne by the cars it sold. Thus, the second requirement of the MFIL was also not met.

The court listed several other factors that courts consider in determining whether a relationship is a "franchise": "(1) franchisor control over hours and days of operation; (2) placing of signs advertising the franchisor; (3) loans by franchisor of equipment; (4) franchisor auditing of franchisee's books; (5) franchisor inspection of franchisee's premises; (6) franchisor control over lighting at franchisee's place of business; (7) franchisor requiring the franchisee to wear uniforms; (8) franchisor control over the setting of prices; (9) franchisor licensing of sales quotas; (11) [*sic*] franchisor training of employees; and (12) offer by franchisor of financial support." The majority of these factors were not present in this case.

The trial court did note that JDI had paid a start-up fee of \$3,500 and was required to pay a monthly fee of \$500. These payments would likely constitute a "franchise fee" under the MFIL had the other two elements of a franchise been satisfied.

Because the contractual agreement between JDI and ABT did not meet the definition of a franchise agreement, the MFIL did not apply. Thus, the termination provisions of the agreement controlled and ABT had not violated any state law by terminating the relationship. The trial court awarded summary judgment to ABT.

◀ See Discussion Cases 5.2, 5.3.

Creation of a Franchise

Franchisors usually recruit franchisees by advertising their particular business. Interested parties then contact the franchisor, who sends out a “franchise kit.” The kits tend to describe the franchise business in very positive terms, which can be misleading to unsophisticated potential franchisees. The federal and state disclosure rules discussed later in this chapter are intended to alleviate this problem.

Once the parties agree to the franchise relationship, they typically sign a detailed contractual agreement. The agreement is almost always drafted by the franchisor and, not surprisingly, often tends to favor that party substantially. These agreements are usually long (often 30 to 50 pages) and are often very complicated. Because of the disparity in bargaining power between the parties, in the event of litigation, the courts generally scrutinize the agreements to make sure that the stronger party (the franchisor) has not taken unfair advantage of the weaker party (the franchisee) (see Case Illustration 5.2).

Generally, the franchise agreement imposes a limited variety of obligations upon the franchisor. The franchisor typically gives the franchisee the right to use its trademark and/or standardized product or service in exchange for a franchise fee. The franchisor generally advertises the product or service in exchange for an advertising fee (often calculated as a percentage of gross sales). The franchisor also provides training programs and manuals and sets out detailed guidelines for the day-to-day operation of the business. Established

CASE ILLUSTRATION 5.2

NAGRAMP v. MAILCOUPS, INC., 469 F.3D 1257 (9TH CIR. 2006) (EN BANC)

FACTS The franchisee and franchisor had entered into an agreement for a direct-mail advertising franchise. The agreement had a provision stating that disputes were to be arbitrated. After two unprofitable years of operation, the franchisee unilaterally terminated the relationship. The franchisor then started an arbitration proceeding, claiming that the franchisee owed it over \$80,000 in fees. The franchisee challenged the validity of the arbitration clause in court.

DECISION The appellate court ruled that the arbitration clause was both procedurally and substantively unconscionable and thus unenforceable. Under California law (which governed the agreement), “[p]rocedural unconscionability analysis focuses on ‘oppression’ or ‘surprise.’” Furthermore, “[o]ppression arises from an inequality of bargaining power that results in no real negotiation and an absence of meaningful choice,” while “[s]urprise involves the extent to which the supposedly agreed-upon terms are hidden in a prolix printed form drafted by the party seeking to enforce

them.” By contrast, “[a]n arbitration provision is substantively unconscionable if it is “overly harsh” or generates “one-sided’ results.” The court explained that “the paramount consideration in assessing [substantive] conscionability is mutuality.”

Here, the franchise agreement was procedurally unconscionable because the franchisee was in a “substantially weaker bargaining position” than the franchisor, the franchisor had drafted the franchise agreement, and the franchisor had presented the agreement to the franchisee on a “take-it-or-leave-it” basis. In fact, the franchisee’s efforts to negotiate certain of the terms had been rebuffed by the franchisor.

The franchise agreement was also substantively unconscionable because it lacked mutuality (in that it allowed the franchisor to bring certain actions in court while restricting the franchisee’s causes of action against the franchisor to arbitration proceedings) and the forum designated for arbitration (the franchisor’s home of Boston, Massachusetts) was oppressive to the franchisee, who was located in California.

franchisors often designate a particular location for the franchise outlet, design and arrange for standardized construction of the facility, and install fixtures and equipment.

The franchisee, on the other hand, is generally required to follow the procedures specified by the franchisor or risk termination. The franchise agreement usually mandates strict accounting procedures and authorizes the franchisor to inspect the books and records at any time. The franchisee is required to pay a number of types of fees as well, such as:

- an initial license fee (i.e., a lump-sum payment for receiving the franchise);
- a royalty fee (i.e., a payment for the use of the franchisor's trade name, property, and assistance, usually calculated as a percentage of gross sales and payable on a monthly basis);
- an assessment fee (which covers things such as advertising, promotional, and administrative costs and which is usually calculated as either a flat monthly or annual fee or as a percentage of gross sales);
- lease fees (i.e., payments for any equipment or land leased from the franchisor); and
- costs of supplies (i.e., payments for any supplies purchased from franchisor).

The franchise agreement also typically requires the franchisee to obtain liability insurance to protect both the franchisor and the franchisee against casualty losses and tort suits and requires the franchisee to comply with state law workers' compensation requirements.

The franchise agreement usually sets forth the duration of the franchise (typically 10 to 20 years) and usually provides for renewals of the term. Typically, the agreement contains a covenant not to compete, which prohibits the franchisee from competing with the franchisor for a stated period after termination of the franchise relationship. (Covenants not to compete are discussed in more detail in Chapter 3.)

Finally, the agreement usually requires the franchisor to give the franchisee a certain time period (e.g., 10 days) to cure any default under the agreement. The franchisor typically must then give notice of termination. In states that regulate termination and nonrenewal of franchises, the franchisor must generally wait a set time period after giving notice (often 90 days) before the termination is actually effective. Most states do not regulate termination and nonrenewal, however. In those states, the franchisee receives only those protections provided by the franchise agreement.

Regulation of the Franchise Relationship

On the one hand, franchise relationships can promote competitive markets, which, as we have noted before, the law favors. On the other hand, the disparity in the bargaining relationship between the franchisor and the franchisee can lead to abuses. Franchise law thus generally attempts to facilitate the franchise relationship while putting in place safeguards to prevent overreaching behavior by the franchisor (who typically is the dominant party in the relationship).

Prior to the 1970s, there was little regulation of franchise relationships at either the state or the federal levels. With the exception of disclosure requirements (discussed below), there are only two areas of significant federal regulation of the franchise relationship today. First, the federal Automobile Dealers' Franchise Act⁷ prevents automobile company franchisors from terminating their dealers without just cause. (Many state legislatures have also passed statutes protecting automobile dealerships from the disproportionately greater power of car manufacturers.) Second, the federal Petroleum Marketing Practices Act⁸ protects motor fuel distributors and dealers from arbitrary terminations.

⁷15 U.S.C. § 1221 *et seq.*

⁸15 U.S.C. §§ 2801-2806, 2821-2824, 2841.

Today, regulation of the offer and sale of franchises or of the franchisor-franchisee relationship can be regulated under one of three sets of laws: (1) federal or state registration and disclosure laws and regulations; (2) state franchise “relationship” laws; and (3) “business opportunities” laws. Most regulation occurs at the state level, which means, of course, that regulation can vary from state to state. State law generally applies to a franchise relationship if: (1) the offer or sale of a franchise is made in or from a state; (2) the franchise will be located within the state; or (3) the intended franchisee is a resident of the state. Franchisors thus must plan their business activities carefully to avoid inadvertently incurring legal liability.

Disclosure

Federal Disclosure Rules Existing federal law primarily addresses *disclosure* issues. (The FTC has declined to regulate the ongoing franchise relationship, although it has the power to do so.) In 1979, the FTC issued its FTC Franchise Disclosure Rule.⁹ The FTC recently amended the Franchise Rule; these amendments took full effect on July 1, 2008. The amended Rule requires each regulated franchisor to prepare an extensive document, the Franchise Disclosure Document (FDD), for each potential franchise purchaser.

Under the amended Rule, the franchisor’s disclosure must include a number of types of information, including: (1) the history of the franchisor; (2) required fees and investment costs; (3) information about the franchisor; (4) financial statements of the franchisor; (5) the litigation and bankruptcy history of the franchisor; and (6) a copy of the franchisor’s standard franchise agreement. The written disclosures must be provided to the potential franchisee at least 14 calendar days before the prospective franchisee signs any binding agreement or makes any payments to the franchisor. The Rule mandates that certain cautionary statements be explicitly and conspicuously made in the document. The amended Rule also provides for a sophisticated franchisee exemption, which means the Rule will not apply to franchisees whose initial investment is at least \$1 million (excluding franchisor financing and unimproved real estate). Also exempted are “large” franchisees, which are entities with at least five years in business and with a net worth at least \$5 million and “insider” franchise purchases involving owners or officers of the franchisor or individuals with at least two years’ management experience within the franchise system.

The FTC’s Franchise Disclosure Rule does not require that the franchisor file its disclosure with the FTC, and no federal agency reviews or approves the contents of the disclosure. Nonetheless, the Rule is a federal trade regulation with the full force and effect of federal law, and failure to make proper disclosure is an unfair or deceptive trade practice under Section 5 of the FTC Act. Thus, if the FTC discovers that the franchisor made an inaccurate disclosure, the FTC may seek injunctions, civil penalties (including fines of up to \$11,000 for each violation), and consumer redress as remedies. These penalties can be severe. The courts have imposed civil penalties of up to \$870,000 in a single case and have ordered consumer redress of up to \$4.9 million. The Rule does not provide a cause of action to private parties (such as a potential franchisee misled by an incorrect disclosure), however.

The original FTC Franchise Rule applied to both traditional franchises and certain business opportunities, such as vending machines and display rack business opportunity ventures. The amended Rule applies only to franchises. The FTC has expressed an intent

⁹16 C.F.R. Part 436. The FTC’s Web site, www.ftc.gov, contains various types of information on franchises, including a Guide to the FTC Franchise Rule.

to deal with amendments to existing business opportunity disclosure requirements through separate rule making in the future.

State Disclosure Rules Fifteen states have franchise investment laws that require franchisors to provide disclosures to potential purchasers as well.¹⁰ State disclosures are made on the same FDD used for federal disclosures. Unlike the federal Disclosure Rule, the state disclosure laws will permit private parties to sue for violations. Thus, the state statutes can provide a more direct remedy for aggrieved investors.

Thirteen of these states require registration as well as disclosure.¹¹ In effect, these states treat the sale of a franchise like the sale of a security. These states generally require the franchisor to file a registration document with state regulators and to obtain their approval before offering franchises to potential buyers. Some states also require franchisors to submit advertisements for franchises for review or approval prior to publication.

Business Opportunity Statutes Twenty-six states have *business opportunity statutes*, which regulate the offer and sale of distribution arrangements directed at unsophisticated “consumer” dealers or distributors.¹² Unlike “franchises,” “business opportunities” do not require the use of the seller’s trademark. (This is the key distinction between the two categories in most states.)

The definition of a business opportunity is quite broad in most states, encompassing virtually any type of business activity that might be offered for sale. Under Texas law, for example, the existence of a marketing program and a payment exceeding \$500 suffices. These state statutes generally require registration and disclosure similar to those required by franchise laws. These state statutes also usually regulate the ongoing business relationship between the seller and the buyer. In addition to providing for a private cause of action for damages and rescission, the business opportunity statutes often give the buyer the right to rescind the agreement within one year of execution and to receive a refund in the event the seller violates the statute. In many instances, a single transaction may be subject to both the business opportunity statute and the state franchise laws.

Legal Issues Arising from the Franchise Relationship

Many types of legal issues can arise in the franchisor-franchisee relationship. These are generally state law issues. About one-half of the states have “franchise relationship” statutes that may regulate items such as: (1) termination of a franchise; (2) transfer or sale of a franchise; and (3) discrimination among franchisees on things such as royalties or other fees. Even in states without such laws, various types of issues may arise in the franchisor-franchisee relationship, and may be addressed under other statutes or under common law.

¹⁰These states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. See www.ftc.gov/bcp/franchise/netdiscl.shtml

¹¹These states are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. *Id.*

¹²These states are Alaska, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, Washington, and Wisconsin. See www.ftc.gov/bcp/franchise/netbusop.shtml

Existence of a Franchise Relationship

It is sometimes difficult to tell whether the relationship between the parties is truly a franchisor-franchisee relationship or whether it involves an employer-employee or principal-agent relationship. It is important from the franchisor's perspective that this relationship be clear, as franchisors are generally not liable for the torts or contractual breaches of their franchisees, but employers or principals may be liable for the torts or breaches of their employees or agents.

It is also important from the franchisee's perspective that the franchisor-franchisee relationship be clear. In some instances, franchisees get certain rights under state law that employees, agents, or other parties do not. For example, many state laws prohibit termination of a franchise without good cause but permit termination of other types of dealers without cause if the underlying contract so permits. On the other hand, if the purported franchisee is found to be an employee, she may be protected by laws regarding unemployment insurance, wages, civil rights, and other employment-related regulation that would not apply to franchisees (see Case Illustration 5.3).

Vicarious Liability of a Franchisor

Although a franchise relationship ordinarily shields a franchisor from liability for the torts or contractual breaches of its franchisee, customers, patrons, or other injured parties may nonetheless succeed in holding the franchisor vicariously liable for the wrongful acts of its franchisees under certain circumstances. There are three theories under which a franchisor might potentially be held liable: (1) the franchisor was *negligent*; (2) the franchisee was an *actual agent* of the franchisor; or (3) the franchisee was an *apparent agent* of the franchisor. All three theories are based to some extent upon the franchisor's exertion of "control" over some aspect of the franchisee's activities. For example, if the franchisor exercises control over the terms and conditions of employment of the franchisee's employees, it may find itself liable for the franchisee's violations of labor or employment laws or for acts of the employees that violate antidiscrimination laws.

CASE ILLUSTRATION 5.3

IN RE FRANCIS, 668 N.Y.S.2D 55 (N.Y. APP. DIV. 3D DEP'T 1998)

FACTS West Sanitation Services, Inc., provides restroom sanitizing services to commercial customers. Glenroy Francis was hired in 1986 as a serviceperson for specified routes. In 1987, West began a franchise program. Francis signed a 23-page franchise agreement. As a franchisee, he performed the same functions that he had as an employee. In 1992, West terminated Francis' franchise for cause. Francis then applied for unemployment insurance benefits. Employees are entitled to such benefits, but franchisees are not.

DECISION The New York Unemployment Insurance Appeal Board determined that West "exercised a sufficient degree of direction and control over [Francis] ... to establish an employment relationship." Among the

factors cited by the Board were West's assignment of a territory and/or customers to Francis; retention of active client control, including billing; establishing weekly schedules for customer service; "paying" Francis; specification of products that could be used; provision of new customer accounts; inspection and evaluation of Francis' performance; requirement that Francis use West's logo; requirement that Francis submit reports; and restrictions on Francis' right to transfer his interest in the customer accounts.

Thus, the Board ruled that West was liable for unemployment insurance contributions for Francis and other similarly-situated individuals. The Appellate Division of the New York Supreme Court upheld the Board upon appeal.

Negligence claims against a franchisor usually arise in the context of premises liability claims. To recover for negligence, the plaintiff must prove: (1) that the franchisor owed a duty of care to the plaintiff; (2) that the duty of care was breached; (3) that the breach caused the plaintiff's injury; and (4) that the plaintiff suffered actual injury.

Thus, if a person is assaulted in a franchise outlet, the franchisor typically is not liable for any resulting injuries because the franchisor does not generally owe a legal duty of care to persons who enter the franchisee's premises. (The franchisee, on the other hand, depending upon the circumstances, might incur liability for failing to provide a secure setting.) The franchisor might assume such a duty of care, however, by exercising control over things such as lighting, security, and general layout of the building. The issue raised in most such cases, then, is whether the franchisor indeed assumed such a duty of care. This is a highly fact-specific inquiry that the court must undertake on a case-by-case basis (see Case Illustration 5.4).

CASE ILLUSTRATION 5.4

***WU v. DUNKIN' DONUTS, INC.*, 105 F. SUPP. 2D 83 (E.D. N.Y. 2000), *AFF'D*, 4 FED. APPX. 82 (2D CIR. 2001)**

FACTS Wendy Hong Wu was an employee of a 24-hour donut store owned by Turnway Donuts, Inc., under a franchise agreement with Dunkin' Donuts, Inc. Early one morning, when Wu was working alone at the store, two teenagers entered the store, gained access to the employee area behind the counter, and brutally attacked and raped Wu. Wu filed suit against Dunkin' Donuts, arguing that the attack resulted in part from the vicarious negligence of Dunkin' Donuts. In particular, she argued that Dunkin' Donuts was vicariously liable for the franchisee's negligent provision of security.

DECISION According to the trial court, the issue presented was whether a franchisor's making of recommendations regarding security matters to its franchisees renders the franchisor legally responsible for ensuring the safety of its franchisees' employees.

The court identified the applicable legal rule as follows: "In deciding whether a franchisor may be held vicariously liable for acts of its franchisees, courts determine whether the franchisor controls the day-to-day operations of the franchisee, and more specifically, whether the franchisor exercises a considerable degree of control over the instrumentality at issue in a given case." The cases from this and other jurisdictions indicate that the franchisor must exercise very specific control over the franchisee and its operations before vicarious liability will attach. For example, a franchisor who retains the right to terminate the relationship for failure to meet standards or to reenter premises and inspect generally does not exercise sufficient control

over the franchisee's security practices so as to give rise to a legal duty on the part of the franchisor.

The trial court concluded that "absent a showing of actual control over the security measures employed by the franchisee, franchisors have no legal duty in such cases." Wu pointed to three particular practices that she argued showed that Dunkin' Donuts retained actual control over security measures. She argued that Dunkin' Donuts: (1) required that the franchisee remain open 24 hours a day; (2) controlled the purchase of security equipment and required a functioning alarm system; and (3) required a site plan that revealed to passersby that Wu was alone.

The court quickly dismissed the first argument, stating that while the requirement that the franchisee stay open 24 hours a day may have heightened the need for adequate security, Dunkin' Donuts did not mandate specific security measures or otherwise control or limit the franchisee's response to this increased risk. Thus, Dunkin' Donuts could not be held vicariously liable on these grounds.

Nor did the evidence support Wu's second argument. While Dunkin' Donuts made security equipment available for purchase and suggested that alarms and other burglary prevention techniques were important, Dunkin' Donuts did not mandate or otherwise exercise control over the purchase of security equipment. Indeed, the franchisee here had unilaterally hired a security consultant and had installed its own security system, including a clear partition, alarm system, and video camera.

Finally, the evidence also did not support Wu's claim that Dunkin' Donuts had required a site plan that revealed to persons outside the store that Wu was working alone. While Dunkin' Donuts *did* provide a standard site plan to its franchisees, the franchise agreement did not require franchisees to conform to this standard plan and, in fact, the franchisee in this instance had made significant interior alterations to the store without seeking or receiving Dunkin' Donuts' prior approval.

The court concluded by noting a public policy concern raised by Wu's arguments: "The possibility ... that the recommended security measures might have helped protect Wu highlights a public policy concern that the court also believes counsels against imposing

liability on Dunkin' Donuts under the circumstances of this case. Dunkin' Donuts expressed a laudable desire to assist its franchisees in protecting their employees and customers, Imposing liability on the basis of such advice could discourage franchisors such as Dunkin' Donuts from taking steps to promote an awareness of security issues among franchisees."

Because "there [was] no evidence that Dunkin' Donuts actually mandated specific security equipment, or otherwise controlled the steps taken by its franchisees in general, and [this franchisee] in particular, to protect employees," the court held that Dunkin' Donuts was not vicariously liable for Wu's injuries. The court granted summary judgment to Dunkin' Donuts.

If the franchisor is too closely involved with the operation of the franchisee, the franchisee may be treated as being the *actual agent* of the franchisor. Under agency law, the principal (the franchisor) may be held liable for the wrongful acts of the agent (the franchisee). If individuals are led to believe that they are dealing with the franchisor directly, rather than with a franchisee operation or with an authorized agent of the franchisor, the franchisor can be held liable under an *apparent agency* theory.

◀ See Discussion Case 5.4.

Franchisors should be careful about the degree of control that they exercise over their franchisees' activities lest they find themselves liable in unexpected situations. Franchisors should take care not to involve themselves in issues such as employment-related decisions or the day-to-day operations of their franchisees (see Case Illustration 5.5).

Franchisors generally are permitted to exercise control to the extent necessary to ensure that the franchisees conform to specified quality or operational standards. In many franchise industries, such as fast-food restaurants, this may well be a very extensive amount of control. The franchise agreement should specify, however, that the franchisor's control is based solely on the need to ensure compliance with stated quality standards and that any comments made by the franchisor regarding other issues are merely suggestions and not commands. Many franchise agreements also contain *indemnification clauses*, which provide that if a third party (including an employee) brings a claim against the franchisor, the franchisee will bear all costs related to the suit and any resulting liability. Franchisors may also require franchisees to carry insurance policies covering employment-related or premises liability claims. Finally, all franchise operations should be required to prominently display signs indicating local ownership. This simple measure can help the franchisor avoid an apparent agency relationship, although it may not completely insulate the franchisor from liability.

Franchise Antitrust Issues

Tying Arrangements Much of the antitrust tie-in litigation (discussed earlier in Chapter 4) over the past 20 years has dealt with franchise contracts, particularly fast-food franchises. Most franchise antitrust claims involve allegations of illegal *tying* by the franchisor. A tying arrangement occurs when a seller conditions the sale of a desired (*tying*) item on the purchase of a second (*tied*) item. The U.S. Supreme Court has established that a tie is unlawful *per se* if the seller possesses economic power in the market

CASE ILLUSTRATION 5.5

**HAMLIN v. MOTEL 6, 2000 OHIO APP. LEXIS 2439
(JUNE 9, 2000)**

FACTS Plaintiffs Abby Fogt and Mary Carter worked at a Motel 6 franchise located in Troy, Ohio. The franchise was owed by BVP, Inc., and the motel was managed by Lisa Serafini. Plaintiffs alleged that they were sexually harassed, assaulted, and abused by Serafini during their employment. Plaintiffs informed Motel 6, the franchisor, of their allegations. Both testified at trial that they were told to “keep it quiet” and that Motel 6 would conduct an on-site investigation. The Director of Franchise Operations for Motel 6 admitted in a deposition that he had received a call from someone complaining of sexual harassment at the Troy Motel 6, that he had told the caller that he would speak to the franchise owner about the matter, that he did refer the complaint to the franchise owner, and that he did not follow up on the complaint.

Plaintiffs filed suit against the franchisor, Motel 6, alleging that: (1) an actual or apparent agency relationship existed between Motel 6 and BVP such that Motel 6 should be held liable for the actions of its franchisee; and (2) that Motel 6 had voluntarily assumed a duty of care to investigate sexual harassment complaints made by employees of its franchisees.

The trial court granted summary judgment to Motel 6. Plaintiffs appealed.

DECISION The appellate court rejected plaintiffs’ argument that an actual agency relationship existed between Motel 6 and BVP, stating: “The key factor in determining the existence of an agency relationship is the right of control vested in the principal.”

The court noted that the franchise agreement at issue here, at first glance, appeared to give Motel 6 the right to control employment decisions for its franchisees. The franchise agreement provided that Motel 6 had the authority to approve any manager with authority over the “day-to-day” operations of its franchisees and that Motel 6 could terminate the franchise of any franchisee who did not “comply promptly” with the standards contained in its confidential manuals. The manuals specifically stated that Motel 6 “will not tolerate discrimination or the appearance of discrimination of any kind” with regard to either employment practices or room availability. The manuals also stated that employees “may” be dismissed for “offending, disrupting,

or harassing guests or fellow employees” at the franchisee’s discretion.

However, the franchise agreement also specifically stated that the franchisee is “solely responsible” for all employment decisions, including firing, hiring, training, wages, and discipline. BVP did not ask Motel 6 for assistance in making employment decisions and Motel 6 did not involve itself with such issues. The appellate court concluded that Motel 6 did not have the right to control employment decisions of the franchisee. The court thus rejected plaintiffs’ claim that Motel 6 was liable under an actual agency theory.

Even when actual agency does not exist, “apparent agency may be conferred if the principal holds its agent out to the public as possessing sufficient authority to act on its behalf and the person dealing with the agent knew these facts and, acting in good faith, had reason to believe that the agent possessed the necessary authority.” Here, however, plaintiffs had both testified that they knew that Motel 6 did not own the motel, that BVP was their employer, that Motel 6 was not involved with employee discipline, and that Serafini made the hiring and firing decisions at the Troy franchise. Thus, no apparent agency relationship existed here either.

The appellate court concluded, however, that the statements made by the Director of Franchise Operations for Motel 6 raised a genuine issue of material fact with regard to plaintiffs’ claim that Motel 6 voluntarily assumed the duty of investigating and rectifying the alleged harassment. The court also found that there was a genuine issue of fact as to whether Motel 6 exercised ordinary care in carrying out this duty (assuming such a duty existed). While a jury might find that Motel 6 did exercise ordinary care by referring the complaint to the franchisee, the jury might instead find that the Motel 6 was obligated to do something more.

The appellate court thus reversed the trial court’s grant of summary judgment to Motel 6 and remanded the case for further proceedings on the issue of whether Motel 6, a franchisor, voluntarily assumed a duty to investigate sexual harassment complaints made by employees of its franchisee. The court affirmed the lower court’s rulings on the agency arguments.

for the tying item and if the arrangement involves a “not insubstantial” amount of interstate commerce.¹³ Tying arrangements that do not meet this standard are evaluated under the rule of reason and may be legal, although courts generally view them with disfavor because of their potential anticompetitive effects.

Tie-in arrangements are common in the franchise setting. A franchisor invariably wants to impose quality control standards on its franchisees, so the standard franchise agreement contains quality control restrictions. Very often the agreement requires the franchisee to purchase supplies and products from the franchisor at set prices or from suppliers who can meet the exact specifications and standards of the franchisor. Usually, the franchisor designates “approved” suppliers from which the franchisees may purchase.

In most franchise tie-in litigation, the plaintiff is a franchisee (or class of franchisees) and the defendant is the franchisor. The complaint is usually that the franchisee was able to obtain a franchise only on the condition that it purchase some additional item or items from the franchisor or a franchisor-approved vendor as well. Thus, the tying item is the franchise itself and the tied item is essential food ingredients or the primary product sold by the franchisor or its approved vendor.

Originally, franchisees won many of these cases. In recent years, however, franchisors have tended to prevail. *Queen City Pizza, Inc. v. Domino’s Pizza, Inc.*,¹⁴ decided by the U.S. Court of Appeals for the Third Circuit in 1997, is an example of this trend. Under the rationale of the *Domino’s Pizza* court, if a product that is substitutable for the tied product is available in the marketplace, it will be difficult for a franchisee to plead a relevant antitrust market in the tied product, even if the franchise agreement prohibits the franchisee from purchasing that product.

Other courts have rejected the *Domino’s Pizza* approach, stating that the validity of a tying claim by a franchisee must be determined by the amount of information possessed by the franchisee at the time it signed the franchise agreement and by the cost barriers to franchisees’ switching franchises, not by whether the tied product has substitutes in the marketplace.¹⁵

◀ See Discussion Case 5.5.

Vertical Price Restraints Many franchisors would like to be able to control the price at which their franchisees sell their products or services. Vertical price restraints have long been suspect under the antitrust law. Originally, these restraints were deemed illegal *per se*, but over the past decade the U.S. Supreme Court has rejected that standard and has adopted the rule of reason standard instead.

First, in 1997, the U.S. Supreme Court decided *State Oil Co. v. Khan*,¹⁶ in which the Court determined vertical *maximum* price-fixing was no longer illegal *per se* but, rather, must be judged by a rule of reason. The Court ruled that a supplier’s imposition of maximum resale prices upon its distributors may have procompetitive effects and actually result in lower prices for consumers. In such an instance, the price-fixing ought not to be barred. The court must make a fact-specific inquiry into the specific challenged conduct, the industry and market involved, the purported justification for the conduct, and intended and actual effects of the conduct on interbrand competition. If the conduct is found to have anticompetitive effects, it is illegal.

¹³*Northern Pacific Railroad Co. v. United States*, 356 U.S. 1, 6 (1958).

¹⁴124 F.3d 430 (3d Cir. 1997).

¹⁵See *Collins v. International Dairy Queen*, 980 F. Supp. 1252 (M.D. Ga. 1997); *Wilson v. Mobil Oil Corp.*, 940 F. Supp. 944 (E.D. La. 1996).

¹⁶522 U.S. 3 (1997). This case is reproduced in Discussion Case 4.3.

Second, in 2007, the Supreme Court held in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*¹⁷ that vertical *minimum* price restraints must also be evaluated under a rule of reason and that such a restraint is illegal only if its anticompetitive effects outweigh its precompetitive effects.

Franchisors should be aware, however, that even if a vertical price-fixing scheme is allowed under the federal antitrust laws, it might still be illegal under state laws relating to consumer protection, unfair trade practices, or franchises. Thus, a franchisor considering vertical price restraints, either maximum or minimum, should always seek legal counsel before implementing such a price scheme. Antitrust law is discussed in greater detail in Chapter 4. Consumer protection and unfair trade practice laws are discussed in Chapter 8.

Co-Branding

Co-branding involves the operation of two or more types of franchises or nonfranchised businesses under a single roof. Many fast-food franchises have entered into co-branding relationships, such as Taco Bell and KFC, and Burger King and TCBY. Co-branding allows franchisors to expand into nontraditional locations, opens up access to desirable sites, allows for cost savings and operating efficiencies, and promotes competitive positioning of the brands. Co-branding works best when it provides synergy between the offerings, such as offering a dessert (frozen yogurt) at a burger chain.

Co-branding results in a complex legal relationship. Suppose, for example, a donut chain and a Mexican fast-food chain decide to co-brand on the theory that the relationship will increase each party's sales in its weaker daily sales time slots. Typically, one party will be the "host franchisor," who already has in place an existing franchise system, has control over the physical sites on which the co-branded business will operate, and who will exercise some control over how the franchisees operate the "guest" brand. The host and guest franchisors will have to decide upon a structure, which can be as complex as a *subfranchise* (in which the guest franchisor grants a "master franchise" to the host franchisor, who then subfranchises the co-brand to its franchisees) or a *cofranchise* (in which the guest franchisor offers the co-brand directly to the host's franchisees with the consent of the host franchisor), or as simple as a *lease* or a *license*. Whatever the structure agreed upon, the parties will probably need to alter their standard franchise agreements to cover topics such as protection of trade secrets and proprietary information, noncompete covenants, royalty arrangements, and termination provisions.¹⁸ Co-branding can also raise issues of "encroachment," discussed below.

Encroachment

Encroachment has been defined as expansion by the franchisor beyond the point that the franchisor would have expanded had it owned all its own outlets.¹⁹ It occurs when a franchisor sells a franchisee an outlet in a particular location, then sells another outlet in close vicinity to a different franchisee. The original franchisee is harmed because the new outlet draws customers and revenue from the original outlet. The franchisor, on the other hand, benefits because royalties from two stores, even though they may cannibalize each other, are greater than royalties from a single store.

Particularly as a result of the growth in co-branding, encroachment issues have been very prominent and prevalent in recent years. Generally, the contractual language of the franchise agreement determines whether impermissible encroachment has occurred.

¹⁷551 U.S. 877 (2007).

¹⁸See generally Kenneth R. Costello, "Baskin Donuts: Hidden Pitfalls in Co-Branding," *Franchising Business & Law Alert* 3, no. 11 (July 1997), 11.

¹⁹Warren S. Grimes, "When Do Franchisors Have Market Power? Antitrust Remedies for Franchisor Opportunism," 65 *Antitrust L.J.* 105, 138 (1996).

CASE ILLUSTRATION 5.6

**AAA ABACHMAN ENTERPRISES, INC. v. STANLEY
STEEMER INTERNATIONAL, INC., 268 FED. APPX. 864
(11TH CIR. 2008)**

FACTS AAA Abachman Enterprises, Inc. (Abachman), is a Stanley Steemer International, Inc., franchisee, with a perpetual and exclusive license to “own and operate a Stanley Steemer carpet and upholstery cleaning business” in the upper half of Palm Beach County, Florida. The franchise agreement gave Abachman the sole right to use Stanley Steemer’s “trademarks, service marks, patents, [and] trade secrets ... solely in a Stanley Steemer Business in that area and in no other manner.”

In February 2006, the franchisor, Stanley Steemer, granted two businesses owned by Thomas Scalera an “exclusive license to own and operate a Stanley Steemer Duct Cleaning Business” for a five year term, and “to use the Stanley Steemer Duct Cleaning Marks, proprietary equipment and products ... in a Stanley Steemer Duct Cleaning Business” in a territory that included the upper half of Palm Beach County and so overlapped with Abachman’s territory.

Abachman sued Stanley Steemer, alleging that Stanley Steemer had breached its franchise agreement by contracting with Scalera’s companies.

DECISION The district court granted summary judgment to Stanley Steemer International, Inc., and the court of appeals affirmed. The appellate court stated: “Where the terms in a contract are not ambiguous, courts are constrained to apply the plain language of the contract.’ The terms of Abachman’s franchise agreement with Stanley Steemer are not ambiguous; they give Abachman the exclusive right to use the mark in its carpet and upholstery business ‘and in no other manner.’” Thus, the court concluded, “Stanley Steemer retain[ed] the right to license its trademark to Scalera’s businesses to use in connection with duct cleaning.”

If, under the terms of the agreement, the franchisee received an exclusive territory, the franchisor is clearly prohibited from locating other units within that territory. (The franchisor may try to avoid such restrictions by offering a similar, but not identical, product, such as a different brand of hotel franchise, within the territory.) Similarly, if the franchise agreement explicitly states that the franchisor has an unrestricted right to locate additional units or that the franchisee does not have an exclusive territory, that language will control as well (see Case Illustration 5.6).

Many encroachment cases involve a middle ground, however, in which the franchise agreement grants a small, protected territory to the franchisee. The franchisor then locates a new unit outside that protected territory but close enough to have a negative impact on the revenues or profitability of the original franchisee. These cases generally implicate the *implied covenant of good faith*. Under the Restatement (Second) of Contracts, “[e]very contract imposes upon each party a duty of good faith and fair dealing”²⁰ This implied covenant is overridden by express language, such as a contractual provision stating that the franchisor has complete discretion to establish new franchises at any location outside the protected territory even if the new units harm the existing franchisee. Where such explicit contractual provisions are missing, however, the courts have to determine whether the franchisor’s actions violated its duty of good faith and fair dealing. In general, the franchisors have tended to win these disputes.

As a practical matter, franchisors should state their encroachment policies explicitly within their franchise agreements so as to avoid litigation with disappointed franchisees.

²⁰Restatement (Second) of Contracts § 205.

Other mechanisms, such as granting franchisees the right of first refusal on new units, can be used to address these problems as well.

The amended Franchise Disclosure Rule also addresses encroachment by requiring the franchisor to disclose whether it or an affiliate has used or has the right to use other distribution channels, including the Internet, catalog sales, telemarketing, or other direct sales, to make sales within the franchisee's territory.

Termination Issues

Generally, franchise agreements provide that the franchisor can terminate the franchise if certain events occur. Most provide for termination "for cause," which includes situations such as the franchisee failing to meet quality control standards or failing to pay required fees. Some state laws restrict the franchisor's ability to terminate or refuse to renew a franchise without cause. A minority of states require that the franchisor provide notice—often 90 or 180 days in advance—before terminating or refusing to renew a franchise.

The courts are concerned that terminations will leave a franchisee with little or nothing to show for what might have been a very large investment of time and money. Thus, the courts often try to protect the franchisee in termination cases. They do not, however, prevent a franchisor from terminating franchisees that fail to meet the obligations of their franchise agreements. In addition, even in states that require "good cause" for termination, the courts recognize that the franchisor's own economic circumstances are relevant to the determination of whether termination was justified. Thus, the courts generally do not second-guess the franchisor's decision to terminate when it is supported by evidence of losses, flat or declining profits or sales, or cancellation of an entire product line.

Multi-Level Marketing

Multi-level marketing, also known as *network* or *matrix marketing*, involves sales of goods or services through distributors, where distributors are typically promised commissions both on their own sales and on sales their recruits have made. It often involves sales of consumer products by independent distributors, often in consumers' homes. Amway, Mary Kay, and Tupperware are well-known multi-level marketing businesses.

Pyramid or *Ponzi schemes*, which are a form of multi-level marketing that involves paying commissions to distributors for recruiting new distributors, are illegal in most states and can violate the federal Postal Lottery Statute.²¹ Pyramid schemes inevitably collapse once no new distributors can be recruited, causing most people involved (except those at the very top) to lose their money.

To avoid prohibitions against pyramid schemes, multi-level marketing plans should pay commissions only on sales and not for recruitment of new participants. If the multi-level marketing plan involves the sale of business opportunities or franchising, it must comply with the requirements of applicable disclosure and/or registration laws.

Franchising and the Internet

Franchisors have been quick to take advantage of the opportunities that the Internet provides. In many respects, however, franchising law has not kept up with the technological advances of the Internet. The rules governing the use of the Internet in this setting are uncertain. In addition, many established franchisors had not anticipated the opportunities that the Internet would create and so had not planned properly in their franchise agreements to address the host of issues that this new communication medium raises.

²¹18 U.S.C. § 1302.

Franchisors face several issues with regard to Internet activities, including: (1) what disclosure obligations apply to a franchisor's advertising of franchises on the Internet? (2) what control does a franchisor have over its franchisee's Internet activities? and (3) when do Internet activities rise to the level of "encroachment"?

"Offering" Franchises on the Internet

Many franchisors maintain Internet sites that contain general information about their franchise system that could be construed as an "offer" of a franchise, thus triggering state disclosure and registration requirements. In addition, the franchise laws in several states require that all franchise advertisements proposed for use within the state be submitted to (and often approved by) state officials prior to use. Definitions of advertisements are broad enough to include website content. California, for example, defines an "advertisement" as "any written or printed communication or any communication by means of recorded telephone messages or spoken on radio, television, or similar communications media, published in connection with an offer or sale of a franchise."²²

Thus, franchisors with websites must be concerned with two issues: (1) must they register in all of the states requiring franchise registration? and (2) must they submit the content of their websites to those states that require franchise advertisements to be approved by state authorities before use?

Currently, the marketing of franchises online is not directly regulated in most states; thus, it not yet clear how most state franchise laws apply to activities on the Internet. Websites reach individuals in every state, and the owner of the site cannot control its dissemination. It initially would appear, therefore, that if a franchisor's website contains information that would cause the site to be a "franchise offer," the site must be registered in all states requiring registration.

States have taken action to lessen this burden on franchisors. In Indiana, for example, the Indiana Securities Administrator issued an order stating that an Internet offer of a franchise will be exempt from Indiana registration requirements if: (1) the offer indicates that franchises will not be sold to persons in Indiana; (2) an offer is not otherwise addressed to any person in Indiana; and (3) no sales of franchises are made in Indiana as a result of the Internet offer.²³ Thus, to avoid registration in Indiana, the franchisor must post a statement on its website stating that franchises are not available within the state and are not sold within the state. Similar rules apply in the other states that regulate franchise advertising.

As already noted, some states require submission or approval of advertisements for franchises. It is not yet clear whether franchisors must submit their website content for approval in states requiring submissions or approvals of advertisements, but it would appear that they should not. Most states exempt advertisements appearing in publications with at least two-thirds of their circulation outside the state from these regulations. Although the states have not yet provided their formal positions on this issue, websites would seem to fall squarely within this exemption.

Franchisor Control Over Franchise Internet Activities

Cybersquatting—the use of an Internet domain name by a company or individual who does not hold the trademark or trade name in that name—is a common problem. Domain names such as "mcdonalds.com," "mtv.com," "panavision.com," and "coke.com" were all originally held by persons other than the registered trademark owners. Cybersquatting issues are discussed in more detail in Chapter 6.

²²Cal. Corp. Code § 31003 (2007).

²³Admin. Order 97-0378AO (Dec. 24, 1997).

The franchise relationship adds another dimension to the cybersquatting problem: a franchisee may register and use a domain name belonging to its franchisor. For example, California Closets Co., a franchisor of closet organization system stores, obtained a temporary restraining order preventing its franchisee from using the domain name “californiacloset.com.”²⁴

Many existing franchise agreements were drafted before the explosion in Internet activity and do not explicitly address Internet issues. Existing language in these documents addressing the franchisor’s intellectual property rights in its marks and trade names may prove insufficient to protect the franchisor’s interests. New franchise agreements should explicitly address these issues, of course, including topics such as the franchisee’s right to establish an Internet site and restrictions upon its content (generally, prior approval of the franchisor of all content is required), permissible domain names, and required “links” between the franchisee’s site and the franchisor’s site.

Internet “Encroachment” Issues

In addition, the Internet poses a special type of encroachment issue for franchisees. While a franchisee might have been granted an exclusive territorial area under its franchise contract, an Internet “virtual store” operated by the franchisor can easily interfere with the franchisee’s sales, placing the franchisor in direct competition with its franchisees. While properly drawn new franchise agreements should explicitly address this issue, older agreements that predate the growth of the Internet do not. Franchisees and franchisors thus have found themselves in litigation as they struggle to determine how existing contract language should be applied to a situation neither party could have anticipated at the time of contracting.

International Issues in Franchising

U.S. franchisors often wish to expand their operations abroad. Federal and state franchising laws generally do not govern such transactions; rather, the franchisor must adhere to the laws of the country or countries in which it wishes to offer franchises. At least 20 countries currently regulate franchising, and more countries are expected to adopt such laws.

Three basic forms of franchising are found at the international level. The most common form is the use of a *master franchise agreement*. Under this arrangement, the franchisor enters into a master franchise agreement with a subfranchisor (usually a foreign national), which authorizes the subfranchisor to (1) develop and operate franchises and (2) grant subfranchises to others. *Direct franchising*, in which the franchisor contracts directly with franchisees in the host country, works best when the laws and customs of the host country are similar to those of the United States. Finally, the franchisor may enter into a *joint venture* with an overseas partner. There are, of course, many variations on these basic categories. The choice of method used depends upon cultural differences between the home and host countries; legal constraints imposed by the host country; and business factors, such as financial and personnel constraints, difficulty of managing relationships over long distances, and differences in commercial practices between the two countries involved.

Offering franchises in foreign countries raises a number of legal issues that are different from those found in domestic franchising relationships. Intellectual property issues become particularly critical in foreign franchising activities. The franchisor faces two separate tasks with regard to intellectual property issues in foreign franchising activities. First, it must determine whether existing marks, trade names, and logos will function in

²⁴*California Closet Co. v. Space Organization Systems, Inc.*, CCH Bus. Franchise Guide ¶ 11,150 (E.D. Wis. 1997).

the new country, both in terms of being culturally and linguistically acceptable and in terms of whether the mark is sufficiently distinct from other marks already in use. Second, the franchisor must be concerned with protection of intellectual property assets. Will the host country's laws adequately protect marks, trade secrets, and copyrights? Should the franchisor apply for additional patents? (Intellectual property law issues are discussed in more detail in Chapter 2, Chapter 3, and Chapter 6.)

In addition, the franchisor must be concerned with the franchise laws, specifically, and business laws, generally, of the host country. Most countries do not regulate franchises, but the franchisor must determine whether disclosure and/or registration laws apply; what securities or antitrust restrictions might be imposed; whether foreign investments and technology transfers are regulated; what contract, commercial, taxation, and labor laws apply; whether import or export controls are in place; what packaging, labeling, or food and drug regulations apply; and what impact the immigration laws might have on staffing and personnel decisions.

DISCUSSION CASES

5.1 Constitutionality of Local Ordinances Restricting Franchise Location *Island Silver & Spice, Inc. v. Islamorada*, 542 F.3d 844 (11th Cir. 2008)

Defendant-Appellant Islamorada, Village of Islands ("Islamorada") appeals from a judgment of the United States District Court for the Southern District of Florida granting injunctive and monetary relief in favor of Plaintiffs-Appellees Island Silver & Spice, Inc., Glenn S. Saiger, and Virginia Saiger (collectively "Island Silver") and invalidating an Islamorada zoning ordinance's "formula retail" restrictions as violations of the Dormant Commerce Clause. We affirm the judgment of the district court.

Background

In January 2002, Islamorada enacted Ordinance 02-02, which prohibited "formula restaurant[s]" and restricted "formula retail" establishments to limited street level frontage and total square footage. The ordinance defines formula retail as:

[a] type of retail sales activity of retail sales establishment ... that is required by contractual or other arrangement to maintain any of the following: standardized array of services or merchandise, trademark, logo, service mark, symbol, decor, architecture, layout, uniform, or similar standardized feature.

Island Silver owns and operates an independent retail store in Islamorada. In June 2002, Island Silver

entered into a contract to sell its property to a developer seeking to establish a Walgreens drug store in the same footprint of Island Silver's existing mixed-retail store. After unsuccessfully protesting the ordinance's restrictions on formula retail stores through the local administrative process, the developer withdrew from the purchase. Island Silver brought a complaint against Islamorada in district court, seeking damages, injunctive relief, and a writ of mandamus on the grounds that the ordinance's formula retail provisions violated its rights [under various provisions of the U.S. and Florida Constitutions].

On February 28, 2007, the district court granted injunctive and monetary relief in favor of Island Silver and invalidated the ordinance's formula retail provisions. The district court found that the provisions violated the Dormant Commerce Clause because they had a discriminatory impact on interstate commerce unsupported by a legitimate state purpose and the putative local benefits were outweighed by the burden imposed on interstate commerce. Islamorada appeals.

* * *

Discussion

The Dormant Commerce Clause prohibits "regulatory measures designed to benefit in-state economic

interests by burdening out-of-state competitors.” To determine whether a regulation violates the Dormant Commerce Clause, we apply one of two levels of analysis. If a regulation “directly regulates or discriminates against interstate commerce,” or has the effect of favoring “in-state economic interests,” the regulation must be shown to “advance[] a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.” If a regulation has “only indirect effects on interstate commerce,” we “examine[] whether the State’s interest is legitimate and whether the burden on interstate commerce clearly exceeds the local benefits.”

The district court correctly determined that the formula retail provision does not facially discriminate against interstate commerce. With respect to the provision’s effects, however, the parties stipulated that the ordinance “effectively prevents the establishment of new formula retail stores,” and “[a] facility limited to no more than 2,000 square feet or 50’ of frontage [as required by the ordinance] can not accommodate the minimum requirements of nationally and regionally branded formula retail stores.” Although the fact that the burden of a regulation falls onto a subset of out-of-state retailers “does not, by itself, establish a claim of discrimination against interstate commerce,” the ordinance’s effective elimination of all new interstate chain retailers has the “practical effect of ... discriminating against” interstate commerce. The formula retail provision is therefore subject to elevated scrutiny.

Under the elevated scrutiny test, a regulation must be supported by “a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.” The burden is on Islamorada to justify the ordinance’s discriminatory effects.

The ordinance’s stated local purposes include the preservation of “unique and natural” “small town” community characteristics, encouragement of “small scale uses, water-oriented uses, [and] a nationally significant natural environment,” and avoidance of increased “traffic congestion ... [and] litter, garbage and rubbish offsite.” The parties stipulated, however, that “Islamorada has a number of [pre-existing] ‘formula retail’ businesses,” Islamorada “has no Historic District, and there are no historic buildings in the vicinity of [Island Silver’s] property,” and “[t]he Ordinance is not necessary for preservation of the historic characteristics of any buildings in the Village.” In addition, because the ordinance “does not address small formula retail stores, which are permitted under the ordinance,

but would presumably affect the Village’s small town character as well,” or large non-chain businesses, the district court found that “[r]estricting formula retail stores, while allowing other large [and] non-unique structures, does not preserve a small town character.” The district court properly determined that, although “[i]n general, preserving a small town community is a legitimate purpose ... , in this instance, [Islamorada] has not demonstrated that it has any small town character to preserve.”

With respect to the stated purpose of encouraging small-scale and natural uses, the parties also stipulated that Islamorada’s existing “zoning allows the use of the property as a retail pharmacy ... and other retail uses,” and that Island Silver operated as “a street level business comprising over twelve thousand square feet of floor area,” which “greatly exceeds the [ordinance’s] dimensional limitations” for formula retail businesses. The district court correctly found that Islamorada “[did] not explain why the ordinance singles out retail stores and restaurants with standardized features,” and that the record did not indicate that Islamorada is “uniquely relaxed or natural,” or that there is “a predominance of natural conditions and characteristics over human intrusions.”

Similarly, the stated purposes of reducing traffic and garbage are undermined by the parties’ stipulations that Islamorada has existing “land development regulations, other than the Ordinance, that govern and control traffic generation of retail uses,” and “that limit the dimensions, location, and use of buildings and signs.” The district court therefore properly concluded that Islamorada failed to provide a legitimate local purpose to justify the ordinance’s discriminatory effects, and that even if such purpose had been shown, “the ordinance does not serve this interest.”

Islamorada’s failure to indicate a legitimate local purpose to justify the ordinance’s discriminatory effects is sufficient to support the district court’s determination that the formula retail provision is invalid under the Dormant Commerce Clause. It should be noted, however, that Islamorada does not assert that the stated purposes of the ordinance cannot be furthered by reasonable nondiscriminatory alternatives, such as Islamorada’s existing land development regulations. Even under the balancing approach advocated by Islamorada, the stipulated facts indicate that the formula retail provision’s disproportionate burden on interstate commerce, such as the effective exclusion of interstate formula retailers, clearly outweighs any legitimate local benefits.

Accordingly, the district court did not err in concluding that the ordinance's formula retail provision violated the Dormant Commerce Clause.

Conclusion

We therefore AFFIRM the judgment of the district court.

QUESTIONS FOR DISCUSSION FOR CASE 5.1

1. Why did the Village of Islamorada pass this ordinance restricting the location of certain businesses within the village limits? What governmental purpose was this ordinance intended to promote?

Is that a legitimate purpose for a local government to pursue?

2. The Commerce Clause of the U.S. Constitution gives Congress the right to regulate commerce among the states. This case deals with the "Dormant Commerce Clause." How does the court define the "Dormant Commerce Clause"?
3. The court describes a two-part test for evaluating whether ordinances violate the Dormant Commerce Clause. What is that test? Which part of the test did the Village's ordinance violate? What would the Village need to show in order for its ordinance to be valid?
-

5.2 Existence of Franchise Relationship

To-Am Equipment Co., Inc. v. Mitsubishi Caterpillar Forklift America, Inc., 152 F.3d 658 (7th Cir. 1998)

Legal terms often have specialized meanings that can surprise even a sophisticated party. The term "franchise," or its derivative "franchisee," is one of those words. The question in this case is whether the district court correctly ruled that certain payments that To-Am Equipment Company made to Mitsubishi Caterpillar Forklift America (MCFA), in connection with To-Am's distributorship for certain Mitsubishi products, could constitute franchise fees within the meaning of the Illinois Franchise Disclosure Act of 1987. That ruling in turn set the stage for a jury verdict in To-Am's favor awarding it \$1.525 million in damages for MCFA's termination of its distribution agreement. MCFA challenges the lower court's legal ruling on appeal. * * * We affirm.

I.

The Mitsubishi keiretsu (the traditional Japanese form of conglomerate) is a well known manufacturer of heavy equipment, including forklift trucks. In June 1985, To-Am entered into a dealership agreement for these forklifts with [MCFA]. * * * To-Am had been doing business in south Chicago since 1973, servicing, renting, and repairing fork-lifts. Over the years it also sold a number of different brands of forklifts ..., though prior to its contract with MCFA it sold only used forklifts. Before allowing To-Am to become a Mitsubishi dealer MCFA required To-Am to relocate to a larger showroom. To-Am complied and moved to Frankfort, Illinois. During the years it served as a

Mitsubishi dealer To-Am continued to handle used forklifts manufactured by Mitsubishi's competitors—in other words, the dealership did not require exclusivity on To-Am's part. On the other hand, the agreement conferred on To-Am an exclusive Area of Primary Responsibility (APR), consisting of four Illinois counties and one county in Indiana, in which MCFA did not have and agreed not to create a competing dealership.

Under the 1985 contract ..., To-Am was required to participate in Mitsubishi's warranty program. This meant, among other things, that To-Am had to maintain trained personnel and provide prompt warranty and non-warranty service on all Mitsubishi products within its APR. To comply with these requirements, To-Am participated in all of MCFA's training programs, apparently for the most part at its own expense. Article III para. 14 of the agreement expressly required To-Am to "maintain an adequate supply of current [MCFA] sales and service publications." To-Am did so by keeping a master set of manuals in its parts department, a second set in its service department, and additional manuals in its mobile service vehicles.... MCFA provided one set of these manuals in 1985 when To-Am became a distributor, but thereafter To-Am had to order additional manuals for the other locations where it kept manuals, for updating, and when manuals wore out. MCFA invoiced To-Am for these additional manuals, and over the years To-Am paid over \$1,600 for them. * * *

In February 1994, MCFA notified To-Am that it was terminating the dealership agreement effective

April 2, 1994, in accordance with Article XI para. 1 of the agreement, which permitted either party to terminate upon 60 days' written notice "or as required by law." This step was a blow to To-Am's business The reason was simple: Mitsubishi fork-lifts were the only new vehicles that To-Am had been selling. Even though new truck sales are themselves relatively low profit generators for dealers, they can create substantial downstream business, ranging from trade-ins that could be resold as used equipment or carried as rental equipment, to service and parts sales. Testimony at trial indicated that, while dealer profit margins on new equipment sales might be as low as 3% the margins on these downstream business opportunities ranged from 30% to 50%. Thus, the loss of To-Am's line of new trucks had ripple effects on its business going far beyond the immediate lost sales.

To-Am therefore brought this suit against MCFA To-Am alleged violations of the Illinois Franchise Disclosure Act for the wrongful termination of its franchise without good cause

*** Prior to trial MCFA conceded that To-Am met the requirement under the Franchise Disclosure Act that the franchisee's business be substantially associated with the franchisor's trademark. MCFA also conceded that the termination was without good cause, as the Act uses the term. ***

II

A. Franchise Fees

The Franchise Disclosure Act defines a franchise fee as follows:

[A]ny fee or charge that a franchisee is required to pay directly or indirectly for the right to enter into a business or sell, resell, or distribute goods, services or franchises under an agreement, including, but not limited to, any such payments for goods or services, provided that the Administrator may by rule define what constitutes an indirect franchise fee, and provided further that the following shall not be considered the payment of a franchise fee [setting forth six exceptions, none of which MCFA argues apply here].

As this section specifically contemplates, the Illinois Attorney General, as the Administrator of the statute, has issued a number of pertinent implementing

regulations. First, he has elaborated on the definition of the term "franchise fee":

A franchise fee within the meaning of Section 3(14) of the Act may be present regardless of the designation given to or the form of the fee, whether payable in lump sum or installments, definite or indefinite in amount, or partly or wholly contingent on future sales, profits or purchases of the franchise business.

14 Ill. Admin. Code § 200.104. In addition, § 200.105 explains:

(a) Any payment(s) in excess of \$500 that is required to be paid by a franchisee to the franchisor or an affiliate of the franchisor constitutes a franchise fee unless specifically excluded by Section 3(14) of the Act.

...

(c) A payment made to a franchisor or affiliate for equipment, materials, real estate services, or other items shall not constitute a franchise fee if the purchase of the items is not required by the franchisor or the franchisee is permitted to purchase the items from sources other than the franchisor or its affiliates and the item is available from such other sources.

These definitions are obviously sweeping in their scope. The sum of \$500, all that has to be paid over the entire life of a franchise, is less than small change for most businesses of any size. Furthermore, the regulations explicitly allow this small amount to be paid either in a lump sum or in installments, to be "definite or indefinite" in amount, and to be "partly or wholly contingent" on different, possibly quite unpredictable, variables. In short, the Illinois legislature and the designated Administrator, the Attorney General, could not have been more clear. They wanted to protect a wide class of dealers, distributors, and other "franchisees" from specified acts, such as terminations of their distributorships (franchises) for anything less than "good cause." ***

MCFA begins with the factual assertion that To-Am was not required to pay it anything under the terms of the agreement, and certainly no form of franchise fee. It is true that the agreement has no article entitled "Periodic Franchise Payments," but the Illinois statute and administrative regulations we have just quoted make it clear that no such precision is required. Article III para. 14 says that the dealer was required to "maintain an adequate supply of current [MCFA] sales and service publications." The jury was entitled to view this as an indirect fee or charge for the right to enter into the

business of distributing MCFA lift trucks, which was payable over time, and which exceeded the statutory floor of \$500 by a factor of more than three. Given MCFA's control of the supply of these manuals, it easily could have built a franchise fee into their price. * * *

* * *

Like many manufacturers, MCFA simply did not appreciate how vigorously Illinois law protects "franchisees." This does not mean that terminations are impossible, but it does mean that they usually must be the subject of negotiation unless the manufacturer is able to show "good cause." MCFA has conceded that it cannot meet that standard While we understand MCFA's concern that dealerships in Illinois are too easily categorized as statutory franchisees, that is a concern appropriately raised to either the Illinois

legislature or Illinois Attorney General, not to this court. We therefore AFFIRM the judgment of the district court.

QUESTIONS FOR DISCUSSION FOR CASE 5.2

1. How does the Illinois Franchise Disclosure Act define a "franchise"? What elements of that definition were at issue here?
 2. Do you think that either To-Am or MCFA thought it was creating a franchise relationship when the parties first entered into this relationship?
 3. Do you think that the outcome of this case is fair? What public policy considerations might support this outcome?
 4. Where should franchisors such as MCFA go to seek redress from this statute and its broad definition of franchises?
-

5.3 Existence of Franchise Relationship

Mary Kay, Inc. v. Isbell, 999 S.W.2d 669 (Ark. 1999)

This case requires our interpretation of the Arkansas Franchise Practices Act and whether the Act applies to the business relationship established between appellee Janet Isbell and appellant Mary Kay, Inc. This court's jurisdiction is also invoked because the case presents issues of first impression and of substantial public interest and issues involving the need for clarification and development of the law.

Isbell's relationship with Mary Kay commenced in 1980 when she signed an agreement to be a beauty consultant for Mary Kay. As a consultant, Isbell was denominated an independent contractor, and, as such, she agreed to promote and sell Mary Kay products to customers at home demonstration parties; she was prohibited by the agreement from selling or displaying those products in retail sales or service establishments. Instead, a Mary Kay consultant's locations for selling products are her home or those of her potential customers. After serving a short period as a beauty consultant and recruiting a sufficient number of her customers to be Mary Kay consultants, Isbell became entitled to be a unit sales director. Isbell signed her first sales director agreement on September 1, 1981, and a second one on July 1, 1991. As a director, Isbell continued to recruit beauty consultants and to help and motivate members of her unit in the sale of Mary Kay cosmetics. She also continued to serve as a beauty consultant. Isbell earned compensation in the form of a

commission on sales she made directly to customers as a consultant; as sales director, she additionally received override commissions based on sales made by the consultants she recruited.

In 1994, Isbell leased storefront space in a Little Rock mall and used the space as a training center. It was about this time when Mary Kay began receiving complaints about Isbell's operation. By letter dated April 11, 1994, Mary Kay's legal coordinator, Sherry Gragg, referred Isbell to the parties' Sales Director Agreement and the company's Director's Guide which was made a part of that agreement. Gragg related that Isbell's office or training center was to be used only as a teaching center and to hold unit meetings. Gragg further instructed that Isbell's office or center should not give the appearance of a cosmetic studio, facial salon, or retail establishment, or be used to display or store Mary Kay products. Gragg reiterated that, under the parties' agreement, a sales director's office could not appear to be a Mary Kay store or be used to make direct sales to customers. Finally, Gragg admonished Isbell to discontinue all photo sessions of potential customers at such location and to remove any window sign advertising "glamour tips" or face makeover programs taking place at the center. Mary Kay also received complaints of Isbell's (1) overly aggressive recruiting, (2) listing of fictitious recruits as consultants, and (3) check kiting practices.

Eventually, in September of 1995, Mary Kay's vice president of sales development, Gary Jinks, notified Isbell by letter that, under the terms of their agreement, the company was terminating its beauty consultant and sales director agreements, and the termination was effective thirty days from the date of the letter. Isbell filed suit against Mary Kay ..., alleging that she was a franchisee under Arkansas's Franchise Practices Act and that Mary Kay failed to comply with the provisions of the Act when terminating Isbell. Isbell asserted, among other things, that Mary Kay's letter of termination failed to comply with § 4-72-204 of the Act because the letter did not give her ninety days' notice or set forth the reasons for her termination. * * *

[The trial court ruled as a matter of law that Mary Kay's termination of Isbell had violated the Act and the jury returned a verdict in Isbell's favor in the amount of \$110,583.33. Both sides appealed.]

* * *

The threshold issue to be decided is whether the Arkansas Franchise Practices Act applies, because if it does, Isbell would be entitled to the designation of franchisee and permitted to invoke the protections and benefits of that Act. The other five issues raised by the respective parties come into play only if the Act is ruled applicable to this case. * * *

To determine whether the Arkansas Franchise Practices Act applies to this case depends upon our interpretation and construction of the pertinent provisions of the Act. In this view, we turn first to Ark. Code Ann. § 4-72-202 (1), which in relevant part defines "franchise" to mean the following:

[A] written or oral agreement for a definite or indefinite period, in which a person grants to another a license to use a trade name, trademark, service mark, or related characteristic within an exclusive or nonexclusive territory, or to sell or distribute goods or services within an exclusive or nonexclusive territory, at wholesale, retail, by lease agreement, or otherwise.

Clearly, Mary Kay entered into a written agreement with Isbell so that Isbell, as an independent contractor, could use Mary Kay's trademark and name to sell its products as provided by their agreement. * * *

While the Act's definition of franchise is helpful, that definition alone is not dispositive of the issue as to whether Isbell, under the parties' agreement, is or is not a franchisee. * * * Section 4-72-203 clearly provides the Act applies only to a franchise that contemplates or

requires the franchise to establish or maintain a place of business in the state. Next, § 4-72-202 (6) defines "place of business" under the Act as meaning "a fixed geographical location at which the franchisee [1] displays for sale and sells the franchisor's goods or [2] offers for sale and sells the franchisor's services." * * * In sum, citing these two statutes, Mary Kay submits that no fixed geographical location for selling products or services was ever contemplated, much less required, by the parties' agreement, and this reason is sufficient alone to preclude Isbell's reliance on the Act. We agree.

We first should note that Isbell concedes that, as a sales director, her agreements with Mary Kay provided that she could not display for sale or sell Mary Kay products from an office, whether that office was located in her home or her training center. * * *

While conceding that the parties' agreements never contemplated that Isbell would or could sell the franchisor's *goods* from a fixed location, she argues no such prohibition prevented her from selling Mary Kay *services* from her home or training center. Specifically, Isbell suggests the facial makeovers and "Glamour Shots" photo sessions that were a part of Mary Kay's demonstration and training program constituted services that the parties contemplated could be sold by Isbell from her center. * * *

* * * [Mary Kay's] Director's Guide, which was made a part of the parties' agreements, very clearly provided that a sales director's office, albeit it her home or training center, could only be used to interview potential recruits and hold unit meetings and other training events. The Guide further provided that the office or center should not give the appearance of a cosmetic studio, facial salon or retail establishment, or give the appearance of being a "Mary Kay" store. * * * Thus, nowhere in the parties' Guide or agreements can it be fairly said that the parties ever contemplated that Isbell could use her office or center as a fixed location to display or sell Mary Kay products or services.

* * *

Finally, Isbell argues that her home constituted a place of business under the Act because as a consultant she occasionally displayed and sold products there. This argument, however, is not supported by the parties' agreement, since it never contemplated a fixed location for the display and sale of products. As previously stated, a Mary Kay consultant's locations for selling products are her home or those of her potential customers. * * * It is thus clear that the requirement of a fixed location is not satisfied by occasional sales

from either Isbell's home or the homes of her potential customers.

In sum, we conclude that the agreements between Janet Isbell and Mary Kay did not contemplate the establishment of a fixed place of business as that term is defined in Ark. Code Ann. § 4-72-202 (6). As such, the business relationship entered into by Isbell and Mary Kay was not a franchise within the protection of the

Arkansas Franchise Practices Act, and the court below erred in so holding. We therefore reverse and dismiss.

QUESTIONS FOR DISCUSSION FOR CASE 5.3

1. Why has the Arkansas Supreme Court agreed to hear this case?
 2. Why is it important from each party's perspective whether Isbell had a fixed place of business?
-

5.4 Vicarious Liability of Franchisor

Miller v. McDonald's Corp., 945 P.2d 1107 (Or. App. 1997)

Plaintiff seeks damages from defendant McDonald's Corporation for injuries that she suffered when she bit into a heart-shaped sapphire stone while eating a Big Mac sandwich that she had purchased at a McDonald's restaurant in Tigard. The trial court granted summary judgment to defendant on the ground that it did not own or operate the restaurant; rather, the owner and operator was a non-party, 3K Restaurants (3K), that held a franchise from defendant. Plaintiff appeals, and we reverse.

Most of the relevant facts are not in dispute 3K owned and operated the restaurant under a License Agreement (the Agreement) with defendant that required it to operate in a manner consistent with the "McDonald's System." The Agreement described that system as including proprietary rights in trade names, service marks and trademarks, as well as

designs and color schemes for restaurant buildings, signs, equipment layouts, formulas and specifications for certain food products, methods of inventory and operation control, bookkeeping and accounting, and manuals covering business practices and policies.

The manuals contain "detailed information relating to operation of the Restaurant," including food formulas and specifications, methods of inventory control, bookkeeping procedures, business practices, and other management, advertising, and personnel policies. 3K, as the licensee, agreed to adopt and exclusively use the formulas, methods, and policies contained in the manuals, including any subsequent modifications, and to use only advertising and promotional materials that defendant either provided or approved in advance in writing.

The Agreement described the way in which 3K was to operate the restaurant in considerable detail. It expressly required 3K to operate in compliance with

defendant's prescribed standards, policies, practices, and procedures, including serving only food and beverage products that defendant designated. 3K had to follow defendant's specifications and blueprints for the equipment and layout of the restaurant, including adopting subsequent reasonable changes that defendant made, and to maintain the restaurant building in compliance with defendant's standards. 3K could not make any changes in the basic design of the building without defendant's approval.

The Agreement required 3K to keep the restaurant open during the hours that defendant prescribed, including maintaining adequate supplies and employing adequate personnel to operate at maximum capacity and efficiency during those hours. 3K also had to keep the restaurant similar in appearance to all other McDonald's restaurants. 3K's employees had to wear McDonald's uniforms, to have a neat and clean appearance, and to provide competent and courteous service. 3K could use only containers and other packaging that bore McDonald's trademarks. The ingredients for the foods and beverages had to meet defendant's standards, and 3K had to use "only those methods of food handling and preparation that [defendant] may designate from time to time." * * * The manuals gave further details that expanded on many of these requirements.

In order to ensure conformity with the standards described in the Agreement, defendant periodically sent field consultants to the restaurant to inspect its operations. 3K trained its employees in accordance with defendant's materials and recommendations and sent some of them to training programs that defendant administered. Failure to comply with the agreed standards could result in loss of the franchise.

Despite these detailed instructions, the Agreement provided that 3K was not an agent of defendant for

any purpose. Rather, it was an independent contractor and was responsible for all obligations and liabilities, including claims based on injury, illness, or death, directly or indirectly resulting from the operation of the restaurant.

Plaintiff went to the restaurant under the assumption that defendant owned, controlled, and managed it. So far as she could tell, the restaurant's appearance was similar to that of other McDonald's restaurants that she had patronized. Nothing disclosed to her that any entity other than defendant was involved in its operation. The only signs that were visible and obvious to the public had the name "McDonald's," the employees wore uniforms with McDonald's insignia, and the menu was the same that plaintiff had seen in other McDonald's restaurants. The general appearance of the restaurant and the food products that it sold were similar to the restaurants and products that plaintiff had seen in national print and television advertising that defendant had run. To the best of plaintiff's knowledge, only McDonald's sells Big Mac hamburgers.

In short, plaintiff testified, she went to the Tigar McDonald's because she relied on defendant's reputation and because she wanted to obtain the same quality of service, standard of care in food preparation, and general attention to detail that she had previously enjoyed at other McDonald's restaurants.

Under these facts, 3K would be directly liable for any injuries that plaintiff suffered as a result of the restaurant's negligence. The issue ... is whether there is evidence that would permit a jury to find defendant vicariously liable for those injuries because of its relationship with 3K. Plaintiff asserts two theories of vicarious liability, actual agency and apparent agency. We hold that there is sufficient evidence to raise a jury issue under both theories. * * *

The kind of actual agency relationship that would make defendant vicariously liable for 3K's negligence requires that defendant have the right to control the *method* by which 3K performed its obligations under the Agreement. * * *

* * *

* * * The Delaware Supreme Court stated the [right to control] test as it applies to [a franchise relationship]:

If, in practical effect, the franchise agreement goes beyond the stage of setting standards, and allocates to the franchisor the right to exercise control over

the daily operations of the franchise, an agency relationship exists.

* * *

[W]e believe that a jury could find that defendant retained sufficient control over 3K's daily operations that an actual agency relationship existed. The Agreement did not simply set standards that 3K had to meet. Rather, it required 3K to use the precise methods that defendant established, both in the Agreement and in the detailed manuals that the Agreement incorporated. Those methods included the ways in which 3K was to handle and prepare food. Defendant enforced the use of those methods by regularly sending inspectors and by its retained power to cancel the Agreement. That evidence would support a finding that defendant had the right to control the way in which 3K performed at least food handling and preparation. In her complaint, plaintiff alleges that 3K's deficiencies in those functions resulted in the sapphire being in the Big Mac and thereby caused her injuries. Thus, * * * there is evidence that defendant had the right to control 3K in the precise part of its business that allegedly resulted in plaintiff's injuries. That is sufficient to raise an issue of actual agency.

Plaintiff next asserts that defendant is vicariously liable for 3K's alleged negligence because 3K was defendant's apparent agent.⁴ The relevant standard is in *Restatement (Second) of Agency*, § 267, which we adopted in *Themins v. Emanuel Lutheran*, 637 P.2d 155 (Or. App. 1981):

One who represents that another is his servant or other agent and thereby causes a third person justifiably to rely upon the care or skill of such apparent agent is subject to liability to the third person for harm caused by the lack of care or skill of the one appearing to be a servant or other agent as if he were such.

We have not applied § 267 to a franchisor/franchisee situation, but courts in a number of other jurisdictions have done so in ways that we find instructive. In most cases the courts have found that there was a jury issue of apparent agency. The crucial issues are whether the putative principal held the third party out as an agent and whether the plaintiff relied on that holding out.

⁴Apparent agency is a distinct concept from apparent authority. Apparent agency creates an agency relationship that does not otherwise exist, while apparent authority expands the authority of an actual agent.

We look first at what may constitute a franchisor's holding a franchisee out as its agent. In the leading case of *Gizzi v. Texaco, Inc.*, 437 F.2d 308 (5th Cir. 1971), the plaintiff purchased a used Volkswagen van from a Texaco service station. He was injured when the brakes failed shortly thereafter. The franchisee had worked on the brakes before selling the car. The station prominently displayed Texaco insignia, including the slogan "Trust your car to the man who wears the star." Texaco engaged in considerable national advertising to convey the impression that its dealers were skilled in automotive servicing. About 30 percent of Texaco dealers sold used cars. There was a Texaco regional office across the street from the station, and those working in that office knew that the franchisee was selling cars from the station. Based on this evidence, the court concluded, under New Jersey law, that the question of apparent agency was for the jury.

* * *

In *Crinkley v. Holiday Inns, Inc.*, 844 F.2d 156 (4th Cir. 1988), the defendant required the use of the Holiday Inn trade name and trademarks, was the original builder of the hotel, and engaged in national advertising that promoted its system of hotels without distinguishing between those that it owned and those that it franchised. The only indication that the defendant did not own this particular Holiday Inn was a sign in the restaurant that stated that the franchisee operated it. Based on this evidence, the court concluded, under North Carolina law, that apparent agency was a question for the jury.

In each of these cases, the franchise agreement required the franchisee to act in ways that identified it with the franchisor. The franchisor imposed those requirements as part of maintaining an image of uniformity of operations and appearance for the franchisor's entire system. Its purpose was to attract the patronage of the public to that entire system. The centrally imposed uniformity is the fundamental basis for the courts' conclusion that there was an issue of fact whether the franchisors held the franchisees out as the franchisors' agents.

In this case, for similar reasons, there is an issue of fact about whether defendant held 3K out as its agent. Everything about the appearance and operation of the Tigard McDonald's identified it with defendant and with the common image for all McDonald's restaurants that defendant has worked to create through national

advertising, common signs and uniforms, common menus, common appearance, and common standards. The possible existence of a sign identifying 3K as the operator does not alter the conclusion that there is an issue of apparent agency for the jury. There are issues of fact of whether that sign was sufficiently visible to the public, in light of plaintiff's apparent failure to see it, and of whether one sign by itself is sufficient to remove the impression that defendant created through all of the other indicia of its control that it, and 3K under the requirements that defendant imposed, presented to the public.

Defendant does not seriously dispute that a jury could find that it held 3K out as its agent. Rather, it argues that there is insufficient evidence that plaintiff justifiably relied on that holding out. It argues that it is not sufficient for her to prove that she went to the Tigard McDonald's because it was a McDonald's restaurant. Rather, she also had to prove that she went to it because she believed that *McDonald's Corporation* operated both it and the other McDonald's restaurants that she had previously patronized. * * *

Defendant's argument both demands a higher level of sophistication about the nature of franchising than the general public can be expected to have and ignores the effect of its own efforts to lead the public to believe that McDonald's restaurants are part of a uniform national system of restaurants with common products and common standards of quality. * * *

Plaintiff testified in her affidavit that her reliance on defendant for the quality of service and food at the Tigard McDonald's came in part from her experience at other McDonald's restaurants. * * * A jury could find that it was defendant's very insistence on uniformity of appearance and standards, designed to cause the public to think of every McDonald's, franchised or unfranchised, as part of the same system, that makes it difficult or impossible for plaintiff to tell whether her previous experiences were at restaurants that defendant owned or franchised.

* * *

[P]laintiff testified that she relied on the general reputation of McDonald's in patronizing the Tigard restaurant and in her expectation of the quality of the food and service that she would receive. Especially in light of defendant's efforts to create a public perception of a common McDonald's system at all McDonald's restaurants, whoever operated them, a jury could find

that plaintiff's reliance was objectively reasonable. The trial court erred in granting summary judgment on the apparent agency theory.

Reversed and remanded.

QUESTIONS FOR DISCUSSION FOR CASE 5.4

1. What is the difference between actual and apparent agency? What tests are used to evaluate whether each is present in a given case?
 2. How visible and obvious do you think signs should be telling customers that a franchisee owns and operates a business? On your last trip to a fast-food restaurant, did you notice who owned the restaurant?
 3. Is it fair to hold McDonald's Corporation liable when its franchisee cooks the food and is most likely in the best position to control whether foreign objects enter the food?
 4. What public policy considerations come into play when you make this determination?
 5. What can a franchisor do to protect itself against liability arising out of the acts of its franchisee?
 6. Procedurally, what will happen next in this case?
-

5.5 Franchise Antitrust Issues

Sheridan v. Marathon Petroleum Co., LLC, 530 F.3d 590 (7th Cir. 2008)

The plaintiffs, a Marathon dealer in Indiana and a company owned by him to whom he assigned his dealership contract, filed suit against Marathon under section 1 of the Sherman Act, 15 U.S.C. § 1, charging it with tying the processing of credit card sales to the Marathon franchise The tying arrangement is challenged under section 1 of the Sherman Act rather than section 3 of the Clayton Act because the things alleged to be tied—the franchise and the processing service—are services rather than commodities. [T]he standards for adjudicating tying under the two statutes are now recognized to be the same.

* * *

The complaint alleges that as a condition of granting a dealer franchise Marathon requires the dealer to agree to process credit card “purchases of petroleum and other products, services provided and merchandise sold at or from the [dealer's] Premises” through a processing service designated by Marathon. The terms of the dealership (set forth in a dealers' handbook cited in the complaint) impose the requirement only with regard to sales paid for with Marathon's proprietary credit card, which however the dealer is required to accept in payment. A dealer who wanted to process sales paid for with other credit cards by means of a different processing system would be contractually free to do so, but he would have to duplicate the processing equipment supplied by Marathon. We'll assume that this would be so costly as to compel dealers to process all their credit card sales by means of Marathon's designated system, since that system can process

credit card sales whether or not they are made with Marathon's credit card, thereby enabling the dealer to handle all such sales with one set of equipment. So Marathon *might* be said to have tied the processing of *all* credit card sales by its dealers to the Marathon franchise, and so we'll assume—for the moment. The plaintiffs contend that such a tie-in is a per se violation of the Sherman Act.

In a tying agreement, a seller conditions the sale of a product or service on the buyer's buying another product or service from or (as in this case) by direction of the seller. The traditional antitrust concern with such an agreement is that if the seller of the tying product is a monopolist, the tie-in will force anyone who wants the monopolized product to buy the tied product from him as well, and the result will be a second monopoly. This will happen, however, only if the tied product is used mainly with the trying product; if it has many other uses, the tie-in will not create a monopoly of the tied product. Suppose the tying product is a mimeograph machine and the tied product is the ink used with the machine, as in the old case of *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912). Since only a small percentage of the total ink supply was used with mimeograph machines, A.B. Dick's monopoly would not have enabled it to monopolize the ink market. If, moreover, A.B. Dick did obtain a monopoly of that market and used it to jack up the price of ink, customers for its machines would not be willing to pay as much for them because their cost of using them would be higher. In economic terms, the machine and the ink used with it are complementary products, and raising the price of a product reduces

the demand for its complements. (If the price of nails rises, the demand for hammers will fall.)

Only if all or most ink were used in conjunction with mimeograph machines might the manufacturer use the tie-in to repel competition. For then someone who wanted to challenge the mimeograph monopoly might have difficulty arranging for a supply of ink for his customers unless he entered the ink business. That might be hard for him to do. Entering two markets having unrelated production characteristics might both entail delay and increase the risk and hence cost of the new entrant.

Tying agreements can also be a method of price discrimination—the more ink the buyer of a mimeograph machine uses, and hence the more he uses the machine, the more valuable in all likelihood the machine is to him. In that event, by charging a high price for the ink and a low price for the machine, the manufacturer can extract more revenue from the higher-value (less elastic) users without losing too many of the low-value users, since they don't use much ink and hence are not much affected by the high price of the ink but benefit from the low price of the machine. However, price discrimination does not violate the Sherman Act unless it has an exclusionary effect. And a monopolist doesn't have to actually take over the market for the tied product in order to discriminate in price. He just has to interpose himself between the sellers of the tied product and his own customers so that he can reprice that product to his customers.

The Supreme Court used to deem tying agreements illegal provided only that, as the language of section 3 of the Clayton Act seemed to require, the tying arrangement embraced a nontrivial amount of interstate commerce. Beginning in the 1970s, however, the Court began to reexamine and in some instances discard antitrust doctrines that (like tying agreements) place limitations on distributors or dealers. The Court has not discarded the tying rule, and we have no authority to do so. But it has modified the rule by requiring proof that the seller has "market power" in the market for the tying product

So "market power" is key, but its meaning requires elucidation. *Monopoly* power we know is a seller's ability to charge a price above the competitive level (roughly speaking, above cost, including the cost of capital) without losing so many sales to existing competitors or new entrants as to make the price increase unprofitable. The word "monopoly" in the expression "monopoly power" was never understood literally, to mean a market with only one seller; a seller who has

a large market share may be able to charge a price persistently above the competitive level despite the existence of competitors. Although the price increase will reduce the seller's output (because quantity demanded falls as price rises), his competitors, if they are small, may not be able to take up enough of the slack by expanding their own output to bring price back down to the competitive level; their costs of doing so would be too high—that is doubtless *why* they are small.

As one moves from a market of one very large seller plus a fringe of small firms to a market of several large firms, monopoly power wanes. Now if one firm tries to charge a price above the competitive level, its competitors may have the productive capacity to be able to replace its reduction in output with an increase in their own output at no higher cost, and price will fall back to the competitive level. Eventually a point is reached at which there is no threat to competition unless sellers are able to agree, tacitly or explicitly, to limit output in order to drive price above the competitive level. The mere possibility of collusion cannot establish monopoly power, even in an attenuated sense to which the term "market power" might attach, because then *every* firm, no matter how small, would be deemed to have it, since successful collusion is always a possibility.

The plaintiffs in drafting their complaint were at least dimly aware that they would have to plead and prove that Marathon had significant unilateral power over the market price of gasoline and so could charge a supra-competitive price (folded into the price for gasoline that it charges its dealers) for credit card processing. But all that the complaint states on this score is that Marathon is "the fourth-largest United States-based integrated oil and gas company and the fifth-largest petroleum refiner in the United States" and sells "petroleum products to approximately 5,600 Marathon and Speedway branded direct-served retail outlets and approximately 3,700 jobber-served retail outlets." Marathon and Speedway's alleged annual sales of six billion gallons of gasoline (improperly swollen by inclusion of Speedway's sales) is only 4.3 percent of total U.S. gasoline sales per year That is no one's idea of market power.

Marathon does of course have a "monopoly" of Marathon franchises. But "Marathon" is not a market; it is a trademark; and a trademark does not confer a monopoly; all it does is prevent a competitor from attaching the same name to his product. "Not even the most zealous antitrust hawk has ever argued that Amoco gasoline, Mobil gasoline, and Shell gasoline"—or, we interject, Marathon gasoline—"are three [with

Marathon, four] separate product markets.” The complaint does not allege that there are any local gasoline markets in which Marathon has monopoly (or market) power. No market share statistics for Marathon either locally or nationally are given, and there is no information in the complaint that would enable local shares to be calculated.

What is true is that a firm selling under conditions of “monopolistic competition”—the situation in which minor product differences (or the kind of locational advantage that a local store, such as a barber shop, might enjoy in competing for some customers) limit the substitutability of otherwise very similar products—will want to trademark its brand in order to distinguish it from its competitors’ brands. But the exploitation of the slight monopoly power thereby enabled does not do enough harm to the economy to warrant trundling out the heavy artillery of federal antitrust law. And anyway in this case monopolistic competition is not alleged either. So we are given no reason to doubt that if Marathon raises the price of using the Marathon name above the competitive level by raising the price of the credit card processing service that it offers, competing oil companies will nullify its price increase simply by keeping their own wholesale gasoline prices at the existing level. The complaint does not allege that Marathon is colluding with the other oil companies to raise the price of credit card processing

There is more that is wrong with the plaintiffs’ charge of illegal tying. Earlier we assumed that Marathon had indeed tied credit card processing to the franchise, but that assumption will not withstand scrutiny. All it has done is require its franchisees to honor Marathon credit cards and to process sales with them through the system designated by Marathon so that customers of Marathon who use its card have the same purchasing experience no matter which Marathon gas station they buy from. The combination of card and card processing enables Marathon to offset

in an economical and expeditious manner revenues from credit card sales against costs of gasoline sold to the dealers. When a dealer makes a sale with a credit card, the Marathon processing system credits his Marathon account with the price of the sale and thus reduces the amount of money that the dealer owes Marathon for the gasoline that he buys from it.

The plaintiffs do not challenge Marathon’s right to offer this service. But once it is in place the dealer has a powerful incentive to route *all* his credit card transactions through the Marathon system, as otherwise he would have to duplicate the processing equipment that Marathon supplies and lose the benefit of being able to use his retail sales revenue to offset what he owes Marathon. The additional cost of using multiple card processing systems is not a penalty imposed by Marathon to force the use of its system, but an economy that flows directly from Marathon’s offering its own credit card and credit card processing service. To call this tying would be like saying that a manufacturer of automobiles who sells tires with his cars is engaged in tying because, although the buyer is free to buy tires from someone else, he is unlikely to do so, having paid for the tires supplied by the car’s manufacturer.

* * *

AFFIRMED.

QUESTIONS FOR DISCUSSION FOR CASE 5.5

1. What does the plaintiff allege are the tied and tying products or services?
2. How does the court determine what the relevant market is in this case? Why is the relevant market not defined as Marathon franchisees, as they are the ones subject to this credit card processing requirement?
3. Why does the court conclude that there is not illegal tying going on here? Is it likely that the plaintiff has other economically viable choices available to it?

DISCUSSION QUESTIONS

1. Several plaintiffs brought actions against Conoco, Inc., claiming that they had been discriminated against on the basis of their race when they attempted to make purchases at three gas stations in Texas operated under the Conoco brand. Conoco directly owned and operated one of the stations, and independent contractors licensed to use the

Conoco trademark operated the other two stations. Evidence, including videotapes, indicated that the clerks had refused to serve the customers and had used racial epithets during some of the incidents. What factors should the court consider and what tests should it apply in determining whether Conoco should be held liable?

2. Lockard worked as a waitress for a Pizza Hut franchise owned by A & M Food Services. The national Pizza Hut franchisor produces several training documents for employees, including a booklet on how to bring sexual harassment complaints to the manager or district representative. The Pizza Hut franchisees actually operated and controlled the restaurants' day-to-day business. Lockard claimed that the restaurant that she worked at maintained a hostile environment because the manager played songs on the jukebox with sexually explicit lyrics. Furthermore, the manager made her serve two specific customers who had a history of making sexual advances to her at the restaurant. She complained that she did not want to serve the customers, but the manager demanded that she do so. When she went back to their table, the customers grabbed and groped her as she tried to take their orders. Lockard quit and sued the franchisor and the franchisee. Should Lockard recover against the franchisor? The franchisee?
3. University Motors, a West Virginia business, entered into a franchise agreement with General Motors Corp. (GMC). The agreement specified that University Motors would require approval from GMC if it wanted to sell another line of vehicles. University Motors began selling a Nissan line of vehicles without first obtaining GMC approval. GMC sought to terminate the franchise and hand-delivered a letter to University Motors stating that the franchise would end 90 days from receipt of the letter. GMC stated that the reason for the termination was the new vehicle line and various deficiencies in University Motor's sales. University Motors filed suit to prevent termination of the franchise, claiming that GMC had violated a West Virginia statute that required a franchisor to deliver a termination letter by certified mail and to give the franchisee 180 days to cure the problem. The statute also required that the franchisor have a good faith reason for terminating because of poor sales or service performance. Should GMC be permitted to terminate University Motors? Why, or why not?
4. Shell Oil Co. owned a gas station and property in Deerfield Beach, Florida. In 1995, Shell entered into a "Motor Fuel Station Lease" with A. Z. Services, Inc., which provided that A. Z. would lease the gas station and property for five years. The parties also entered into a "Dealer Agreement," which established a franchise agreement between the two parties. Under the Dealer Agreement, A. Z. had the right to operate the gas station under Shell's trademarks, brand name, service marks, and other Shell identifications in connection with the sale of motor fuel and other petroleum products. A year later, without notice to or consent by Shell, A. Z. removed all Shell trademarks and identification, stopped selling Shell products, and began selling the products of a Shell competitor, Skipper's Choice. Shell terminated the franchise agreement and filed suit seeking an injunction to prohibit A. Z. from selling Skipper's Choice products and to vacate the property. A. Z. defended by claiming that Shell had unlawfully tied the lease of the property to the sale of Shell fuel. How should the court rule on this antitrust claim?
5. In 1995, Golf U.S.A. entered into a franchise agreement granting Express Golf the right to operate a retail store using Golf U.S.A.'s methods, name, designs, systems, and service marks. The franchise agreement also stated that "[a]ny and all disputes, claims and controversies arising out of or relating to this Agreement ... shall be resolved by arbitration conducted in Oklahoma County, State of Oklahoma." Golf U.S.A. is an Oklahoma corporation. The golf retail store failed within nine months, and Charles Barker, the sole shareholder of Express Golf, brought this action against Golf U.S.A. for fraudulent misrepresentation. He alleged that Golf U.S.A. misrepresented the success of its retail operations, thereby leading him to sign the franchise agreement. Golf U.S.A. moved to dismiss the case, arguing that the dispute should be decided by arbitration and not by the judiciary. Barker claimed that the arbitration clause was unconscionable and therefore unenforceable. No statute prohibits the inclusion of arbitration clauses in franchise agreements. Should Barker be permitted to litigate in court or should the arbitration clause of the franchise agreement control?
6. Weaver operated two Burger King restaurants under two separate franchise agreements. Restaurant 1 was located in Great Falls, Montana, and Weaver leased the facility from Burger King. Restaurant 2 was also located in Great Falls, but Weaver owned the facility. Both franchise agreements required Weaver to make monthly royalty payments and advertising contributions to Burger King Corp. and provided that Florida law would control in the event of a dispute. The agreement for Restaurant 1 contained no provisions regarding geographic scope, but the agreement for Restaurant 2 stipulated that "this franchise is for the specified location only and does not in any

way grant or imply any area, market, or territorial rights proprietary to FRANCHISEE.” Neither agreement contained any limitations on the locations of future Burger King restaurants.

In 1989, another Burger King franchise opened in Great Falls. Weaver was upset by the competition, felt that Burger King had breached its obligations under the franchise agreements, and stopped making rent, royalty, and advertising payments, though he continued to use Burger King’s marks and system. Burger King sued for breach of contract. Weaver counterclaimed, arguing that Burger King had breached the implied covenant of good faith and fair dealing, which, under Florida law, is part of every contract. Florida law does not recognize actions for breach of an implied covenant of good faith and fair dealing when: (a) the party breaching the implied covenant has performed all of the express contractual provisions in good faith and (b) the implied duty that was breached would vary the express terms of the contract. Which party should prevail here, and why?

7. In 1993, Airborne Freight Corp. (Airborne), a package delivery service, and East Wind Express, Inc. (East Wind) entered into a contract under which East Wind agreed to provide services to Airborne, such as pickup, transport, and delivery of shipments between Airborne’s customers and facilities in northern Oregon. Customers would call Airborne and ask to have a package delivered to another area. Airborne would radio an East Wind driver, who would then pick up the customer’s package. Airborne billed the customer and assumed all liability for the package from the time of arrival at its pickup to the package’s final destination. Under the contract, Airborne paid East Wind based on the average number of packages carried per day, and East Wind was “not entitled to receive any portion of any charges made by Airborne to its shippers.” The contract also stated that East Wind’s use of Airborne’s trademarks on its uniforms and trucks was an advertising service and was to be compensated according to advertising fees. Airborne specified the standards that applied to the use of its trademarks by East Wind.

Eventually, the relationship between the two companies disintegrated, and Airborne terminated the contract. East Wind brought this action against Airborne, asserting that at-will terminations violated the Washington Franchise Investment Protection Act. Airborne argued that East Wind was an independent contractor, who could be terminated at

will, and not a franchisee. What are the requirements for a franchise relationship? Under these standards, is Airborne a franchisee or an independent contractor?

8. As of June 1995, Little Caesar Enterprises, Inc. (LCE) had 536 franchises nationwide operating 2,867 carryout-type restaurants. LCE also owned and operated 1,000 carryout restaurants and 500 restaurants located in Kmart stores. Blue Line Distributing, Inc., purchased the necessary supplies for the restaurants, bundled them into single units, and sold them to the franchisees. In June 1989, LCE and Blue Line entered into a licensing agreement granting Blue Line the exclusive right to distribute products containing the Little Caesar logo. Franchise agreements used to give franchisees the right to use LCE-approved alternative suppliers, but the 1990 Franchise Agreement excluded logoed products from the list of products that could be obtained from alternative suppliers. Logoed products, such as paper products, condiments, and packaging, are necessary to the operation of a franchise.

Plaintiffs bought Little Caesar franchises between 1990 and 1995 and are operating under the 1990 Franchise Agreement. They argue that Blue Line charges supracompetitive prices for the logoed products and that the exclusive license granted to Blue Line precludes them from obtaining cheaper products from alternative suppliers. They have brought this class action, alleging that LCE has unlawfully tied Blue Line’s products to the purchase of a Little Caesar franchise. LCE argues that plaintiffs knew about the Blue Line distributorship, agreed to the terms when signing the 1990 Agreement, and that LCE lacks sufficient market power to force a tying arrangement on plaintiffs. How should the court resolve this antitrust claim, and why?

9. Tosco Corporation is an independent refiner and marketer of petroleum products. In 1994, Tosco purchased from BP Exploration & Oil, Inc. (“BP”) all service stations owned by BP in Northern California, along with a license to use the “BP” trademark in California. The license for the trademark expires on August 1, 2006, and Tosco pays BP royalties for the use of the marks. In accordance with the sale, BP terminated all franchises, and Tosco subsequently offered the terminated franchisees a new franchise agreement to sell petroleum products under the “BP” trademark. The new franchise agreements were scheduled to expire on April 15, 1998.

On March 31, 1997, Tosco purchased the 76 Products Company from Union Oil Company of

California, which included approximately 900 service stations in California and the right to use the “Union 76” and “76” trademarks in perpetuity.

In 1997, Tosco decided that it would be most effective to sell products at the service stations under only one brand and chose to sell under the “Union 76” trademark because use of that mark required no royalty payments. In December 1997, Tosco offered all of its BP franchisees renewal of the franchise agreement on condition that they sell fuel under the “Union 76” mark.

Plaintiffs are service station dealers who refused to agree to the change in marks, preferring to retain the “BP” mark. Tosco notified plaintiffs that their franchises would not be renewed for failure to agree to a change in a provision of the franchise agreement. Plaintiffs brought this action, contending that under the Petroleum Marketing Practices Act (PMPA) Tosco could not condition renewal of a franchise agreement on the franchisee’s consent to “rebrand” the product. The relevant portion of the PMPA states that such conditional agreements are lawful, as long as the “changes or additions are the result of determinations made by the franchisor in good faith and in the normal course of business” and not for the purpose of preventing renewal of the franchise.

What factors should the court consider in resolving this dispute?

10. Dana Hoffnagle was an employee at a McDonald’s restaurant owned by a franchisee, Rapid-Mac, Inc. At 10:00 one evening, two men entered the restaurant, grabbed Hoffnagle, and took her out to the parking lot where they attempted to force her into their car. Tammy Geiger, a managerial employee, came to Hoffnagle’s assistance and helped her escape from the men and return to the restaurant. Geiger noticed the two men driving their car around the parking lot, but did not lock the doors or telephone the police. Later, one of the men reentered the restaurant and again attempted to force Hoffnagle outside. Geiger intervened again, and the men left the restaurant premises. Geiger then telephoned the police department.

Hoffnagle filed for workers’ compensation benefits from her employer, Rapid-Mac, which she received. She then filed suit against McDonald’s Corp., which was Rapid-Mac’s franchisor, arguing that McDonald’s Corp. had the ability to control the operations of the franchisee and was liable for negligence for failing to exercise such control.

The contractual agreements between McDonald’s and Rapid-Mac required the franchisee to adhere to

the franchisor’s standards and policies “for providing for the uniform operation of all McDonald’s restaurants within the McDonald’s system including, but not limited to, serving only designated food and beverage products, the use of only prescribed equipment and building layout and designs, strict adherence to designated food and beverage specifications and to prescribed standards of quality, service and cleanliness in [the] restaurant operation.” The agreements also required Rapid-Mac to adopt and use business manuals prepared by McDonald’s and for McDonald’s to make training available at “Hamburger University” for the franchisee and its managerial employees. McDonald’s had the right to inspect the restaurant at all reasonable times to ensure compliance with the standards and policies and had the right to terminate the franchisee if the standards and policies were not met.

Hoffnagle argued that these agreements gave McDonald’s the right to control the restaurant and property upon which she was assaulted and that McDonald’s was liable for negligence in failing to exercise that control, particularly in failing to provide adequate security or in failing to direct the franchisee to provide adequate security. Specifically, she argued that the franchisee’s managerial employee, Geiger, was not appropriately trained because she failed to lock the doors or telephone the police after the first assault. Should McDonald’s, as the franchisor, be liable for Hoffnagle’s injuries? What factors would you consider in making this determination?

11. Martinez was injured when he was struck by a bicycle being ridden by Pardo. At the time of the accident, Pardo was making deliveries for his employer, Higher Powered Pizza, which was a franchisee of Papa John’s International, Inc. Martinez sued Papa John’s, arguing that it was vicariously liable for the acts of its franchisee.

The franchisee agreement between Higher Powered Pizza and Papa John’s stated that the franchisee “shall have full responsibility for the conduct and terms of employment for [its] employees and the day-to-day operation of [its] business”; the only control the agreement reserved to Papa John’s involved enforcement of standards in areas such as food quality and preparation, hours of operation, menu items, employee uniform guidelines, and packaging requirements. This included the right to perform inspections (limited to review of sales and order forms), audits to ensure compliance with company standards, and observation of interaction with customers.

Should Papa John's be held liable for the injuries caused to Pardo?

12. Defendant manufactures a line of upscale sodas marketed under the name "Stewart's." Plaintiffs are several beverage distributors who distributed Defendant's sodas in Minnesota. Plaintiffs were distributors of beer before Defendant approached them. Thus, Plaintiffs already owned the facilities (e.g., warehouses and refrigerators) and equipment (e.g., trucks and handcarts), and already employed the personnel (e.g., drivers, warehouse workers, and bookkeepers) necessary for the distribution of beverages at the time they began distributing Stewart's sodas.

After several years of using Plaintiffs as its distributors, Defendant decided to distribute its products directly, and terminated Plaintiffs' distribution agreements.

The Minnesota Franchise Act (MFA) protects franchisees from being terminated without good cause by franchisors. Defendant argues that it did not need "good cause" to terminate the Plaintiffs, however, because it was not a franchisor and Plaintiffs were not franchisees within the meaning of the MFA.

Plaintiffs argued that they were franchisees under the "business opportunity" provision of the MFA, which defines a "franchise" as: "the sale or lease of any products ... to the purchaser ... for the purpose of enabling the purchaser to start a business and in which the seller: ... (iii) guarantees that the purchaser will derive income from the business which exceeds the price paid to the seller."

How should the court rule on the Plaintiffs' claim? What policy considerations support that outcome?