Franchise Law Journal

STATEMENT OF IDENTIFICATION

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Franchise Law Journal

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From the Editor-in-Chief

John M. Doroghazi*

Mr. Doroghazi

The year 2021 is now in the books, hopefully never to be revisited or repeated.[1] In the spirit of change and new beginnings, change has come for "Franchising & Distribution Currents" (Currents). But we are lawyers, so the change is modest and incremental.

On that issue, our decision is informed by your feedback. The Forum on Franchising conducts periodic surveys of its members to identify trends and determine where the membership finds room for improvement. The most recent survey results were provided to the Governing Committee and Senior Appointed Leadership in October 2021 shortly before the Forum's Annual Meeting. For the *Journal*, the message was clear: most of you[2] are very satisfied with the *Journal* and consider it a valuable part of your Forum membership. One theme that did arise from the survey and the comments accompanying it was that the Currents are not particularly current by the time they arrive in the mail, often identify cases that are merely another example of a well-settled legal principle, and sometimes are too dense. Members also voiced how much they liked the monthly case note put out by the Litigation and Alternative Dispute Resolution Division (LADR), but indicated that finding past LADR case notes is difficult because they are currently published only by an email to whatever the Forum's email distribution platform happens to be.[3]

1. Unless, of course, our future selves decide that it is necessary to go back in time to 2021 to try and fix the past. *See*, *e.g.*, South Park: Post-Covid: The Return of Covid (Paramount+ 2021).

2. The exception being the handful of few readers who complained about the *Journal*'s content (split pretty evenly between "the articles are too general" and "the articles are too esoteric"). For any reader who thinks the *Journal* can or should go a different direction in content, I invite you to submit an article so that you can shape your own destiny.

3. I do not invite any comments on the email distribution platform.

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As such, we are giving Currents a slight make-over that is certain to have maximum effect (think Laney in late 1990s teen movie staple *She's All That*).[4] In this issue, we have cut the number of cases included in Currents by half, seeking to focus on cases that truly break ground or are unusual in some way. As an added bonus, we will also be republishing recent-LADR case notes in Currents so that LADR's well-received case notes are always easily accessible. We've started with publishing the LADR case notes from April–June 2021 in this issue and will look to publish about three notes an issue, but we will reevaluate this cadence after a few issues. I look forward to receiving reader feedback[5] on whether this change is a welcome one or an early-term blunder from the new Editor-in-Chief.

Now to the actual articles in this edition. Because the pandemic continues to touch everything in all of our lives, this edition kicks off with two pandemic-related articles. First up is an article by Dean Fournaris and Bob Burstein addressing how the COVID-19 pandemic may have impacted lost-profits damage claims in "The Potential Impact of COVID-19 on Franchise Lost Profits Claims." Second, Adrian Felix and Jessica McGrath give us some insights on how to prepare for the next pandemic in "Once in a Blue Moon? Perhaps. . . . Preparing Your Franchise for the Next Pandemic."

Our next article comes from Thomas Telesca, Elizabeth Sy, and Briana Enck and tackles an important topic for every franchise system with an arbitration clause: "Must Arbitrators Follow the Law?"

From the North Star State, James Long and Jevon Bindman have provided us with an excellent overview of the often-overlooked doctrine of equitable recoupment in "Equitable Recoupment: A Limited Remedy for Dealer or Franchise Terminations When Statutory Protection Is Absent."

Closing the issue out are two articles addressing important franchise system management topics. Mark Burzych has given us a thorough overview of how and when to use criminal background checks in a franchise system in "Using Criminal Background Checks in a Franchise System." Finally, a doyen of the franchising bar, Ted Pearce, has written an article discussing the challenges of a maturing franchise system and how to address them in "Addressing Issues That Arise in a Mature Franchise System."

Finally, the new and improved Currents, now titled "LADR Case Notes (April–June 2021) and Franchising & Distribution Currents (Winter 2022)," is brought to you by Bill Bryner, Jared Miller, and Kevin Shelley.

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4. She's All That (Miramax Films 1999). For those of you not steeped in late 1990's teen comedy culture, Laney (played by Rachel Leigh Cook) transforms from unnoticed bookworm to campus heartbreaker mainly by not wearing glasses anymore at the suggestion of big man on campus and suitor Zack (played by Freddie Prince Jr.).

5. I actually don't look forward to getting any feedback on this point unless it is unabashedly positive, but I will receive it nonetheless.

The Potential Impact of COVID-19 on Franchise Lost Profits Claims

*Constantine T. Fournaris & Robert S. Burstein**

I. Introduction

Mr. Fournaris

Mr. Burstein

The COVID-19 pandemic initially had a devastating impact on business worldwide, and franchised businesses and franchisors in the United States were not spared. A study conducted by the International Franchise Association (IFA) on the impact of the pandemic in the United States found that, during the first six months of the pandemic, more than 1.4 million franchise jobs were lost, of which 40.2% were permanent, and over 32,000 franchised businesses closed, of which 10,875 were permanent.[1] The pandemic and public health measures instituted to combat it eroded business revenues and profits by generally depressing consumer activity and confidence, limiting the number of customers that may be in the business at the same time, requiring the adoption of mitigation procedures that increased operating costs and, in some cases, requiring that businesses stop operating in whole or in part. Some sectors, however, actually experienced an increase in business, such as restaurants that already offered or quickly adapted to offer takeout and delivery services, and businesses that offered products for delivery to a bored and largely stay-at-home population.

In the franchise world, economic pain was acutely felt by both the franchisees, whose profits evaporated or businesses closed, and by the franchisors, who saw the market for new franchises shrink in the face of economic headwinds and royalty streams decline as franchise-level businesses slowed or stopped. States reopened at varying rates, and vaccines began to rollout in

1. IFA: *1.4 Million Franchise Jobs Lost, 32 Franchises Closed Since March* (Sept. 21, 2020), https://www.franchise.org/media-center/press-releases/ifa-14-million-franchise-jobs-lost-32000-franchises-closed-since-march.

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mid-December 2020. By mid-February 2021, the outlook for the franchise sector had improved greatly, with IFA predicting that the number of franchised businesses would grow by the end of the year to offset 2020 losses and the number of franchise jobs would grow more than 10%, almost recovering fully from the 11.2% decline in 2020 employment, provided that COVID-19 was managed.[2] In July 2021, a fourth wave of COVID-19 swept through the United States fueled by the more transmissible Delta variant.[3] The new surge in cases led businesses to delay their plans to require employees to return to the office starting in September 2021, creating concern that the economic recovery could be negatively impacted.[4] At the time of this article's publication, the Omicron variant has just been discovered, with conflicting reports about its transmissibility and severity.[5]

When the influence of the pandemic recedes from the economy, the abatement may not benefit all sectors. The business challenges that existed and may continue to exist for some may translate into increased tension between franchisor and franchisee. Indeed, the burden of complying with parties' respective obligations under their franchise agreements may seem to outweigh the benefits of continued participation in a franchise system that has been hamstrung by the pandemic. Some of the tens of thousands of franchised businesses that have closed or may still close, and the many more that have seen their profits erode, have sought or will seek early termination of their franchise agreements to avoid continued losses. When faced with the burden of operating at a loss or trying to compensate for losses sustained at the height of the pandemic, franchisees may simply close their businesses regardless of the commitments in their franchise agreements. On the other hand, franchisors may become more aggressive about pursuing claims against franchisees for potential violations to try to enforce quality controls and preserve goodwill if the franchisees have fallen behind in compliance with brand standards due to the economic stresses of the pandemic, in which case the franchisors will seek to recover their lost future royalty streams to compensate for the loss of revenue until they can install a new franchisee to service the terminated franchisee's service area. Thus, it is likely that the pandemic's long-term impact will cause an overall increase in franchisor-franchisee disputes and litigation.

2. Kate Rogers, *Franchising Industry Expects It's Poised to Rebound, If Covid Is Brought Under Control*, CNBC (Feb. 17, 2021), https://www.cnbc.com/2021/02/17/franchising-industry-expects-rebound-if-covid-under-control.html.

3. Karen Weintraub, *The Fourth Wave of COVID-19 Cases Is Here. Will We Escape the UK's Fate? It's Too Soon to Know*, USA TODAY (July 16, 2021), https://www.usatoday.com/story/news/health/2021/07/16/covid-19-fourth-wave-pandemic-surge-deaths-hospitalizations/7976034002.

4. Matt Egan, *The Delta Variant Is Slowing Office Reopenings. It Could Slow the Recovery Too*, CNN Bus. (Aug. 5, 2021), https://www.cnn.com/2021/08/05/economy/delta-economy-office-reopening/index.html.

5. Joanna Sugden & Gabriele Steinhauser, *Omicron, the New Covid-19 Variant: What to Know*, Wall St. J. (Dec. 10, 2021), https://www.wsj.com/articles/omicron-coronavirus-variant-what-to-know-11637935500.

While the pandemic forced in-person hearings into indefinite stasis in many jurisdictions and substantially immobilized many court dockets, it is inevitable that, as restrictions are lifted and court and arbitration proceedings resume in earnest, there will be new disputes that arose during the pandemic involving claims by both franchisors and franchisees that are likely to lead to litigation or arbitration. At the same time, pre-existing franchise litigation that had been disrupted during the pandemic will resume, albeit with potentially substantial changes in the underlying claims because of the pandemic's impact. The impact of the pandemic will extend far beyond scheduling delays in these pending and as-yet unasserted cases. Indeed, as set forth below, the pandemic may serve to limit the potential damages available in franchise litigation by compromising a plaintiff's ability to meet its burden of proof to sustain a claim for lost profits. Similarly, a defendant may assert that the pandemic or the government-mandated closures may, under certain circumstances, excuse performance under the parties' agreement. As a result, for some claims, the onset of the pandemic might serve as a functional barrier on lost profit damages available to a plaintiff in a franchise dispute.

The purpose of this article is to examine the potential impact of the COVID-19 pandemic on franchise lost profits claims. The specific issues include whether the impact on business operations caused by the pandemic might sever the causal chain between a purported breach and the alleged resulting lost profits, providing a potential defense by excusing performance or making the calculation of lost profits too speculative.

II. Proving a Lost Profits Claim in Franchise Litigation

A plaintiff seeking lost profits must, of course, prevail on its underlying cause of action as a prerequisite to receiving an award of lost profits.[6] Commonly in franchise litigation, lost profits claims are asserted as breach of contract claims arising out of one of the parties' alleged failure to perform their respective obligations under the franchise agreement. In a standard breach of contract claim, a plaintiff must establish the existence of a contract, a breach of that contract, and damages caused by the breach.[7] Thus, a breaching party will only be liable for the harms for which its breach is the "proximate cause" of the damages sustained by the plaintiff.[8]

6. *See*, *e.g.*, Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC, 423 F. App'x 274, 281 (4th Cir. 2011).

7. *See*, *e.g.*, Khorchid v. 7-Eleven, Inc., 2018 WL 149643, at *21 (D.N.J. Oct. 22, 2018).

8. *Meineke Car Care Ctrs.*, 423 F. App'x at 281. A minority of courts have disavowed the proximate cause approach and instead claim to use "traditional contract law analysis." *See*, *e.g.*, Legacy Acad., Inc. v. JLK, Inc., 765 S.E.2d 472, 475 (Ga. Ct. App. 2014) (collecting cases). One such court framed the inquiry as follows: "Under Georgia law, damages growing out of a breach of contract must be such as could be traced solely to breach, must have arisen according to the usual course of things, and be such as the parties contemplated as a probable result of such breach." Progressive Child Care Sys., Inc. v. Kids 'R' Kids Int'l, Inc., 2008 WL 4831339, at *4 (Tex. Ct. App. Nov. 6, 2008) (citations omitted). However, as a practical matter, the approaches

A. *Proximate Cause*

"Proximate causation" limits the extent to which a breaching party can be held responsible for injuries to other parties where those injuries were the result of some act or cause other than the alleged breaching conduct.[9] This same causal analysis also applies to claims for lost profits. To be entitled to lost profits, the loss must have been caused by the underlying breach rather than some other cause or source of harm.[10]

Lost profit damages will only be available to a plaintiff if that plaintiff can prove that the lost profits flowed consequentially from the claimed breach. As the Third Circuit has held, lost profit damages must be "a proximate consequence of the breach, not merely remote or possible."[11] Thus, for a plaintiff to establish that it is entitled to an award of lost profits, it must prove not only that the underlying breach was both the "but-for" cause of its lost profits, but also that the conduct was a "substantial factor in bringing about the harm" and that the lost profits were caused by the breach and not some other factor.[12] Moreover, if a plaintiff cannot prove that its lost profits were attributable specifically to the underlying breach where there are other potential causes of their loss, that lost profits claim should be rejected.[13]

B. *Proving the Amount of Lost Profits*

Given that an award of lost profits necessarily requires an evaluation of potential events that ultimately did not come to pass, courts must weed out claims for damages that are too remote or speculative.[14] Claims for lost profits are subjected to a heightened burden and must be proven with

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of these minority jurisdictions may substantially mirror the superseding/intervening cause analysis conducted by the majority jurisdictions described in more detail below.

9. *See* Exxon Co., U.S.A. v. Sofec, Inc., 517 U.S. 830, 839–40 (1996) ("Although the principles of legal causation sometimes receive labels in contract analysis different from the 'proximate causation' label most frequently employed in tort analysis, these principles nevertheless exist to restrict liability in contract as well.") (citations omitted); Nat'l Mkt. Share, Inc. v. Sterling Nat'l Bank, 392 F.3d 520, 525 (2d Cir. 2004) (holding that "as in tort, a plaintiff must prove that a defendant's breach *directly and proximately caused* his or her damages") (citations omitted).

10. *See, e.g.*, *Meineke Car Care Ctrs.*, 423 F. App'x at 282 (applying North Carolina proximate cause analysis to franchisor's claims of lost profits); Interim Healthcare Inc. v. Health Care@ Home, LLC, 2018 WL 830113, at *3 (S.D. Fla. Feb. 12, 2018) (applying Florida law and incorporating proximate cause into franchise lost profits analysis); JTH Tax, Inc. v. Lee, 514 F. Supp. 2d 818, 825 n.9 (E.D. Va. 2007) (same); Postal Instant Press, Inc. v. Sealy, 51 Cal. Rptr. 2d 365, 368–69 (Ct. App. 1996) (same); *see also* Maaco Franchisor SPV, LLC v. Cruce, 2021 WL 706424, at *4–6 (W.D.N.C. Feb. 23, 2021) (applying North Carolina law and following *Meineke*); Grout Doctor Global Franchise Corp. v. Groutman, Inc., 2015 WL 2353698, at *2–3 (E.D.N.C. May 14, 2015) (same); Hardee's Food Sys., Inc. v. Hallbeck, 2011 WL 4407435, at *3 (E.D. Mo. Sept. 21, 2011) (applying Missouri law and following *Meineke*); Kissinger, Inc. v. Singh, 304 F. Supp. 2d 944, 949–51 (W.D. Mich. 2003) (agreeing with *Sealy*).

11. Nat'l Controls Corp. v. Nat'l Semiconductor Corp., 833 F.2d 491, 496 (3d Cir. 1987) (citation omitted).

12. *Id.* (citation omitted).

13. *See id.*

14. DeMent v. Abbott Cap. Corp., 589 F. Supp. 1378, 1386 (N.D. Ill. 1984) ("Of course, recovery of lost profits should be subject to the ordinary limitations concerning remoteness (or proximate cause) and speculativeness (or certainty) . . . .").

"reasonable certainty," or they will be deemed "too speculative" and will be rejected.[15]

Unfortunately, this "reasonable certainty" standard is not well defined, and courts have observed the difficulty in determining the precise quantum of proof needed to meet this standard.[16] When making this evaluation, courts seek to balance the possibility of awarding a windfall to a wrongdoer by applying too high a bar to the recovery of lost profits, but also prevent that wrongdoer from becoming an unwitting guarantor of profits for plaintiffs.[17]

To carry its burden, a plaintiff must present evidence that is sufficiently persuasive not only to prove that it should be granted relief on its underlying claim, but also to prove that it meets this heightened "reasonable certainty" standard required for an award of lost profits and do so without the benefit of bright-line rules about what that standard requires or how it will be applied. Carrying this burden requires a showing of objective facts and other proof of the profits lost.[18] In evaluating the adequacy of a plaintiff's proof, courts will look to case-specific factors—such as the length of the contract, the nature of the items or services to be provided thereunder—as well as other factors that may impact the plaintiff's ability to generate a profit based on the contract, including the plaintiff's expertise in the particular business, and other external factors that may have influenced an alleged lost profit.[19] As set forth below, the impact of the pandemic will make proving that a defendant's conduct was responsible for a plaintiff's lost profits with "reasonable certainty" increasingly complicated.

III. Intervening and Superseding Acts May Affect Proximate Cause Analysis

A. *Definitions of Intervening and Superseding Acts*

There are two primary ways in which the causal chain necessary to establish a claim for lost profits can be impacted: (1) through an intervening force or act, which "actively operates in producing harm to another after the actor's negligent act or omission has been committed"; or (2) by a superseding cause "which by its intervention prevents the actor from being liable for harm to another which his antecedent negligence is a substantial factor in bringing

15. Delahanty v. First Pa. Bank, N.A., 464 A.2d 1243, 1261 (Pa. Super. Ct. 1983).

16. *See* Hardwick v. Dravo Equip. Co., 569 P.2d 588, 594 (Or. 1977) ("I must confess, however, that I have no more idea what reasonable certainty means than I have as to the meaning of certainty. I would assume that it is some lesser quantum of proof than that we require in criminal cases; namely, proof beyond a reasonable doubt or to a 'moral certainty.'") (Lent, J., concurring).

17. *See* Burger King Corp. v. Hinton, Inc., 203 F. Supp. 2d 1357, 1366 (S.D. Fla. 2002); TRI Cnty. Wholesale Distribs., Inc. v. Labatt USA Operating Co., LLC, 828 F.3d 421, 433–35 (6th Cir. 2016).

18. *See*, *e.g.*, Brisbin v. Superior Valve Co., 398 F.3d 279, 289–93 (3d Cir. 2005).

19. *See id.*

about."[20] Thus, given multiple potential causes for the loss of profits, a plaintiff must distinguish the impact of distinct factors capable of causing its loss of profits and prove that, among other things, the defendant's alleged misconduct is a substantial and proximate cause of the loss of profits.

As the Supreme Court explained in *Exxon Co., U.S.A. v. Sofec, Inc.*, the superseding cause doctrine "is applied where the defendant's negligence in fact substantially contributed to the plaintiff's injury, but the injury was actually brought about by a later cause of independent origin that was not foreseeable."[21] An event operates as a superseding cause if it occurs (1) later than the defendant's alleged misconduct, (2) was the actual cause of the harm to the plaintiff, (3) originated from some source other than the defendant's alleged misconduct, and (4) was not reasonably foreseeable.[22]

Thus, in instances where the plaintiff's lost profit injury may have been caused by two or more events, and either one "operating alone would have been sufficient to cause the identical result, some test of proximate causation, other than 'but-for' is needed."[23] However, "[a] cause can be thought 'superseding' only if it is a 'cause of independent origin that was not foreseeable.'"[24]

An event is an intervening cause if it is an independent event unrelated to the defendant's alleged misconduct that was not reasonably foreseeable and "completely breaks the connection between fault and damages."[25] In conducting a proximate cause analysis, a court also examines whether there were other superseding or intervening causes that show that some other act, cause, or party was responsible for the lost profits damage and, as a result, the defendant should not be required to pay an award.

B. *Plaintiff Bears Burden of Negating Existence of Intervening and Superseding Acts*

The plaintiff bears the burden of establishing that the defendant's conduct was the proximate cause of its loss even where the defendant asserts that a separate cause severed the causal chain in its defense. In *Nycal Offshore Development Corp. v. United States*, an oil company plaintiff argued that because the defendant asserted that it was not liable for lost profits damages due to intervening causes that interrupted the chain of causation, the burden

20. Rabutino v. Freedom State Realty Co., 809 A.2d 933, 941 (Pa. Super. Ct. 2002) (quoting Restatement (Second) of Torts § 441 (1965)).

21. Exxon Co., U.S.A. v. Sofec, Inc., 517 U.S. 830, 837 (1996) (cleaned up).

22. *See, e.g.*, Canada *ex rel.* v. McCarthy, 567 N.W.2d 496, 507 (Minn. 1997) ("For an intervening cause to be considered a superseding cause, the intervening cause must satisfy four elements: 1) its harmful effects must have occurred after the original negligence; 2) it must not have been brought about by the original negligence; 3) it must have actively worked to bring about a result which would not otherwise have followed from the original negligence; and 4) it must not have been reasonably foreseeable by the original wrongdoer.") (citation omitted).

23. Eagle-Picher Indus., Inc. v. Balbos, 604 A.2d 445, 459 (Md. Ct. App. 1992) (quoting W. Keeton, Prosser & Keeton on The Law of Torts § 41, at 266 (5th ed. 1984)).

24. Staub v. Proctor Hosp., 562 U.S. 411, 420 (2011) (quoting *Exxon Co., U.S.A.*, 517 U.S. at 837).

25. Kilpatrick v. Wiley, Rein & Fielding, 909 P.2d 1283, 1293 (Utah Ct. App. 1996).

of proof on causation shifted to the defendant. The court refused to shift the burden and held that "the plaintiff must show, by a preponderance of the evidence, that the plaintiff's alleged loss was 'the proximate result of the breach.'"[26] The court also declined to separate other potential causes of loss (like the presence and market price of oil, production costs, and the impact of the prevailing regulatory scheme) from the general proximate cause analysis; that is to say, the analysis requires comparison of defendant's alleged conduct against all other potential causes of loss.[27]

Plaintiffs pursuing lost profits claims must prepare to prove that, among the variety of case-specific potential causes of their loss, the defendant's conduct and not the collective impact of all other causes led to that loss. In some jurisdictions, a claim for lost profits from breach of contract specifically and expressly incorporates proximate causation requirements including intervening cause analysis. For example, in Oklahoma, "[t]o recover for anticipated lost profits, [plaintiff] must demonstrate: 1) [that] the loss is within the contemplation of the parties at the time the contract was made, 2) [that] the loss flows directly or proximately from the breach . . . and 3) [that] the loss is capable of reasonably accurate measurement or estimate."[28]

Many other jurisdictions include a proximate cause analysis when evaluating a claim for lost profits.[29] In some jurisdictions, a party claiming loss of future profits from a breach of contract must demonstrate with certainty that the lost profits were caused by the breach and not a separate intervening cause while establishing the defendant's liability.[30] Thus, to prevail on a claim for lost profits, a plaintiff must necessarily demonstrate that the defendant's conduct was the proximate cause of its harm.[31] A necessary component of

26. Nycal Offshore Dev. Corp. v. United States, 743 F.3d 837, 843 (Fed. Cir. 2014) (quoting Energy Cap. Corp. v. United States, 302 F.3d 1314, 1324–25 (Fed. Cir. 2002)); Cal. Fed. Bank, F.S.B. v. United States, 245 F.3d 1342, 1349 (Fed. Cir. 2001) (applying Federal Circuit law).

27. *Nycal Offshore Dev.*, 743 F.3d at 844 n.2 ("Evidence of such 'intervening causes' is not analyzed separately from other causes, but is 'an integral part of the proximate cause analysis.'") (quoting Nat'l Mkt. Share, Inc. v. Sterling Nat'l Bank, 392 F.3d 520, 527 (2d Cir. 2004)).

28. Specialty Beverages, L.L.C. v. Pabst Brewing Co., 537 F.3d 1165, 1179 (10th Cir. 2008) (Oklahoma law) (refined).

29. *See, e.g.*, ID Sec. Sys. Canada, Inc. v. Checkpoint Sys., Inc., 249 F. Supp. 2d 622, 696–97 (E.D. Pa. 2003) (Pennsylvania law); Tacoma Auto Mall, Inc. v. Nissan N. Am., Inc., 279 P.3d 487, 499–500 (Wash. Ct. App. 2012); *cf.* IBP, Inc. v. Hady Enters., Inc., 267 F. Supp. 2d 1148, 1169 (N.D. Fla. 2002) (Florida law) ("[L]ost profits are only allowed if the court is satisfied that the wrongful act of the defendant caused the loss of profits.") (citations omitted); Siga Tech., Inc. v. PharmAthene, Inc., 132 A.3d 1108, 1152–53 (Del. 2015) ("[U]ncertainties not attributed to the wrongdoer in a breach of contract case should be excluded from the damages calculus.") (citation omitted); Cook Assoc., Inc. v. Warnick, 664 P.2d 1161, 1165 (Utah 1983) (causation requirement).

30. *See, e.g.*, Kenford Co., Inc. v. Erie Cnty., 493 N.E.2d 234, 235 (N.Y. 1986) ("[T]he damages may not be merely speculative, possible or imaginary, but must be reasonably certain and directly traceable to the breach, not remote or the result of other intervening causes.") (citation omitted).

31. In some jurisdictions, proximate cause analysis in lost profits claims takes the form of a separate "substantial factor" test. For example, in Florida, a "plaintiff need not show that the defendant's action was the sole cause of the damages sought; instead, the plaintiff's burden is to show that the defendant's action was a 'substantial factor' in causing the lost profits and

that analysis is an evaluation of other potential causes of harm that could have interrupted the causal chain of events such that the defendant should not be held liable for a plaintiff's claimed loss.

C. *Proximate Cause and Lost Profits in Franchise Litigation*

In franchise litigation, disputes are common regarding whether the causal chain has been severed by an intervening act. A defendant may allege that the plaintiff-franchisor's termination of a franchise agreement is an intervening act that precludes the recovery of lost profits by the franchisor in a later claim for breach. In such instances, it is not uncommon for the franchisee to claim that the franchisor should not be entitled to an award of lost profits because the franchisor's act of terminating the franchise agreement was the actual and intervening cause of any lost profits in that the termination severed the causal chain between the alleged breach and the claim for damages. However, the effectiveness of this argument depends on the underlying facts unique to each case.

In *Meineke Car Care Centers, Inc. v. RLB Holdings, LLC*, the Fourth Circuit used a "straightforward" proximate cause approach to evaluate whether to award lost profits where the Meineke franchisee chose to shut down its franchises and, thereafter, the franchisor terminated the franchise agreements.[32] The court observed that, "[e]ven where a court has held that the franchisor is not entitled to recover lost profits, the rationale for that decision has usually been that the franchisor's lawful termination of the parties' agreement was the proximate cause of lost profits rather than the franchisee's breach; the most common example being a franchisee's breach for failing to pay past due royalties."[33] But, because the franchisee chose to cease operating before the franchisor terminated the franchise agreements, the franchisor's actions did "not cause [the franchisee] to stop operating the Shops and thereby stop generating revenues."[34] Thus, the franchisor's termination of the franchise agreement did not sever the causal chain between the franchisee's earlier misconduct and the franchisor's lost profits damages.[35] As a result, the Fourth Circuit overturned the district court's grant of summary judgment and allowed the franchisor's claim for lost profits to proceed.

Postal Instant Press, Inc. v. Sealy[36] is an example of the converse outcome on similar facts where a franchisor terminated the franchise agreement in response to a franchisee's failure to make past royalty payments. The court held that the franchisor's action (not the franchisee's) caused the loss of future profits and, as a result, the franchisor could not establish the required

establish the amount with reasonable certainty." Ariz. Chem. Co., LLC v. Mohawk Indus., Inc., 193 So. 3d 95, 103 (Fla. Dist. Ct. App. 2016) (citations omitted).

32. Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC, 423 Fed. App'x 274, 282 (4th Cir. 2011).

33. *Id.* at 282 n.8.

34. *Id.* at 283.

35. *See id.*

36. Postal Instant Press, Inc. v. Sealy, 51 Cal. Rptr. 2d 365 (Ct. App. 1996).

link between the franchisee's conduct and the loss of profits. The court noted that "it was the franchisor's own decision to terminate the franchise agreement that deprived it of its entitlement to those future royalty payments."[37] The court determined that a failure to pay past royalties would not be a "natural and direct" cause of a loss of future royalties and advertising fees and, therefore, declined to award the franchisor lost profits.[38] The court also found that awarding future royalties would have been "unreasonable, unconscionable and oppressive" and explained that, even if the franchisor had made an adequate showing that the franchisee's conduct caused it to lose future profits, the court would have declined to grant an award of those damages as "contrary to substantial justice."[39]

The analysis of whether a plaintiff is entitled to lost profits in cases where there are other potential causes of the underlying damages often hinges on the critical issues of the timing of the breach as compared to the occurrence of the potential alternative cause and whether a sufficient factual link exists between the defendant's alleged conduct and the loss of future profits.

IV. Proximate Cause Determinations Involving Crises

A. *Proximate Cause in Pre-COVID-19 Crises*

While the COVID-19 pandemic may present unique challenges to potential litigants, examining the impact of prior crises and other widespread market disruptions on lost profits claims provides some insight into how a court might handle the impact of the pandemic on pending and future claims. In *Gregory v. Popeyes Famous Fried Chicken & Biscuits, Inc.*,[40] a franchisee claimed that its failure to pay royalties and advertising fund contributions required under the franchise agreement should be excused due to the "supervening impossibility of performance," caused by an economic recession in the area its stores operated and the entry of a new competing chain offering similar products that caused the franchisee to sustain substantial losses and close multiple stores as a result. However, the Sixth Circuit rejected this claimed impossibility defense reasoning that "economic recession and the failure of a franchise business to live up to its hoped for potential is not a viable affirmative defense to a claim of debt for failure to pay an unambiguous contractual obligation."[41]

37. *Id.* at 370.
38. *Id.* at 369–71.
39. *Id.* at 373.
40. Gregory v. Popeyes Famous Fried Chicken & Biscuits, Inc., 857 F.2d 1474 (Table), 1988 U.S. App. LEXIS 12304 (6th Cir. Sept. 9, 1988).
41. *Id.* at *4; *see also* Medallion Bank v. Makridis, 2021 WL 53155, at *2 (N.Y. Sup. Ct. Jan. 6, 2021) (the court rejecting defendant's claim that failure to make note payments should be excused under the impossibility doctrine due to the collapse of the taxicab industry: "Impossibility excuses a party's performance only when the destruction of the subject matter of the contract or the means of performance makes performance objectively impossible. Moreover, the impossibility must be produced by an unanticipated event that could not have been foreseen or

In *EV Scarsdale Corp. v. Engel & Voelkers North East LLC*,[42] the plaintiffs alleged statutory claims under the New York and Rhode Island franchise statutes for fraudulent misrepresentations in connection with the sales of real estate agency franchises between late 2007 and 2009, coinciding with the timing of the Great Recession. The court granted defendant's summary judgment due to plaintiff's failure to rebut defendant's prima facie showing of the absence of loss causation.[43] The court first observed that "loss causation—proof that plaintiff's loss was caused by defendant's fraudulent misrepresentation—is an 'essential,' indispensable element of a fraud claim."[44] The court then noted that one New York appellate court, "[t]aking a page from the well-settled federal caselaw concerning securities fraud during a period where the overall market experienced a downturn," had "effectively adopted [the] federal standard, and held that it is *plaintiff's* burden to demonstrate loss causation."[45] The court found the litigation emanating from the financial crisis persuasive precedent "concerning the question of if and how a real estate investor must disentangle the causes of his own losses as being a product of the defendant's alleged fraud from the overall market events that caused everyone's real estate investments to fail."[46] The defendants proffered an expert report explaining why the plaintiff's franchises likely failed due to the financial crisis. The plaintiff did not submit any fact or evidence concerning causation or offer a theory as to how much of their losses were caused other than by the market downturn and "utterly doom[ed] their fraud claims."[47]

In *Mrs. Fields Franchising, LLC v. MFGPC*, the Tenth Circuit reversed a district court's ruling that the plaintiff's damages were irreparable because they could not be reasonably calculated due to the impact of the Great Recession and a warehouse fire that purportedly impacted the plaintiff's profitability.[48] The Tenth Circuit disagreed and instead found that lost profits could be adequately calculated based on the "years prior to or following the recession" and the warehouse fire as a "reasonable proxy" to calculate the plaintiff's claimed damages.[49] Thus, the court acknowledged that the recession and warehouse fire would impact profitability, but ultimately determined that there was sufficient evidence from periods where the business was unaffected by these challenges to allow the parties to isolate their effect and calculate lost profit for the remaining term of the underlying agreement.

guarded against in the contract.") (quoting Kel Kim Corp. v Cent. Mkts., Inc., 519 N.E.2d 295 (N.Y. 1987)).

42. EV Scarsdale Corp. v. Engel & Voelkers N.E. LLC, 2017 WL 5513329 (N.Y. Sup. Ct. Nov. 16, 2017).

43. *Id.* at *2, *9.

44. *Id.* at *5 (citations omitted).

45. *Id.* at *6 (citations omitted).

46. *Id.*

47. *Id.* at *8.

48. Mrs. Fields Franchising, LLC v. MFGPC, 941 F.3d 1221, 1235 (10th Cir. 2019).

49. *Id.* at 1236.

When adjudicating claims which have arisen during or after the COVID-19 pandemic, courts are likely to employ a similar approach when evaluating a claim for lost profits. For businesses that operated both before and after the pandemic, a similar analysis to that conducted in *Mrs. Fields Franchising* may become the standard for establishing lost profits claims. For businesses that closed or for which the pandemic caused longer lasting or more complex effects, finding a "reasonable proxy" for lost profits may be substantially more challenging. The uneven nature of the economic recovery, with multiple waves of the pandemic and potential difficulty in finding a demarcation point to identify when the pandemic's effects ended, will contribute to the challenge.[50]

In other instances, where the prevailing economic conditions are directly tied to discrete profit-making opportunities, courts have reduced lost profit awards to account for the impact of recessions where those prevailing economic conditions specifically relate to the underlying business activities at issue in the litigation. In *Haven Associates v. Donro Realty Corp.*, the court found that the plaintiff was entitled to lost profits that it would have received for the sale of certain unsold real estate lots but did not award the full amount that the plaintiff sought. Rather, the court determined that the impact of a housing recession would have eroded the profits which the plaintiff would have earned and reduced the potential award accordingly.[51] In franchise litigation, courts may be willing to reduce potential lost profit awards if a defendant can show that the impact of the pandemic would have had a specific impact on the plaintiff's ability to make a profit.

In *Federal Insurance Co. v. General Electric Co.*,[52] the court found that damage to an MRI machine that occurred during Hurricane Katrina could have resulted from a variety of factors and was not a direct result of the storm. Thus, there was a genuine issue of material fact as to the underlying cause of the damage, which made summary judgment inappropriate notwithstanding the vast destruction caused by the storm.[53] In another case arising from Hurricane Katrina, the court declined to draw a causal link between the government's construction of certain protective measures and damages caused by the storm.[54] The court distinguished between the actions taken by the government in constructing and installing floodwalls and the damage caused by the storm. The court held that the government's action "did not in the least cause the flood" and, as such, "it would not follow that the flooding was 'directly attributable' to the [government's] protective measures, as opposed to the severe nature of the storm."[55] The court did not reach the question of

50. *See supra* Part I.
51. *See* Haven Assoc. v. Donro Realty Corp., 121 A.D.2d 504, 508 (N.Y. App. Div. 1986).
52. Fed. Ins. Co. v. Gen. Elec. Co., 2009 WL 4728696 (S.D. Miss. Dec. 3, 2009).
53. *Id.* at *6
54. *See* Nicholson v. United States, 77 Fed. Cl. 605, 618 (2007).
55. *Id.*

whether "a storm of [Hurricane Katrina's] magnitude is foreseeable," because the floodwalls that the government constructed did not *cause* the flooding.[56]

In a case arising out of damage caused by Typhoon Paka, the court noted that an especially strong typhoon near Guam was "not 'so far outside the range of human experience that ordinary care did not require that it should be anticipated or provided against.'"[57] The court also found that because the defendant had received notice of the storm forty-eight hours before it struck, the defendant could have taken additional measures to prevent damages that it caused and, as such, the storm would not act as an intervening cause.[58] As described in more detail below, issues regarding foreseeability of the COVID-19 pandemic and its overall role in the causal chain leading to a plaintiff's alleged loss may be determinative of certain potential defenses, though that evaluation will be fact-specific to each case.

In *Moulthrop v. Hyett*, the plaintiff sued the manufacturer of a brick-drying machine that it had purchased because the device only processed between 7,500 and 10,000 bricks a day instead of the promised 25,000.[59] The court refused to award lost profit damages for the entire period of the machine's faulty operation because, during that time, a yellow fever epidemic spread through the region and the market for construction imploded.[60] Because the lost profits caused by the outbreak and the attendant decrease in demand was neither contemplated by the parties nor "the necessary or natural consequence of the partial incapacity of the machine," the purchaser could not recover those damages.[61]

As evidenced from the foregoing cases, there is not a bright-line rule that delineates whether a court will determine whether or not an external crisis severs the causal link between a plaintiff's claim and the potential damages. In some instances, as in *Mrs. Fields Franchising, LLC v. MFGPC*,[62] where the external crisis occurred after the alleged breach, courts appear willing to allow a plaintiff to establish their claim for damages based on the parties' other business dealings. Moreover, where a plaintiff would stand to reap a windfall from potential lost profits from a crisis not contemplated and/or reasonably foreseeable to the parties, courts appear reluctant to award the additional measure of lost profits that was caused by the crisis. On the other hand, a defendant may be able to persuade a court to limit potential recovery where a plaintiff's ability to make a profit would have also been impacted by external factors as in *Haven Associates*. The key distinction is seemingly whether the loss is attributable to the alleged breach or the impact of the external crisis.

56. *Id.*
57. Nissan Motor Corp. v. Sea Star Grp. Inc., 2002 WL 1471713, at *4 (Guam 2002) (quoting Olan Mills, Inc. v. Cannon Aircraft Exec. Terminal, Inc., 160 S.E.2d 735, 741 (N.C. 1968)).
58. *Id.*
59. Moulthrop v. Hyett, 17 So. 32, 33 (Ala. 1895).
60. *Id.* at 34.
61. *Id.*
62. Mrs. Fields Franchising, LLC v. MFGPC, 941 F.3d 1221 (10th Cir. 2019).

B. *Is COVID-19 an Act of God or Force Majeure, or Does It Make Performance Impossible?*

In addition to expecting defendants to argue that the pandemic was a superseding or intervening act in order to refute claims where alleging that their acts were the proximate cause of lost profit, defendants may also attempt to construct other potential defenses based solely on the occurrence of the pandemic. Among those defenses likely to be asserted are the impossibility defenses and the "Act of God" or force majeure clause.

The "Act of God" doctrine at common law "is an affirmative defense to . . . causation" that releases a defendant from liability "for an injury proximately caused . . . [and] due exclusively to forces of nature, without human intervention, which could not have been prevented by the use of due care and reasonable foresight."[63] The doctrine applies to "events in nature so extraordinary that the history of climatic variations and other conditions in the particular locality affords no reasonable warning of them."[64]

Traditional examples of the doctrine include "irresistible disaster[s], the result of natural causes, such as earthquakes, violent storms, lightning and unprecedented floods."[65] However, in cases where human actions caused the harm, the doctrine typically does not apply.[66] For example, where wastewater disposal injections "caused the seismic and earthquake activity in question," there were legitimate questions about liability.[67] In *Phelps v. School District No. 109*, *Wayne County*, the court decided that diseases causing school closures did not remove a school's contractual duties. The court stated that "[t]he general rule . . . is that, where performance of the contract is rendered impossible by act of God or the public enemy, the district is relieved from liability, but where the school is closed on account of a contagious disease, or destruction of the school building by fire, and the teacher is ready and willing to continue his duties under the contract, no deduction can be made from his salary for the time the school is closed."[68] The court reasoned that while the school closed to protect the public health, a closure because of disease "was a contingency that might happen, and whether the school authorities took the initiative, or whether it was done by action of the board

63. Eli Invs., LLC v. Silver Slipper Casino Venture, LLC, 118 So. 3d 151, 156 (Miss. 2013) (internal quotation marks and citations omitted); *see also* Aspen Am. Ins. Co. v. Interstate Warehousing, Inc., 372 F. Supp. 3d 709, 723 (N.D. Ind. 2019) (Michigan law); Phoenix Lithographing Corp. v. Bind Rite Servs., Inc., 27 F. Supp. 3d 636, 640–43 (E.D. Pa. 2014) (Pennsylvania law; describing history of Act of God common law defense; defendant must prove not only that it breached the contract due to a natural force well outside human control but also did all a reasonable person could be expected to do to avoid injury to plaintiff; the defense (or exception) is often modified or set forth in the parties' agreement as a vis major clause) (citations omitted).

64. *Eli Invs., LLC*, 118 So. 3d at 156 (quoting McFarland v. Entergy Miss., Inc., 919 So. 2d 894, 904 (Miss. 2006)).

65. *See, e.g.*, Am. Water Mgmt. Servs., LLC v. Div. of Oil & Gas Res. Mgmt., 118 N.E.3d 385, 399 (Ohio Ct. App. 2018) (internal quotation marks and citation omitted).

66. *See id.*

67. *Id.*

68. Phelps v. Sch. Dist. No. 109, Wayne County, 134 N.E. 312, 312 (Ill. 1922).

of health, does not alter the rights of the parties to the contract. It works no hardship on any one [sic] to require school authorities to insert in the contract of employment a provision exempting them from liability in the event of the school being closed on account of a contagious epidemic."[69] That is, the court determined it to be the responsibility of the contracting parties to determine in advance that the teacher assumed the risk of a pandemic, not the school.

The prevailing consensus among courts appears to be that the COVID-19 pandemic constitutes a "natural disaster"; however, that factor alone is not sufficient to provide a blanket excuse for non-performance under a contract.[70] At present, it is unlikely that a court would view lost profits harm as an Act of God, as in most instances the underlying cause of a business's lost profits is human decision making and not the direct impact of the virus.[71] Indeed, the most likely cause for lost profits arising out of the virus is the business harm stemming from shutdown orders, business closures, and increased cleaning, sanitation, and other procedures, which are all human-driven factors. Therefore, it is likely that a court will look to potentially applicable contractual terms when evaluating a defense premised on the impact of the pandemic.[72]

Courts may look to the presence or absence of force majeure clauses in determining whether performance might have been excused under the contract through the proper exercise of a force majeure provision. Force majeure clauses represent the parties' allocation of risk between them and are not limited to acts of nature.[73] In *JN Contemporary Art LLC v. Phillips Auctioneers LLC*, the United States District Court for the Southern District of New York found that the pandemic and its impact on a contemplated art auction constituted "circumstances beyond our or your reasonable control"

69. *Id.* at 314; *see also* McKay v. Barnett, 60 P. 1100 (Utah 1900) (smallpox epidemic school closure).

70. *See* Easom v. US Well Servs., Inc., 2021 WL 1092344, at *7–8 (S.D. Tex. Mar. 19, 2021) (collecting cases where the pandemic has been determined to be or described as a "natural disaster").

71. *See* Act of God, Black's Law Dictionary (11th ed. 2019) ("An overwhelming, unpreventable event caused *exclusively* by forces of nature, such as an earthquake, flood, or tornado.") (emphasis added).

72. *See, e.g.*, AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, 2020 WL 7024929, at *55 (Del. Ch. Nov. 30, 2020) (evaluating the "Material Adverse Effect" clause of a purchase agreement to determine if the pandemic met the requirements); Lampo Grp. v. Marriott Hotel Servs., Inc., 2021 WL 3490063, at *8 (M.D. Tenn. Aug. 9, 2021) (denying plaintiff's motion for judgment on the pleadings and finding that factual issues existed regarding plaintiff's claims that it was justified in terminating a contract to host a large conference under the termination for cause and force majeure clauses: "[T]he COVID pandemic plus the attendant restrictions on business operations could, indeed, be deemed a *force majeure* that would authorize termination of the Agreement. The question is whether these conditions actually made performance of the contract, by either party, illegal or impossible.").

73. *See, e.g.*, 1600 Walnut Corp. v. Cole Haan Co., 530 F. Supp. 3d 555, 558–59 (E.D. Pa. Mar. 30, 2021).

within the scope of the governing contract's force majeure provision.[74] In reaching that conclusion, the court compared the impact of the pandemic to the non-exhaustive list of example "circumstances" provided in the contract, including a "natural disaster," as well as the contract specifically providing for an in-person (and not an online) auction.[75] The court concluded that the pandemic and its effects were sufficiently similar to the enumerated circumstances in the contract's non-exhaustive list of examples falling within the scope of the force majure clause and permitted the parties to terminate their agreement.[76] On the other hand, the United States District Court for the Northern District of Ohio in *Belk v. Le Chaperon Rouge Co*. specifically highlighted the *absence* of a force majeure clause in a settlement agreement executed at the outset of the pandemic in rejecting the defendant's arguments to set aside its defaults under that agreement.[77] Thus, parties must tailor their arguments to the specific provisions of their underlying contracts.

Some courts have already rejected similar defenses premised on the doctrine of impossibility of performance allegedly arising out of the pandemic's impact. Impossibility of performance and frustration of purpose are common law theories.[78] In *Lantino v. Clay LLC*, the United States District Court for the Southern District of New York held that financial difficulties triggered by the pandemic and its impact on the defendant's business did not excuse performance under the settlement agreement pursuant to New York's impossibility doctrine, which specifically excludes economic hardship.[79]

Other New York courts evaluating impossibility of performance defenses have also observed that the pandemic has not "destroyed" an underlying business but rather made operating it more costly and challenging. Absent destruction of the underlying business, a New York state court in *Cab Bedford*

74. JN Contemp. Art LLC v. Phillips Auctioneers LLC, 507 F. Supp. 3d 490, 501 (S.D.N.Y. 2020).

75. *Id.* at 503.

76. *Id.*

77. Belk v. Le Chaperon Rouge Co., 2020 WL 3642880, at *10 (N.D. Ohio July 6, 2020).

78. *See*, *e.g.*, *1600 Walnut Corp.*, 530 F. Supp. 3d at 558 (court should allocate risk based on common law theories such as impossibility and frustration of purpose only where there is no contractual allocation of risk under a force majeure clause).

79. *See* Lantino v. Clay LLC, 2020 WL 2239957, at *3 (S.D.N.Y. May 8, 2020); *see also* Gap Inc. v. Ponte Gadea New York LLC, 2021 WL 861121, at *7–12 (S.D.N.Y. Mar. 8, 2021) (granting summary judgment to landlord and rejecting tenant Gap's asserted defenses, finding that COVID-19 pandemic and resulting lockdowns did not constitute a "casualty" under the lease, did not frustrate the purpose of the lease, did not render performance impossible or impractical, did not lead to failure of consideration and the parties, and did not make a mutual mistake in drafting the lease by failing to foresee and address the possibility of a pandemic); A/R Retail LLC v. Hugo Boss Retail, Inc., 149 N.Y.S.3d 808 (N.Y. Sup. Ct. 2021) (similar). *But see* 267 Dev., LLC v. Brooklyn Babies & Toddlers, LLC, 2021 WL 963955, at *2 (N.Y. Sup. Ct. Mar. 15, 2021) (after noting the doctrine of impossibility was applied in a case involving travel contracts following the September 11 terrorist attacks where New York City was in virtual lockdown, the court held that performance under defendant's lease was excused by the common law doctrine of impossibility, finding the closures mandated by Governor Cuomo's Executive Orders in response to the COVID-19 pandemic had rendered defendant's performance under the lease "objectively impossible" and that the mandated closures were unforeseeable, which is a required element of the doctrine of impossibility) (citations omitted).

LLC v. Equinox Bedford Ave., Inc. declined to find that performance under the business's lease was "impossible."[80] Similarly, in *Fives 160th, LLC v. Zhao*, another New York state court would not imply a force majeure clause due to the pandemic when none existed in the lease and rejected the defendant tenants' alleged defense of impossibility, stating that "[f]inancial difficulty or economic hardship of the promisor, even to the extent of insolvency or bankruptcy, does not establish impossibility sufficient to excuse performance of a contractual obligation."[81] The court noted that "[t]he excuse of impossibility is generally limited to the destruction of the means of performance by an act of God, vis major, or by law" and that "[t]he impossibility must be produced by an unanticipated event that could not be foreseen or guarded against in the contract."[82] The court reasoned that "[t]he contract here was entered into by commercial parties who could have anticipated the possibility that future events might result in financial disadvantage on the part of either party, even if the precise cause or extent of such financial disadvantage was not foreseen at the time the contract was executed."[83]

In rejecting the "impossibility" defense, courts have found that these defenses require literal impossibility and not impracticability or an increasingly difficult performance. It appears unlikely that the COVID-19 pandemic will be considered an Act of God or have rendered contractual performance impossible absent extraordinary case-specific circumstances. Asserting these defenses is likely to become increasingly difficult as businesses have reopened and business restrictions have been lifted to varying degrees. Thus, a defendant will be unlikely to rely on the pandemic's interruption to, or impact on, operations as a complete defense.

C. *COVID-19's Impact on the Causation Analysis*

According to conventional proximate-cause principles, whether COVID-19 operates as an intervening cause in franchise lost profits cases depends on two issues: (1) the foreseeability of the pandemic; and (2) the pandemic's causal effect on profits. This analysis will be fact specific and guided primarily by two factors: (a) the timing of the contract execution or the alleged conduct as it relates to the onset of the pandemic; and (b) the particular mechanism by which the pandemic is alleged to have impacted the plaintiff's ability to make a profit.

While some scholars observe that "reasonable minds differ" on the question of whether the "pandemic is viewed as akin to other types of natural disasters," it is unlikely that a court will find that a litigant had advanced knowledge of the potential impact of the pandemic sufficient to affect the

80. Cab Bedford LLC v. Equinox Bedford Ave., Inc., 2020 WL 7629593, at *3 (N.Y. Sup. Ct. Dec. 22, 2020) ("That there are more hurdles to running the business is not a basis to invoke the impossibility doctrine.").

81. Fives 160th, LLC v. Zhao, 2021 WL 1298090, at *2 (N.Y. Sup. Ct. 2021 Apr. 6, 2021) (citations omitted).

82. *Id.* (citations omitted).

83. *Id.* at 4 (citation omitted).

causation analysis absent a specific evidentiary showing of such knowledge.[84] Indeed, some courts have rejected arguments that the effects of the pandemic would be foreseeable as "ridiculous."[85] However, for contracts that were formed during the course of the pandemic, it will be relatively likely that the potential impact will be determined to have been sufficiently foreseeable and that, consequently, the pandemic would not serve as an intervening cause.

For example, in *Belk*, the defendant defaulted on a settlement agreement by failing to make a payment required under that agreement. The defendant asserted that it was impossible to fund the required settlement payment due to the pandemic and the related closure orders' impact on business.[86] The court, however, found that "it was reasonably foreseeable on March 12, 2020 [the date of the agreement] that COVID-19 could have a significant negative impact on Defendants' business operations and financial ability to fund the settlement payment."[87] In these instances, where a contract is formed during the pandemic, a defendant will be precluded from asserting that the pandemic was an unforeseeable intervening cause.

The COVID-19 pandemic may also have a substantial impact as a confounding variable, making plaintiff's burden of proof more difficult. Indeed, as set forth above, to be entitled to lost profits, a plaintiff must establish with "reasonable certainty" that the defendant's misconduct was a "substantial cause" of those lost profits. In nearly every action for lost profits, a defendant will be able to assert that some or all of the loss suffered by the plaintiff was caused by the pandemic, and not the alleged misconduct, all the while knowing that the plaintiff bears the burden to prove causation and of untangling potential causes of its loss.[88] This circumstance will represent a substantial hurdle for plaintiffs that do not have a pre-pandemic history of operation capable of providing persuasive evidence of the business's profitability.

The issue of timing may be a critical one as courts try to determine if the pandemic itself was an intervening factor or substantial alternative cause, occurring after the breach, providing a separate and independent basis for the claimed damages occurring close in time to the breach or a wholly independent cause occurring before the breach. This analysis is not likely to be a simple one. Indeed, courts may struggle to identify the precise instant when COVID-19 started—is the relevant time attributed to the emergence of the pandemic in China, when it was first discovered in the United States, or

84. Andrew A. Schwartz, *Contracts and COVID-19*, 73 Stan. L. Rev. Online 48, 57 (2020).

85. ITS Soho LLC v. 598 Broadway Realty Assocs., Inc., 2020 WL 7629588, at *2 n.1 (N.Y. Sup. Ct. Dec. 22, 2020).

86. Belk v. Le Chaperon Rouge Co., 2020 WL 3642880, at *11 (N.D. Ohio July 6, 2020).

87. *Id.*

88. Nycal Offshore Dev. Corp. v. United States, 743 F.3d 837, 843–44 (Fed. Cir. 2014); *see also* Big City Dynasty Corp. v. FP Holdings, 2021 WL 1949384, at *4 (D. Nev. May 14, 2021) ("A jury will have to sort out whether and when the parties could have performed despite the shutdown orders, including whether the parties could have rescheduled as the force majeure clause required the parties to attempt to do and whether [Defendant] could have reconfigured its nightclub or dayclub to allow the parties to perform their contractual obligations.").

the first wave of shutdown orders in the United States? Further, at what point did the impact of the pandemic become "foreseeable" in relation to the underlying contract and/or breach? Courts may also examine the prevailing conditions in the specific location at issue to assist in that determination. For example, a court may be willing to fix a date for the onset of the pandemic based on a governmental emergency order or shutdown but could potentially struggle to determine the onset in a jurisdiction that did not issue shutdown orders until well after the effect of the pandemic had become clear.

For claims that accrued before the onset of the pandemic, a plaintiff must ensure that they are capable of marshalling sufficient proof to distinguish between profits which were lost as a result of the breach and those which were lost due to the pandemic. The susceptibility of this issue to proof will likely depend on the amount of time between the alleged misconduct and the pandemic. As in *Mrs. Fields Franchising*, a plaintiff that has a demonstrable history of operating and that can adequately establish a period of harm apart from the pandemic will be better suited for establishing with reasonable certainty the profits that it has lost than a plaintiff without the ability to make such a showing.[89] Those plaintiffs that cannot point to compelling evidence from pre- and post-pandemic operations will need to look elsewhere to find a "reasonable proxy" to support their damages claim. That may require conducting discovery into other similar businesses or employing other methods to calculate lost profit.

For a claim that accrued during the pandemic, a plaintiff must articulate how the defendant's conduct caused a separate loss of profits distinct from the harms caused by the pandemic. For a plaintiff whose business was shuttered entirely, it will be challenging to identify how the harm was attributable to the defendant as compared to arising from the pandemic or the corresponding shutdown orders. Indeed, it may not be possible to prove such matters until after the business, or appropriately comparable businesses, begin operating again so that there is an appropriate evidentiary basis to make a comparison and attribute the various harms.

On the other hand, defendants will be less likely to successfully rely on the pandemic's impact as an unforeseeable intervening cause in defense of claims arising out of contracts executed during or shortly before the pandemic began impacting business operations. This possibility could include situations where the franchisors and franchisees entered into new or amended franchise agreements, or where the franchisor offered certain programs specifically tailored to address the pandemic's impact or which required the franchisee to execute a new contract and/or renew or reaffirm an existing contract. A defendant will likely be unable to claim that the impact of the pandemic was not "foreseeable" and may not be able to assert a defense premised on the pandemic as an intervening cause as a result.

89. *See* Mrs. Fields Franchising, LLC v. MFGPC, 941 F.3d 1221 (10th Cir. 2019).

D. *Potential Defenses*

Given the significant impact that the pandemic may have on pending and as-yet unasserted cases, litigants must be aware of whether and how the pandemic's impact on the dispute at issue may impact potential defenses and the plaintiff's ability to carry its burden of proof. As set forth above, to prove that a plaintiff is entitled to lost profit damages, the plaintiff must establish that claim with "reasonable certainty": this obligation is more challenging and complex due to the impact of the pandemic. Moreover, while it is unlikely that the pandemic will be considered an Act of God or have rendered performance under a franchise agreement impossible as the primary impact appears to be financial and not the "destruction" of the underlying business, some other additional defenses may be available due to the pandemic that can serve to undercut or otherwise offset a claim for lost profits.

1. The Burden of Proof

Even if lost profit damages remain available as a matter of law, a plaintiff's ability to carry its burden of proof to show that it is entitled to such damages may be confounded by the pandemic. The most common methods of proving lost profits are through a "before and after" type of analysis or the "yardstick test."[90] Using the "before and after" analysis, a plaintiff seeks to prove its lost profits by comparing the amount that they were earning prior to the alleged breach and the amount that they were earning after the alleged breach, to show that the defendant should be liable for the difference.[91] The "yardstick test" substitutes data from comparable businesses when the plaintiff does not have a sufficient earnings record to allow the estimation of lost profits.[92] However, where the impact of the pandemic overlaps with the time period used in the "before and after" analysis, a plaintiff's ability to prove that the difference between those two amounts is properly attributed to the defendant's conduct will be more difficult. Further, a defendant will likely be able to point to longer term trends that extend beyond the initial tranche of shutdown orders. For example, the potential continued prevalence of work-from-home may disproportionately impact certain types of franchised businesses that catered to a class of customers that has potentially permanently shrunk, or that have not been able to adapt to shifting customer preferences that developed during the lockdown or mitigation measures.

90. *See*, *e.g.*, MM Steel, L.P. v. JSW Steel (USA) Inc., 806 F.3d 835, 851 (5th Cir. 2015) ("There are two generally recognized methods of proving lost profits: (1) the before and after theory; and (2) the yardstick test. The before and after theory compares the plaintiff's profit record prior to the violation with that subsequent to it. . . . [T]he yardstick test . . . consists of a study of the profits of business operations that are closely comparable to the plaintiff's. Although allowances can be made for differences between the firms, the business used as a standard must be as nearly identical to the plaintiff's as possible.") (quoting Lehrman v. Gulf Oil Corp., 500 F.2d 659, 667 (5th Cir.1974)).

91. *See*, *e.g.*, Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC, 423 Fed. App'x 274, 285–86 (4th Cir. 2011) ("Meineke's calculations were based on a historical analysis of the Shops' *actual* revenues projected into the future . . . .").

92. *Id.*

Moreover, defendants may claim that a plaintiff should not be entitled to the full measure of its lost profit even where the breach occurred before the onset of the pandemic by attempting to prove that the long-term effects of the pandemic will permanently impair future profitability. To do so, a defendant may present expert testimony and other evidence designed to show that the plaintiff's business would not have withstood the pandemic and therefore would have closed, or that the prevailing business trends and/or consumer habits shifted during or in response to the pandemic. This proof would require a substantial analysis of both the plaintiff's operation and financial condition, but also evidence showing prevailing market conditions, shifts in consumer behavior, and the impact on other similar businesses (which would almost certainly include some analysis of the average performance in at least similarly situated regions or areas of the franchise system at issue). The likelihood of success of such a defense will necessarily depend on the facts that gave rise to the specific claims at issue; however, it is likely that, if for no other reasons, defendants will attempt to invoke the potential impacts of the pandemic to muddy the waters and make plaintiff's burden of proof more challenging to meet.

Thus, a plaintiff may need to conduct more in-depth discovery than might have been required previously to ensure that it can distinguish and isolate the impact of the alleged breach and carry its burden of proof. To do so, a plaintiff should consider, for example, conducting third-party discovery of comparable franchised businesses that have a longer history of operations or that resumed operations after the pandemic and its impacts began to diminish in order to develop additional evidence of the profits that a comparable business unaffected by the alleged breach would have generated. On the other hand, a defendant must be prepared to demonstrate how such a comparison between a plaintiff's claimed damages and other businesses' financial performance would be inappropriate and/or unreliable. A defendant should seek to present evidence regarding the unavoidable business impact of the pandemic that would have eroded potential profits by undertaking a specific analysis of the timing of public health measures that impacted business, changes in consumer behavior during the pandemic, changes in operating costs, and other factors that may have impacted ongoing or future profitability.

Similarly, a defendant can attempt to distinguish between a plaintiff's business and those that are used as a basis for comparison using the "yardstick test." For example, a business that continued operating may have been able to take advantage of government assistance programs that would not have been available to one that had previously closed; a factor that could inflate the profits of that operating business and make it an inappropriate source for comparison. Moreover, the impact of the pandemic may vary substantially across different jurisdictions that have required different levels of restrictions on business activity. Thus, a business located in one county may have had a very different impact from the pandemic than one in a neighboring county simply on the other side of the county line. A defendant should seek to highlight these differences in rebutting a claim for lost profits based on an inappropriate comparison between operating businesses.

2. Applicable Contractual Limitations

As set forth above, the pandemic's impact on any individual lost profits claim will depend on the specific underlying facts. However, there are likely to be features common across claims that may have significant impacts. For instance, where the underlying contracts contain liquidated damages clauses, such clauses will likely still apply regardless of the impact of the pandemic. Indeed, the purpose of liquidated damages is to "reasonably forecast the harm resulting from the breach"[93] and are enforceable if (1) at the time the parties executed their contract the actual damages that would follow from a breach were not readily ascertainable and (2) the stipulated damages represent a reasonable estimate and are not so grossly disproportionate so that they constitute an unenforceable penalty.[94] Thus, it is unlikely that a court would set aside a contractually bargained-for liquidated-damages clause due to the impact of the pandemic absent some other defect inherent in that clause or other contractually provided for basis for setting aside that clause.

Likewise, contractual limitations on the type or scope of damages permitted in actions for breach are likely to be enforced.[95] Thus, in instances where the parties have limited the availability of lost profits damages in enforceable contractual terms, it is unlikely that a court will modify those terms based on the impact of the pandemic. Indeed, to do so would likely be counter to the underlying motivation for agreeing to such terms in the first place, as their primary purpose would be to reduce uncertainty and provide for an efficient manner to assess damages for breach regardless of the circumstances surrounding that breach.

V. Conclusion

While the economic ripples caused by the pandemic will inevitably have a significant impact on current and future litigation, the effect will certainly not be uniform. Indeed, determining how and to what extent a potential claim has been impacted by the pandemic will require an intensive and fact-specific evaluation of the interplay between the claims and potential other causes for loss. Similarly, the complexity of litigation and the cost of pursuing the same are likely to increase as the parties will be required to

93. Knights Franchise Sys. Inc. v. First Value RC, LLC, 2017 WL 1170849, at *3 (D.N.J. Mar. 29, 2017) (citation omitted).

94. Circuitronix, LLC v. Kinwong Elec. (Hong Kong) Co., Ltd., 993 F.3d 1299, 1306 (11th Cir. 2021) (applying Florida law) (citations omitted).

95. *See*, *e.g.*, 1228 Inv. Grp. v. IDT Domestic Telecom, 852 Fed. App'x 684, 688 (3d Cir. 2021) (enforcing an unambiguous contractual provision which limited potential damages); United Inv. Grp., LLC v. Beggars Pizza Franchise Corp., 2017 WL 5642376, at *4–6 (Ill. App. Ct. Nov. 22, 2017) (enforcing a limitation of damages provision in a franchise agreement).

marshal more proof than they would have been required to before the onset of the pandemic. At the same time, the potential for a full recovery generally has likely decreased as profits have fallen and cash reserves have eroded impairing a defendant's ability to satisfy a potential judgment. Further, the negative impacts of the pandemic may fade or even be overcome for some businesses if the economy surges post-pandemic as some predict. As a result, parties must be especially mindful about the new challenges facing a plaintiff asserting a claim for lost profits and consider whether and how such challenges impact their litigation strategy and calculus.

Once in a Blue Moon? Perhaps . . . . Preparing Your Franchise for the Next Pandemic

*Adrian K. Felix & Jessica McGrath**

I. Introduction

Mr. Felix

Ms. McGrath

Before the SARS-CoV-2 (COVID-19) pandemic,[1] the last global disease outbreak was the H1N1 influenza (swine flu) pandemic of 2009, which spread from Mexico and the United States to other parts of the world in just two months.[2] Although yielding a relatively low death toll and economic impact, the unprecedented global rate at which the swine flu spread was a harbinger of the risk a more virulent disease could pose in the future with the continued globalization of the world's economies and populations. Just eleven years later, the world was suddenly confronted with that risk in the form of the novel coronavirus.

The United States and other countries have struggled to contain the COVID-19 virus since February 2020. The health, economic and social impacts of the pandemic have been significant during that time, including over five million reported deaths worldwide, overwhelmed healthcare systems, supply chain disruptions, mandatory business and school closures, travel restrictions, and postponement or cancellation of large, public

1. A "pandemic" is defined as an infectious disease epidemic that has spread across a wide geographic area and typically affects a significant proportion of the population. Ctrs. for Disease Control & Prevention, Principles of Epidemiology in Public Health Practices (2012), https://www.cdc.gov/csels/dsepd/ss1978/lesson1/ section11.html.

2. *Past Pandemics*, Ctrs. for Disease Control & Prevention (Aug. 18, 2018), https://www.cdc.gov/flu/pandemic-resources/basics/past-pandemics.html.

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gatherings and events (e.g., the 2020 Summer Olympics in Tokyo). Indeed, with more than 48.7 million people infected and over 781,000 deaths,[3] the total estimated economic cost (direct and indirect) of the COVID-19 pandemic to the United States alone will exceed $16.1 trillion.[4]

It is impossible to predict what the next pandemic will be or when it will occur, but the factors believed to contribute to the occurrence and spread of novel infectious diseases like the 2009 swine flu and COVID-19 (i.e., overpopulation, animal husbandry, human encroachment on wildlife habitats, global trade and travel, and climate change) continue to exist and will likely be exacerbated with time. So, even as the world begins to emerge from the current pandemic, experts caution that the next pandemic could already be on its way.[5]

This article reflects on the lessons learned over the past year and a half and what steps franchise businesses can take now to prepare their systems for the next pandemic (or other major market disruptor).

II. Key Strategies for Successfully Navigating a Pandemic

The COVID-19 pandemic exposed critical weaknesses—if not outright failures—in the existing infrastructure, plans, and preparedness of many franchise systems. Franchisors and franchisees alike were forced to scramble and employ ad hoc approaches to address the impacts of the pandemic as those impacts arose. Some worked, but many did not. Below are four key takeaways from strategies that helped businesses to successfully navigate and, in some cases, thrive during the COVID-19 pandemic.[6]

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3. WHO Coronavirus (COVID-19) Dashboard, https://covid.who.int (last visited Dec. 7, 2021).

4. David M. Cutler & Lawrence H. Summers, *The COVID-19 Pandemic and the $16 Trillion Virus*, 324 JAMA 1495 (2020).

5. The Centers for Disease Control and Prevention (CDC), World Health Organization (WHO), and other groups currently monitor thousands of diseases that have the potential to become the next pandemic, including variants of the avian and swine flu, Ebola, and Zika. *Viruses of Special Concern*, Ctrs. for Disease Control & Prevention (Apr. 29, 2019), https://www.cdc.gov/flu/pandemic-resources/monitoring/viruses-concern.html; *10 Infectious Diseases That Could Be the Next Pandemic*, Gavi (May 7, 2020), https://www.gavi.org/vaccineswork/10-infectious-diseases-could-be-next-pandemic; W. Qui, *The Pandemic and Its Impacts*, 9-10 Health, Culture & Soc'y J. 4 (2016–2017), https://hcs.pitt.edu/ojs/index.php/hcs/article/viewFile/221/280; Maureen Miller, *The Next Pandemic Is Already Happening–Targeted Disease Surveillance Can Help Prevent It*, Yahoo! News (Aug. 1, 2021), https://news.yahoo.com/next-pandemic-already-happening-targeted-130202377.html.

6. *See* Sean Ludwig, *8 Franchises That Are Thriving During the Pandemic*, U.S. Chamber of Commerce (Aug. 13, 2020), https://www.uschamber.com/co/start/startup/successful-franchises-during-pandemic [hereinafter *8 Thriving Franchises*].

A. *Regularly Perform a 360 Degree Assessment of the Business and Develop a Crisis Management Plan*

The common refrain that "knowledge is power" is particularly true when it comes to operating a successful business. Knowledge gives business owners the power to identify their company's strengths and weaknesses and plan and act accordingly.

In 2020, employment in the franchise sector declined by 11.2%, nearly 20,000 establishments were forced to close their doors, economic output decreased by 14.9%, and gross domestic product (GDP) declined by 5.7%.[7] Mandatory shutdowns, customer capacity limits, and decreased sales were evident factors behind the industry's 2020 performance. Perhaps less obvious and confounding factors were that some executive teams did not know how to quickly stabilize their companies, how to reduce their risk and liabilities, where to focus their limited reserves, or how to adapt their business models to meet the changed demands and needs of their customers and employees.

Positioning a business to successfully navigate the next pandemic or market disruptor starts with knowing it at a micro level. This means leadership must perform a critical analysis of the industry and its cycle(s), the market conditions that are best and worst for the business and customers, the company's market position, and the company's financial health and situation. It also means taking a hard look at where the business is most vulnerable (e.g., supply chains, technology, labor, and/or production), the basic resources the business needs in order to operate, and, on the flip side, the things the business can forgo, if necessary, without significantly and irreversibly impacting its operations.

A comprehensive analysis, like the one contemplated here, likely requires input from various employees or internal departments. Therefore, businesses should consider establishing an internal task force that consists of members from key or critical areas of the organization, such as operations, marketing/communications, legal, and accounting.[8] The task force should plan to meet regularly to review and update the state of the business because markets are not static and elements of the task force's initial assessment will necessarily require updates to account for shifts in market dynamics. In addition, the task force should create (and update as necessary) a crisis management plan identifying different possible crisis scenarios and their potential impacts, the core response team (and point person(s) of that team), and actionable steps for each scenario. Businesses should be mindful of any third-party assistance that may be needed to aid in the execution of their crisis management plan. For example, during the COVID-19 pandemic, the co-author's company,

7. FRANData, 2021 Economic Outlook for Franchising 3, 7–8 (2021), https://www.franchise.org/sites/default/files/2021-02/Economic%20Outlook%202021_web2.pdf [hereinafter Economic Outlook Report].

8. Nora Doyle-Burr, *Dartmouth Administrators Look Back on College's COVID-19 Task Force*, Valley News (July 14, 2021), https://vtdigger.org/2021/07/14/dartmouth-administrators-look-back-on-colleges-covid-19-task-force.

Certified Restoration Drycleaning Network, LLC (CRDN), worked with employment groups to ensure their human resource policies complied with the constantly evolving COVID regulations, and it employed government lobbyists to help protect the system's interests, including seeking to have franchisees' restoration services designated as an "essential business."

B. *Establish and Maintain a Strong Relationship with a Financial Lending Institution*

Business leaders generally agree that maintaining sufficient liquidity is critical to a business during a crisis or turbulent markets because it affords the owner a higher degree of control and flexibility in managing its operations while cash flow is tight or uncertain. Liquidity can, of course, take the form of cash, cash equivalents, and accounts receivable. But liquidity can also mean having access to lines of credit and other loans, which requires having a relationship with a lending institution.

The fact that many systems lacked access to sufficient capital to endure the pandemic downturn was another significant factor behind the franchise industry's reported employment numbers and closures in 2020.[9] In particular, many franchise systems did not have strong, pre-existing banking relationships, and that weakness was magnified during the federal government's roll-out of the Paycheck Protection Program (PPP).[10]

Congress initially funded the PPP with $350 billion, which funds were administered by private lenders.[11] Loan applications for the program were supposed to be processed and funded on a first-come, first-served basis until the allocated funds were depleted. But participating lenders, particularly the major banks that accounted for one-fifth of the PPP loans made, added their own guidelines that required PPP loan applicants to have an existing borrowing and/or core banking relationship with that institution and no line of credit with any other institution.[12] So, when the initial $350 billion was officially depleted in just twenty days, many businesses who did not have strong existing banking relationships found themselves in the back of the PPP line

9. Economic Outlook Report, *supra* note 7, at 2.

10. The PPP was part of the larger Coronavirus Aid, Relief, and Economic Securities Act (CARES Act), passed on March 27, 2020, and was designed to provide forgivable SBA-backed loans to small businesses impacted by the COVID-19 Pandemic. CARES Act, Pub. L. No. 116-136, § 1102, 134 Stat. 281, 286–94 (codified as amended in scattered sections of 2, 5, 12, 15, 20, 21, 29, 42, and 45 U.S.C.).

11. CARES Act, § 1102(a)(2); U.S. Dep't of Treasury, PPP Borrower Information Sheet: Borrowers, https://home.treasury.gov/system/files/136/PPP%20Borrower%20Information%20Fact%20Sheet.pdf.

12. Prachi Bhardwaj, *Small Business Loans and the Coronavirus Stimulus: Here's How the Major Banks Are Handling PPP Applications*, Money (Apr. 10, 2020), https://money.com/sba-loans-stimulus-ppp-application-requirements; Caroline Hwang, *PPP Loans: Lender List and Requirements*, Yahoo! Fin. (Apr. 6, 2020), https://finance.yahoo.com/news/ppp-loans-lender-list-requirements-173706601.html; Jonathan O'Connell, Andrew Van Dam, Aaron Gregg & Alyssa Flowers, *More Than Half of Emergency Small Business Funds Went to Larger Businesses, New Data Shows*, Wash. Post (Dec. 3, 2020), https://www.washingtonpost.com/business/2020/12/01/ppp-sba-data [hereinafter *Emergency Funds*].

and effectively excluded from obtaining the capital lifeline.[13] And, if not for the over $285 million in additional funding subsequently allocated to the PPP by Congress, it is estimated that another 36,000 franchise businesses would have been forced to close down.[14]

One of the key takeaways from the COVID-19 pandemic is the importance of building cash reserves and developing and maintaining a strong relationship with a lending institution to ensure that one's business has potential access to the capital needed to help it navigate and survive the next pandemic or market disruptor.

C. *Create a System Support Plan in Collaboration with the Franchise Network*

Franchisors are not only responsible for preparing their own businesses, but also for providing guidance, support, and resources to their franchisees to ensure that they are likewise prepared for the practical realities of a pandemic or other market disruptor. As franchisors found during the COVID-19 pandemic, effectively assisting franchisees to traverse the seemingly infinite variables of a pandemic had the simultaneous effect of strengthening their systems and bolstering their brand reputation and recognition through demonstrated resilience.

1. Communication Strategy

Having a good communication strategy is critical. Franchisees justifiably became uneasy and overwhelmed and looked to franchisors for help with the constantly evolving information that they received during the COVID-19 pandemic (including significant topics affecting businesses' ability and obligations required to operate, infection updates and statistics, financial resources available, legal regulations and guidelines). Thus, franchisors quickly learned the importance of creating a thorough communication strategy to ensure that they provided accurate information, resources, and guidance to their franchisees to help support their teams' well-being and business operations. Moreover, franchisors learned that, as the voice of the system, if they were silent, misinformation and resentment for a lack of leadership often quickly filled the void, or worse, resulted in actions not representative of the franchisor's brand or culture.

A robust communication plan entails frequent contact in multiple formats (e.g., updates posted to company intranets, town halls, emails, and video messages), with content catered to the appropriate audience(s)—franchisees, customers, or corporate employees.[15] It also includes sharing and discussing

13. *Emergency Funds*, *supra* note 12; Ben Popken & Andrew W. Lehren, *Release of PPP Loan Recipients' Data Reveals Troubling Patterns*, NBC News (Dec. 2, 2020), https://www.nbcnews.com/business/business-news/release-ppp-loan-recipients-data-reveals-troubling-patterns-n1249629.

14. Economic Outlook Report, *supra* note 7, at 3.

15. Dawn Kroeger, *How to Create a Robust Internal Communications Strategy During a Pandemic*, Int'l Franchise Ass'n (May 13, 2020), https://community.franchise.org/article/member-news/how-create-robust-internal-communications-strategy-during-pandemic [hereinafter *Robust Communications Strategy*]; Andrae Marrocco, *Looking for the Positives in the Pandemic*, Franchise

with franchisees relevant customer and employee-facing collateral, signage, handouts, and other printable resources in advance of posting. To that end, franchisors should engage their franchise systems[16] (and any advisory councils) and provide a platform, such as an intranet/portal or surveys, to ask questions and share best practices and experiences.

It is no surprise that franchisors reported that some of the best suggestions and feedback that they received during the COVID-19 pandemic came from their franchisees because of variations in regulation and impact among different states and localities.[17] So facilitating the sharing of information among similarly situated franchisees can prove invaluable during such times. Further, franchisors can showcase positive franchisee experiences and successful initiatives to help fuel system morale and camaraderie.

2. "Best Practices" Plan

Franchisors should develop and share a "best practices" plan to help franchisees mitigate pandemic-related vulnerabilities (i.e., operational disruptions, reduced customer demand, risk of reputational damage, and diminished workforce) and respond to changing demands during a pandemic, while maintaining and stretching resources.

As part of any "best practice" plan, franchisees, like franchisors, should perform 360 degree business assessments, which include a review of their financial health and, importantly, their current and future access to cash, as discussed earlier. Franchisors should encourage franchisees to prepare and regularly update their financials and other key business metrics to enable them to assess their ability to absorb additional expenses or revenue decreases that could occur during a crisis. For example, the COVID-19 pandemic required businesses to incur the expense of obtaining personal protective equipment (PPE) for employees and implementing certain social distancing and cleaning protocols. Maintaining updated financials and other business metrics will also position franchisees to quickly apply for funds and assistance offered from governmental, industry, or other organizations (such as PPP loans awarded during the COVID-19 pandemic). Given that business financial reviews can be overwhelming and downright frightening, franchisors may consider compiling and sharing with existing franchisees sample worksheets and other financial resources.

Along those lines, a well-constructed "best practices" plan should incorporate methods for protecting and creating flexibility with financial resources. The ideal approaches may vary by system, but consider things such as preemptively seeking lease concessions (e.g., rent abatement or deferral, or

Times (Nov. 5, 2020), https://www.franchisetimes.com/franchise_insights/looking-for-the-positives-in-the-pandemic/article_b52134f2-ed14-5018-8a2f-15c97a388fba.html.

16. *Robust Communications Strategy*, *supra* note 15.

17. Heather Ripley, *How One Band of Business Owners Came Together to Thrive During the Pandemic*, Printing Impressions (Oct. 12, 2020), https://www.piworld.com/post/how-one-band-business-owners-came-together-thrive-during-pandemic.

prepayment savings), negotiating amendments to supplier/vendor contracts that have performance or purchase requirements, and centralizing or consolidating locations and/or production facilities.

A comprehensive "best practices" plan should also include workforce considerations. Employment issues wreaked havoc on businesses during the COVID-19 pandemic. For instance, as the pandemic surged, employers had to make reductions in their workforce and/or furlough workers, and limit or cease day-to-day operations due to mandatory stay-at-home orders, while simultaneously scrambling to outfit, regulate, and manage remote workforces and cybersecurity issues, and keep abreast of and digest legislative developments. Then, upon reopening, employers were forced to address workplace fears of disease contraction (and now vaccine hesitancy), implement detailed reopening emergency response plans requiring significant oversight, provide PPE, and instigate internal processes and controls to prevent the spread of disease.[18] The impact of the foregoing issues were reflected not only in the 11.2% decline in employment in the franchise sector, but also in the current difficulties facing employers across many industries in trying to bring back or find new workers.[19]

Keeping in mind that it typically costs far less to keep existing employees than to find new ones,[20] it is important to offer strategies targeted toward employee hiring and retention. Again, the right strategies (or combination thereof) will vary by system. A few of those that proved successful for franchise systems during the height of the COVID-19 pandemic included (1) limiting hours of operation as a means to reduce operational costs; (2) limiting hours worked by each employee to keep as many employees working as possible; (3) organizing shared labor arrangements with neighboring franchisees to keep employees working full-time; and (4) preemptively aligning with temporary staffing agencies and/or securing a reserve of contracted labor.

Additionally, many franchisees, often with franchisor encouragement, implemented incentive programs to attract returning staff and/or new

18. *See*, *e.g.*, Massey v. McDonald's Corp., No. 2020-ch-04247, 2020 WL 5700872, at *1 (Ill. Cir. Ct. June 24, 2020) (involving a group of employees of several McDonald's corporate and franchised stores who brought an action for negligence and public nuisance against McDonald's Corp. and the franchisee operators for failure to establish, implement, and enforce COVID safety measures).

19. *See* Lisa Fickenscher, *Businesses Are Struggling to Hire Workers—and Say Uncle Same Is to Blame*, N.Y. Post (Apr. 14, 2021), https://nypost.com/2021/04/14/businesses-are-struggling-to-hire-workers-and-say-uncle-sam-is-to-blame ("Workers are hard to find despite the vaccination rollout and stubbornly high unemployment rate."); Alex Lockie, *Fast Food Franchises Face 'Nightmare' Worker Shortage*, 1851 Franchise (Apr. 7, 2021), https://1851franchise.com/fast-food-franchises-face-nightmare-worker-shortage-2715431#home; *see also Job Openings and Labor Turnover Survey News Release*, U.S. Bureau of Labor Stat. (July 7, 2021), https://www.bls.gov/news.release/archives/jolts_07072021.htm (observing that there were 9.2 million job openings in the United States as of May 2021).

20. *See* Work Institute, 2020 Retention Report 10 (2020), https://info.workinstitute.com/hubfs/ 2020%20Retention%20Report/Work%20Institutes%202020%20Retention%20Report.pdf (estimating conservatively that it cost thirty percent of an employee's salary to replace them).

hires. For example, various Taco Bell and Chipotle locations have promoted increased benefits for their general managers (including four weeks paid vacation and eight weeks paid maternity leave),[21] Fazoli's has increased its minimum wage by eight percent,[22] and some New York City restaurants have offered $300 signing bonuses to waitstaff.[23] McDonald's has also launched a robust worker compensation program, co-funded by McDonald's and its franchisees, which includes increased wages (up to ten percent), paid time-off, tuition assistance, and a piloted emergency childcare program.[24] Beyond wages, a competitive incentive program can create appealing work environments by incorporating benefits such as implementing flexible remote or in-person schedules; taking actions to develop and define corporate and social purpose (appealing to the current societal demands for corporate responsibility); enhancing onsite perks such as snacks, drinks, and recreational areas; fostering team building with additional in-person or remote activities (e.g., hosting virtual game shows or team outings); and seeking feedback directly from staff to identify incentives and polices to foster a positive, inclusive culture and increased morale.

As a final "best practice," franchisors should also remind franchisees to comply with evolving federal, state, and local guidelines throughout any pandemic. Although it remains the franchisee's obligation to fully research and adhere to the applicable laws,[25] franchisors should—without going beyond the limits of what may risk joint employer liability—consider providing aid in the form of template and/or sample policies (e.g., reopening/return to work policies and employee handbooks) and communications (e.g., employee/internal and customer/external communications), as well as providing statewide or local research and/or resources with respect to key pandemic-related regulations.

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21. Tracey Willmont, *Franchises Paying Workers Just to Interview Amid Worker Shortage Crisis*, 1851 Franchise, (Apr. 23, 2021), https://1851franchise.com/franchises-paying-workers-just-to-interview-amid-worker-shortage-crisis-2715519#stories [hereinafter *Franchises Paying Workers*]; Jordan Valinsky, *Chipotle Says Employees Can Make $100,000 After Just 3 Years on the Job*, CNN Bus. (May 11, 2021), https://www.cnn.com/2021/05/10/business/chipotle-wage-increase/index.html.

22. *Franchises Paying Workers*, *supra* note 21.

23. Steve Cuozzo, *Worker Shortage Further Hurting NYC Restaurants*, N.Y. Post (Apr. 16, 2021), https://nypost.com/2021/04/16/worker-shortage-further-hurting-nyc-restaurants.

24. Nadine El-Bawab, *McDonald's Adds Tuition, Child Care to Sweetened Benefits in a Bid to Attract Workers*, CNBC (July 12, 2021), https://www.cnbc.com/2021/07/12/mcdonalds-reportedly-adds-tuition-child-care-to-sweetened-benefits-to-attract-new-workers.html.

25. Communications and documentation shared with franchisees should include disclaimer language to reinforce the franchisor/franchisee relationship and responsibilities. Franchisees should be encouraged to seek their own local counsel for legal and financial advice regarding the interpretation and application of pandemic related orders and guidelines (especially those related to employment matters) as well as any suggestions or materials provided by the franchisor.

3. Franchisor Assistance Programs

Franchisors need to determine what they can do directly to lessen the financial and operational burdens on franchisees in the next pandemic and are wise to preemptively establish uniform programs for possible incentives, concessions, or waivers. They should consider providing reasonable royalty or other fee concessions (such as discounts, forbearance, postponement, or forgiveness), relaxing or extending franchise opening obligations (such as locating and opening new stores or facilities, branding/rebranding, and securing pre-commencement licenses or permits and insurance), and offering extensions or reductions to ongoing and/or outstanding operational requirements like development schedules or remodeling. Franchisors should also leverage their purchasing power and resources in any way possible, including negotiating system-wide discounts (or favored pricing) and other contractual term adjustments and/or concessions from system vendors and suppliers.

In a similar supportive vein, if franchise locations are forced to close—temporarily or permanently—due to another pandemic, franchisors may want to consider waiving franchise agreement terms or suspending strict enforcement of term compliance. With a temporary closure, a franchisor may, for example, agree to a limited period in which to waive the obligation to operate the business full-time and any correlative performance requirements. And with permanent closures, franchisors may consider reducing or waiving future expected fees and/or termination fees or providing limited refunds on initial franchise fees for unopened locations. The practical reality is that locations brought to the brink of closure by disaster are less likely to survive and contribute to the system long-term. A franchisor's ability to collect fees in such instances is apt to be significantly reduced, and insisting on full compliance may force franchisees into bankruptcy. Moreover, franchisors may find franchisee-sympathetic courts that are reluctant to further inhibit franchised business operations during a pandemic, thus making it less likely that contractual obligations will be fully enforced or that full damages will be awarded, and making it more advantageous to pre-establish closure and/or termination parameters.

Regardless of the assistance program features established, franchisors must define clear program terms and conditions—including parameters such as the covered dates/periods, minimum and/or maximum amounts of concessions, eligibility, and documentation requirements—and clearly communicate those terms and conditions upfront with its system to encourage program awareness and utilization. Internally, franchisors will need to implement methods to track program usage and status of participants—such as those nearing concession term expirations, repayment status for any financial assistance, number of closures, and any related waivers. Franchisor also will need to create methods and systems to evaluate, in real time, the effectiveness and particulars of the program. Uniform treatment of franchisees participating in any such programs is a must; provided, however, that a franchisor may determine one or more groups or classes of franchisees are disparately affected by the pandemic and provide additional or differing terms for such groups or classes, so long as this option is explained and substantiated.[26]

Finally, franchisors should be mindful that certain actions may not be suitable during a life- and business-threatening pandemic. Certainly, for most systems, it is not the time to implement expensive system standard modifications, name or brand changes, or initiate compliance efforts that will further strain already limited resources. Effectively constructing a pandemic relief program should serve as another opportunity for franchisors to illustrate the value and strength of their franchise systems through the provision of thoughtful and significant aid otherwise unavailable to independent mom-and-pop businesses.

D. *"BOLO" for Opportunities*

"In the midst of chaos, there is also opportunity."[27] A pandemic can present certain options or possibilities that were not previously available in a normal market. Franchisors and franchisees alike should "be on the lookout" for those opportunities.

1. Operational Cost Savings

The cost of debt is typically lower during a significant market downturn,[28] so a pandemic may be a great time to investigate securing financing. In addition, significant market disruptions or slowdowns will (or should) cause most businesses to take a hard look at their current expenses and budget strategies, and, as a result, creditors are likely to take proactive steps to shore up their cash flow. For instance, some commercial landlords offered substantial concessions, such as rent reduction, temporary abatement of parking fees, and waiver of certain lease costs, to lessees who were willing to prepay their rent and/or renew or extend their leases. And, in a similar vein, rather than risk wholesale defaults, credit card companies offered relief to customers in the form of lowered or deferred monthly payments, waiver of late fees, and reduced interest rates.[29] Identifying and taking advantage of these cost-saving opportunities will not only help reduce a business's total expenses during a volatile time, but also can help a business secure favorable terms for the future when times get better.

26. Some states prohibit disparate treatment between franchisees that is unreasonable, unfair, or arbitrary. *See, e.g.*, Haw. Rev. Stat. § 482E-6(2)(B); 815 Ill. Comp. Stat. § 705/18; Ind. Code § 23-2-2.7-2(5); Wash. Rev. Code § 19.1000.180(2)(c).

27. Sun-Tzu, The Art of War (1910).

28. Jeffrey Cheng, Tyler Powell, Dave Skidmore & David Wessel, *What's the Fed Doing in Response to the COVID-19 Crisis? What More Could It Do?*, Brookings (Mar. 30, 2021), https://www.brookings.edu/research/fed-response-to-covid19 [hereinafter *What's the Fed Doing?*].

29. *Credit Card Debt During Coronavirus: Relief Options and Tips*, Consumer Fin. Prot. Bureau (May 19, 2020), https://www.consumerfinance.gov/about-us/blog/credit-card-debt-during-coronavirus-relief-options-tips.

2. Remodels/Unit Updates

During the height of the COVID-19 pandemic, "non-essential businesses" were subject to indefinite, mandatory shutdowns (in some instances, more than once) under state or local government emergency orders. But construction, which was deemed to be an "essential business" in many states,[30] was largely able to continue. This combination of events (along with the decreased cost of debt) presented hotels and restaurants a perfect opportunity to make necessary renovations and capital improvements without the typical concern of the impact of such work on operations and customers.

3. Restructure/Consolidate/Adapt Franchise Model

The handcuffing effects of a global crisis should open franchisors' eyes to the need for system flexibility and encourage reconsideration of their models and structures at large. Nimble systems able to diversify their services and lines of business and adapt to an altered consumer environment can limit their vulnerabilities and the overall effect of financial crises.

For example, during the COVID-19 pandemic, many fast casual businesses added or grew drive-through and delivery services when in-room dining was not possible, grocery stores offered curbside pickup and home delivery, and many retail stores added curbside pickup as well.[31] Restoration and cleaning companies also expanded offerings to encompass disinfecting and sanitization products and services, touting adherence to CDC and other health organization protocol.[32] Similarly, drycleaners promoted their clothing and household item cleaning services as sufficient to kill infection, and, although most drycleaners lost retail store customers in droves, many added pickup and delivery drycleaning and laundry services and/or prominently marketed such services as "contact-free" to help offset their losses.[33]

Successful business model pivots will transcend a pandemic by aligning with long-term trends merely intensified—but not necessarily caused—by

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30. Journal of Light Construction, Coronavirus Construction Limits: State-by-State Tracker (2020), https://www.jlconline.com/coronavirus-construction-limits-state-by-state-tracker.

31. *See 8 Thriving Franchises*, *supra* note 6 (describing how Wingstop improved online ordering and delivery, helping grow same-store sales twenty-eight percent year over year); *see also How Wireless Zone's Strategic Pivots and Philanthropic Initiatives Have Helped the Brand Thrive amid the Pandemic*, Int'l Franchise Ass'n (Nov. 16, 2020), https://community.franchise.org/article/franchising-gives-back/how-wireless-zones-strategic-pivots-and-philanthropic-initiatives (stating that Wireless Zone focused on safety and pivoted its model to include enhanced safety measures, a fully contact-free experience, modified hours of operation, phone orders, and curbside pickup).

32. *See 8 Thriving Franchises*, *supra* note 6 (providing that Servpro rolled out pandemic-targeted cleaning services); *see also* ServPro, https://www.servpro.com/resources/specialty-cleaning/coronavirus (detailing COVID-targeted services).

33. *See*, *e.g.*, Tide Cleaners, https://tidecleaners.com/en-us/touchpoints/pickup-delivery (touting contactless service as benefit to dry-cleaning delivery); Lapels, https://mylapels.com/covid-19-update (explaining that its GreenEarth cleaning process is likely "the most effective dry cleaning method available to inactivate bacteria and viruses and to potentially inactivate the COVID-19 virus as well").

a pandemic, become an extension of a company's existing capabilities and ultimately may prove profitable.[34] Production of components of PPE and/or disinfecting products may prove lucrative in a health crisis, but incorporating technological advancement into products or services may prove more viable in the long-run.

To that point, in addition to full-blown restructuring, franchisors should review their models and processes for pandemic-propelled improvements and efficiencies. There was no greater driver of efficiency on display during the pandemic than technology. Technology effectively made work during the pandemic possible for nonessential office workforces reliant upon video conferencing platforms such as Zoom, Cisco Webex, MicrosoftTeams, and GoToWebinar. And many companies are incorporating their newfound appreciation for such platforms into post-pandemic standard operating procedures by, for instance, transitioning at least portions of their previously on-site staff to permanent remote positions and allowing flexible hybrid remote/in-person schedules (which has the added bonus of attracting a much larger talent pool).[35]

Virtual meeting technology can also be used to provide greater and more flexible franchisee interaction and support. For example, by offering some or all training virtually, franchisors can considerably increase the frequency and size of classes offered, virtually eliminate travel time, reduce scheduling conflicts, and remove food, lodging, and travel expenses for participants, all while providing additional training fee revenue and allowing the brand's products/services to get to market faster. In addition, franchisors can also keep precise records of class content and attendees, as well circulate portions or whole class recordings with the trainees for reference/refresher purposes, by recording training sessions. That said, franchisors will have to balance this convenience and cost savings against the quality of training.

Beyond training, remote meeting platforms can serve as temporary or permanent replacements for large-scale system meetings like regional meetings or conventions. Franchisors might also consider offering dual virtual and in-person meeting options to increase attendance. Further, the simple two-way screen sharing of most meeting technology (or even Facetime) can also reduce expensive in-field visits/assistance by allowing virtual face-to-face interaction for check-ins, troubleshooting, and training follow-up. Similarly, franchisors and franchisees alike can implement meeting technology

34. Mauro F. Guillén, *How Businesses Have Successfully Pivoted During the Pandemic*, Harvard Bus. Rev. (July 7, 2020), https://hbr.org/2020/07/how-businesses-have-successfully-pivoted-during-the-pandemic; *see*, *e.g.*, Stephanie Schomer, *Why These 4 Franchises Expect a Post-Pandemic Business Boom*, Entrepreneur (Apr. 22, 2021), https://www.entrepreneur.com/slideshow/368636 (describing how Painting with a Twist rolled out Twist at Home painting kits when its core model of hosting painting and wine drinking events in-person was curtailed by the COVID-19 pandemic and how the kits have proven an important long-term revenue contributor).

35. Rohit Arora, *Which Companies Did Well During the Coronavirus Pandemic?*, Forbes (June 30, 2020), https://www.forbes.com/sites/rohitarora/2020/06/30/which-companies-did-well-during-the-coronavirus-pandemic/?sh=5e46977d7409.

or Facetime to assist in sales efforts, as it is customary (and often preferred) now to forgo donuts or lunch and connect virtually. This choice can greatly increase the volume and frequency of sales opportunities.

A myriad of other technological improvements should be considered as well, knowing consumer demand for convenience and speed of service/delivery are not going anywhere. For example, software applications (apps) are one popular technology used to transact business quickly and efficiently while providing customers with more information related to their orders, such as instant order confirmation, status updates, chat functions, and feedback/review opportunities. Any software available that can improve operational efficiencies, such as shipping and invoicing, should also be evaluated.

In addition, when developing new or modified models or products and services, franchisors should consider ideas and input from franchisees and advisory councils, who serve on the front lines. It is likely that some franchisees have experimented (authorized or otherwise) with the products, services, or processes that a franchisor seeks to implement. Additionally, as with any system upgrades, it is important to be mindful of both the financial implications of any restructuring plan and the timing of implementation thereof (i.e., current market conditions, duration of the plan rollout, and system lifecycle).

4. Business Acquisition Considerations/Readiness

The strongest and the most adaptable franchise systems generally performed better than others during the COVID-19 pandemic (e.g., business services, commercial and residential services, real estate, and retail food, products, and services performed well).[36] But those franchisors receptive to acquisitions or divestitures in the wake of the crisis were also able to fare well.

Indeed, although the overall rate of acquisitions initially slowed significantly during the COVID-19 pandemic, momentum reportedly picked up,[37] and the franchise industry continues to contribute noteworthy transactions,[38] with some placing a premium on systems that successfully weathered

36. *Id.*; Economic Outlook Report, *supra* note 7, at 10.

37. *See* Michele E. McHale, Eric Wozniak & Joe Wagner, *COVID-19 is Shaping M&A: Here's What Private Equity Needs to Know*, Plante Moran (Feb. 19, 2021), https://www.plantemoran.com/explore-our-thinking/insight/2020/09/transacting-in-the-age-of-covid19 (noting second quarter 2020 deals declined forty-one percent from the first quarter of the year; however, in buy-side deals, Plante Moran reported private equity add-on and strategic acquisitions on the rise).

38. *E.g.*, *NPC International Completes Sale of Substantially All Assets*, Bus. Wire (Mar. 24, 2021), https://www.businesswire.com/news/home/20210324005828/en/NPC-International-Completes-Sale-of-Substantially-All-Assets (discussing the sale by NPC International, the largest franchisee of both Pizza Hut and Wendy's, of substantially all of its assets and five Wendy's franchisees to Flynn Restaurant Group, the largest U.S. restaurant franchisee, for $801 million in a distressed sale prompted by NPC's Chapter 11 filing); Joanna Fantozzi, *Inspire Brands Completes Purchase of Dunkin' Brands for $11.3 Billion*, Nation's Rest. News (Dec. 15, 2020), https://www.nrn.com/quick-service/inspire-brands-completes-purchase-dunkin-brands-group-113-billion (noting the buyout of Dunkin' Brands for $11.3 billion in October 2020 by Roark Capital-backed Inspire Brands, the parent company of Arby's, Sonic, Buffalo Wild Wings, and

the pandemic.[39] Private equity firms and other strategic buyers have also employed multiple creative deal structures, including asset acquisitions, share sales, accelerated auctions, and Chapter 11/Section 363 sales, providing opportunities for resilient and thriving franchise models, as well as those hard hit by the COVID-19 pandemic.[40]

A distressed market may bring exceptional opportunities (and historically low interest rates for buyers),[41] but not without marked risk. The underlying data of a franchise transaction, including everything from unit metrics to revenue, may be affected by a pandemic (e.g., potentially skewed year-over-year sales data, uncharacteristically high turnover/closure and default rates, inflated compliance issues, etc.). In turn, the ability to accurately portray a franchise system's health, forecast future growth and sustainability, and calculate and arrive at a valuation is also affected. Similarly, and aside from accelerated and/or fire sales, deals may take longer due to considerations such as prolonged due diligence periods and quality of earnings closings, lender caution, and the sheer uncertainty of the times.[42] Further still, deals in this environment may be more likely to fuel post-closing disputes.

Looking ahead, as indicated earlier, companies should prepare and maintain financial documentation and secure solid banking relationships (with an emphasis on documenting historical data and information related to pandemic-time performance that lenders and buyers will undoubtedly scrutinize) to position themselves to take advantage of any and all opportunities. If a prospective deal does present itself, franchisors should be prepared to address the additional risks and considerations associated with mergers and acquisition transactions in a distressed market.

III. Conclusion

The COVID-19 pandemic gave business leaders an intensive course in crisis management and navigating a public health emergency. While some franchise businesses did not pass, others were able to do more than just survive. Seeing as scientists predict that the next pandemic may be just around the

Jimmy John's); *ServiceMaster Acquires TWO MEN AND A TRUCK®*, ServiceMaster (Aug. 3, 2021), https://www.servicemaster.com/servicemaster-brands-acquires-two-men-and-a-truck (noting acquisition for an undisclosed amount of franchised moving company).

39. According to a representative from North Point investment bank, franchise system transactions they advised on during the COVID-19 pandemic (through July 2021) averaged EBITDA (earnings before interest, taxes, depreciation, and amortization) multiples of 10.6x, with a higher average EBITDA multiple of 12.8x awarded to restaurant enterprises. *Accord* Eddy Goldberg, *What's the Deal? Buying and Selling Franchises During Covid* Franchising.com (Feb. 2, 2021), https://www.franchising.com/articles/whats_the_deal_buying_and_selling_franchises_during_covid.html (providing that valuations are up for QSRs and brands that increased revenue throughout the pandemic) [hereinafter *What's the Deal?*].

40. Jay Gary Finkelstein & Erik B. Wulff, *Strengthening Franchise Systems Post COVID-19: Strategic Acquisitions*, DLA Piper (Apr. 23, 2020), https://www.dlapiper.com/en/uk/insights/publications/2020/04/strengthening-franchise-systems-post-covid-19--strategic-acquisitions.

41. *What's the Fed Doing?*, *supra* note 28; *What's the Deal?*, *supra* note 39.

42. *What's the Deal?*, *supra* note 39.

corner, it is important to examine the strategies that proved most successful during the current pandemic.

There are four key steps that franchise systems can take now to help prepare for the next pandemic. One, form a task force to regularly conduct a full and in-depth assessment of the business and create a crisis management plan. Two, prioritize building cash reserves and establishing and maintaining a strong relationship with a financial lending institution to ensure that the business has access (or potential access) to capital during a market disruption or downturn. Three, create a system support plan with the franchise network, which includes a communications strategy, best practices guide, and potential franchisee-assistance programs. And four, be on the lookout for and position the business to take advantage of opportunities that may not have previously been available, such as operational cost savings, remodels, and unit upgrades, restructuring or adapting the franchise model, and business sales or acquisitions.

Those businesses that generally fared the best during the COVID-19 pandemic were the ones that were prepared both financially and operationally to adapt to the needs and demands of the changed market and were able to take advantage of new rules and opportunities that are likely here to stay—at least until the next pandemic (or other market disruptor) changes things again.

Must Arbitrators Follow the Law?

*Thomas A. Telesca, Elizabeth S. Sy & Briana Enck**

I. Introduction

Mr. Telesca

Ms. Sy

Ms. Enck

Arbitration is a widely used alternative to traditional court litigation for franchise-related disputes. Many franchise agreements require parties to arbitrate their disputes based on certain (mis)perceptions. For instance, arbitration is touted as private, faster, and cheaper than court litigation. Arbitration normally allows a franchisor to retain the litigation counsel of its choice unconstrained by the admission requirements to the bar of a particular court.[1] Arbitration is also perceived as a deterrent to franchisees from bringing claims against franchisors because of the added cost of the initial filing fees or because a franchisee has to likely share in the cost of the "judge," absent a prevailing party provision. Leaving aside whether those (mis)perceptions match reality, which is not the subject of this article,[2] before inserting or negotiating an arbitration provision in a franchise agreement, one other important factor to consider is whether arbitrators are required to follow the law and what a franchisor or franchisee can do if the arbitrator does not.

This consideration may be more significant in a franchise context than in some others where the

1. Certain states, such as Connecticut, require attorneys to be admitted to practice law in the state in which the arbitration proceeding is taking place as it would constitute practicing law, even though attorney representation was not required in the arbitration proceedings. *Doctor's Assocs., Inc. v. Jamieson*, 2006 WL 2348849 (Conn. Super. Ct. July 19, 2006) (granting pro hac vice admission for out-of-state counsel to practice law in arbitration proceeding).

2. *See, e.g.*, Michael Garner, *Dispute Resolution in the Twenty-First Century: The Challenge to Get ADR Right*, 40 Franchise L.J. 1 (2020) (explaining that "[o]n the one hand, ADR provisions may indeed be a productive way to resolve disputes" and, on the other hand, "they may be tools to delay, frustrate, and ultimately defeat legitimate claims of one of the parties").

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well-developed body of law designed to protect both franchisors and franchisees differs at the federal and state levels as well as from state to state. Franchise lawyers expect that the decision-maker, whether judge or arbitrator, will appreciate those differences and be bound by the applicable law so that they can better advise clients on reasonably predictable outcomes. If, for example, a party is arbitrating a case over the alleged failure to make proper disclosures in a franchise disclosure document or perhaps more specifically, whether New Jersey's notice requirement for termination, cancellation, or the intent not to renew to the franchisee applies, the party may ask: Must the arbitrator follow the law, and what can I do if the arbitrator does not?

The answer depends on a number of factors: what the franchise agreement says; what the arbitration clause in the franchise agreement says; what the arbitrator thinks; whether a party moves to confirm or vacate the arbitration award in state or federal court, which state or federal circuit has jurisdiction over the arbitration; and, finally, what claims and arguments were presented to the arbitrator. This article provides a brief overview of arbitration and arbitrators generally with respect to their obligation to follow the law; offers ways to lessen the likelihood that an arbitrator will not follow the law; discusses various standards to vacate an unfavorable arbitration award which does not follow the law; and examines the circuit split regarding the elusive manifest disregard of the law doctrine.

II. Arbitration and Arbitrators

It is well known that arbitration is a private process by which the parties give a neutral third party the authority to resolve their dispute. Although the process is similar to court litigation, discovery is usually limited, the rules of evidence are relaxed, and the award is final. Appellate review does not normally exist. As such, in theory, the arbitration process should be quicker and less expensive than traditional litigation.

The arbitrator's award can be enforced by a court, but only vacated on *very* narrow grounds. Although, at least in the authors' experience, most arbitrators are guided by the applicable law and address the issues at hand, if an arbitrator chooses to ignore the law, the relief available may be limited at best. Only in the most egregious of circumstances is a court likely to insert itself into a private arbitral proceeding and vacate an arbitrator's award.

A. *Who Are Arbitrators?*

Because arbitration awards are rarely vacated, as more fully discussed later, it is important to select the right arbitrator. Arbitrators may come from a wide range of professional and educational backgrounds and are not necessarily attorneys or judges. Although many have experience in the legal field, others have experience in, for example, the finance, information technology, and construction fields. As a result, some arbitrators may not be well-versed or familiar with the nuances of the law that should apply in a particular case.

This circumstance could be especially problematic in the franchise context where the rules may vary from state to state and between state and federal law, which could wreak havoc on a franchise lawyer's well-thought-out litigation strategy and his or her client's expectations.

To guard against an arbitrator ignoring or misapplying relevant law, parties normally select well-experienced lawyers or retired judges as arbitrators. Often, those arbitrators work through nationally recognized alternative dispute resolution (ADR) organizations, such as JAMS or the American Arbitration Association (AAA). The AAA lists the following seven qualifications for its arbitrators on its website:

a. Minimum of 15 years of senior level legal, business or professional experience;
b. Educational degree(s) and/or professional license(s) appropriate to your field of expertise;
c. Knowledgeable regarding cybersecurity and the benefits and risks associated with relevant technology;
d. Training or experience in arbitration and/or other forms of dispute resolution;
e. Honors, awards and citations indicating leadership in your field;
f. Training or experience in arbitration and/or other forms;
g. Membership in a professional association(s); and
h. Other relevant experience or accomplishments (e.g., published articles).[3]

AAA arbitrators must also attend and successfully complete a two-day Arbitration Fundamentals and Best Practices for New AAA Arbitrators program and an online Award Writing course.[4] In its Statement of Ethical Principles, the AAA represents that its rules, administrative procedures, and due process protocols follow the law.[5]

One of the benefits of using an established ADR organization is that it should allow for the selection of a trained arbitrator with franchise experience. JAMS, for example, maintains a list of neutrals that have franchise experience, and the International Institute for Conflict Prevention & Resolution offers a franchise panel.[6] The parties are able to research and review a potential arbitrator's background to see if he or she is a good fit for their particular dispute.

B. *An Arbitrator's Perspective May Impact the Outcome*

Anecdotally, and as supported by two more formal surveys, arbitrators understand that they have certain flexibility when it comes to following the law. Arbitration is generally perceived as providing a forum in which to

3. *Application Process for Admittance to the AAA National Roster of Arbitrators*, Am. Arb. Ass'n, https://www.adr.org/sites/default/files/document_repository/AAA_Application_Process_NationalRoster.pdf (last visited June 28, 2021).
4. *Id.*
5. *AAA Statement of Ethical Principles*, Am. Arb. Ass'n, https://www.adr.org/StatementofEthicalPrinciples (last visited Aug. 2, 2021).
6. *See, e.g.*, *All Neutrals*, JAMS, https://www.jamsadr.com/neutrals (last visited Nov. 28, 2021); *Franchise Panel*, Int'l Centre for Conflict Prevention & Resol., https://www.cpradr.org/neutrals/specialty-panels/franchise-panel (last visited Nov. 28, 2021).

resolve disputes in an equitable rather than strictly legal manner. Indeed, sixty years ago, in a 1961 *Columbia Law Review* survey regarding the attitudes of arbitrators in relation to following the law, eighty percent of the arbitrators surveyed "thought that they ought to reach their decisions within the context of the principles of substantive rules of law," but almost ninety percent "believed that they were free to ignore these rules whenever they thought that more just decisions would be reached by so doing."[7] This perceived flexibility to be "fair" may benefit or harm a client depending on the outcome and what is at stake.

Thirty years later, in a 1994 survey, AAA construction arbitrators were asked whether they "always follow the law in formulating [their] awards."[8] Only seventy-two percent (149 of 207) responded "yes," while twenty percent (42 of 207) responded "no" (although eight percent did not respond to the question).[9] The arbitrators surveyed were given the option to explain their responses. Out of the thirty-three who explained their "no" response, eleven "stated they did not know the law and therefore could not follow it."[10] Out of the fifty-eight who explained their "yes" answer, nineteen stated that

> they attempted to follow the law as they were able to understand it. Seventeen believed it was essential or their duty to follow the law. Four attempted to follow the law, but said it was not always clear or agreed upon. Four said they followed the law but tempered it with a concept of "equity." Three followed the law to avoid a challenge to the award.[11]

These surveys largely mirror the authors' experience with arbitration. Arbitrators use the law as a guide to achieving a fair result, but, in certain circumstances, an arbitrator's own sense of "equity" comes to play a role in the arbitrator's award. This reality may be more of a reason to specify in the arbitration clause of the franchise agreement that the arbitrator must have franchise experience so that he or she understands the contours and nuances of the varied franchise laws that may have already taken into account a sense of what is equitable. For example, a franchisor may want to include the following in its franchise agreement's arbitration clause: "The arbitrator(s) shall be independent, impartial and qualified by education, experience and training in the franchise industry to decide upon disputes under this agreement."[12]

Even courts have acknowledged the result of the two surveys, noting that opting for arbitration might be a sacrifice of legal precision where, inter alia, arbitrators are under no duty to apply the law. For example, in *Bowles Financial Group, Inc. v. Stifel, Nicolaus & Co.*, the Tenth Circuit noted that "[a]rbitration provides neither the procedural protections nor the assurance

7. Soia Mentschikoff, *Commercial Arbitration*, 61 Colum. L. Rev. 846, 861 (1961).

8. Dean B. Thomson, *Arbitration Theory and Practice: A Survey of AAA Construction Arbitrators*, 23 Hofstra L. Rev. 137, 154 (1994).

9. *Id.*

10. *Id.* at 155.

11. *Id.*

12. *See Clause Builder Tool*, Am. Arb. Ass'n, https://www.clausebuilder.org/cb/faces/index (last visited Dec. 1, 2021).

of the proper application of substantive law offered by the judicial system."[13] In *Fagan v. Village of Harriman*, a New York appellate court stated that "[a]n arbitrator is not bound by principles of substantive law or rules of evidence, and may do justice and apply his or her own sense of law and equity to the facts as he or she finds them to be."[14] Without the right to appeal an arbitration award that does not follow the law, using arbitration may be risky, despite its other perceived benefits.

C. *Ways to Ensure an Arbitrator Follows the Law*

Regardless of an arbitrator's view of his or her obligation to follow the law, to ensure adherence to applicable law and its ensuing predictability, there are ways to lessen the likelihood that an arbitrator does not follow the law. JAMS and AAA, for example, provide rules addressing which substantive and procedural law the arbitrator should follow. Rule 24(c) of the JAMS Comprehensive Arbitration Rules & Procedures provides:

> In determining the merits of the dispute, the Arbitrator shall be guided by the rules of law agreed upon by the Parties. In the absence of such agreement, the Arbitrator shall be guided by the rules of law and equity that he or she deems to be most appropriate. The Arbitrator may grant any remedy or relief that is just and equitable and within the scope of the Parties' Agreement, including, but not limited to, specific performance of a contract or any other equitable or legal remedy.[15]

The JAMS rule can be read to give the arbitrator extensive flexibility in crafting what he or she believes is an appropriate award only "guided by" and not bound by the law. Similarly, the AAA's Preliminary Hearing Procedures require that the arbitration rules, substantive law, and procedural law governing the proceeding be addressed at the preliminary hearing.[16] As such, even if the parties' agreement does not have a choice of law provision, they may be able to attempt to agree on applicable law at the preliminary hearing.

Because an arbitrator may base his or her decisions on an individual perception of what is "right" or "fair," the outcome might run contrary to precedent.[17] This result may be beneficial or detrimental, depending on a party's particular position and goals in a particular case. To minimize the risk of an arbitrator's ruling going awry, the parties should agree on the applicable law in advance of

13. Bowles Fin. Grp., Inc. v. Stifel, Nicolaus & Co., 22 F.3d 1010, 1011 (10th Cir. 1994).

14. Fagan v. Village of Harriman, 140 A.D.3d 868, 868 (N.Y. App. Div. 2016) (internal quotations and citations omitted); *see also* Allstate Ins. Co. v. GEICO, 100 A.D.3d 878 (N.Y. App. Div. 2012).

15. *JAMS Comprehensive Arbitration Rules & Procedures*, Jams (June 1, 2021), https://www.jamsadr.com/rules-comprehensive-arbitration/#Rule-24.

16. *Arbitration Rules and Mediation Procedures*, Am. Arb. Ass'n 32 (2013), https://www.imsif.com/files/Commercial_Rules.pdf (last visited June 28, 2021).

17. *See, e.g.*, *Arbitration vs. Litigation: The Choice Matters*, Warner Norcross + Judd (Feb. 8, 2018), https://www.wnj.com/Publications/Arbitration-vs-Litigation-The-Choice-Matters ("In litigation, judges are constrained by the rules of evidence and, of course, by precedent based on prior cases. This helps to ensure that judges do not substitute their opinions of what is fair and just in place of what the law allows or requires and promotes relatively consistent (and predictable) outcomes of similar issues. . . Arbitrators are not placed under the same restrictions as judges, which means that arbitrators are not bound to follow precedent or to exclude evidence.).

any arbitration. The franchise agreement is the obvious place to memorialize this agreement. To further avoid any doubt, the arbitration clause itself should address the applicable substantive law the arbitrator must follow, specifying which state or federal law(s) governs, as well as the applicable procedural law for enforcing the clause itself or confirming and/or vacating an award.

In the absence of an agreement on applicable law between the parties, the arbitrator will decide, which may lead to the application of unfavorable or inapt law. Additionally, although it may increase the cost because the parties must pay for the arbitrator's time, requiring the arbitrator to issue a reasoned award is another way to ensure that the arbitrator follows the applicable law. It should be noted that the rules of some ADR organizations permit appeals within the ADR organization if the parties agree, or the arbitration clause itself may permit appeals within the designated arbitral body.[18] This mechanism is another way to ensure that the arbitrator follows applicable law. Lastly, while negotiating or drafting the arbitration clause, a lawyer should consider whether federal or state law governs the enforcement of the arbitration award. This choice may be critical once the arbitration proceeding is complete, as seen in part III.A., below.

III. Can an Unfavorable Award Be Vacated?

Once an arbitration hearing is complete and the arbitrator issues an award, the case may still be far from over. Depending on the outcome, a party may have to confirm or, on the other hand, seek to vacate that award if, for instance, the arbitrator ignored the applicable law. In this regard, Rule 25 of JAMS Rules states:

> Proceedings to enforce, confirm, modify or vacate an Award will be controlled by and conducted in conformity with the Federal Arbitration Act, 9 U.S.C. Sec[.] 1, *et seq*., or applicable state law. The Parties to an Arbitration under these Rules shall be deemed to have consented that judgment upon the Award may be entered in any court having jurisdiction thereof.[19]

Although JAMS Rule 25 addresses enforcing, confirming, modifying, or vacating an arbitration award, it is very broadly drafted and allows parties to seek relief in any court with jurisdiction. The court selected could lead to varying results.

As stated in the JAMS rules, applications to confirm or vacate an award may be made in federal court under the Federal Arbitration Act (FAA)[20] or applicable state law. The U.S. Supreme Court has interpreted the scope of the FAA to apply to arbitrations in which the subject matter affects interstate

18. *See*, *e.g.*, *Arbitration Appeal Procedure*, JAMS (June 2003), https://www.jamsadr.com/appeal; *Optional Appellate Arbitration Rules*, AM. ARB. ASS'N (Nov. 1, 2013), https://www.adr.org/sites/default/files/AAA-ICDR_Optional_Appellate_Arbitration_Rules.pdf.

19. *JAMS Comprehensive Arbitration Rules & Procedures*, JAMS (June 1, 2021), https://www.jamsadr.com/rules-comprehensive-arbitration/#Rule-25.

20. 9 U.S.C. § 1 et seq.

commerce.[21] Therefore, for a wholly intrastate arbitration that does not affect interstate commerce, the process for confirming, or the grounds for vacating, an arbitration award is determined by state law, unless the parties designate the FAA to apply to the dispute.

It is important to note that there may be differences between the FAA and state law governed arbitrations, such as whether an arbitrator may award attorneys' fees to the prevailing party or how much time a party has to file a motion or application to vacate an award. For example, under the FAA, unless prohibited by the arbitration agreement, arbitrators may award attorneys' fees.[22] However, in New York, "attorneys' fees may not be recovered in an arbitration proceeding unless they are expressly provided for in the arbitration agreement. If the parties' agreement does not provide for an award of attorneys' fees, then an arbitrator who awards an attorneys' fee has exceeded the scope of his or her powers."[23] Additionally, under the FAA, a notice of motion to vacate must be served upon the adverse party within three months once the award is filed or delivered.[24] In New York, an application to vacate an award must be made within ninety days after its delivery.[25] Whereas, in Connecticut, an application to vacate an award must be made within thirty days from the notice of the award to the party to the arbitration who makes the motion.[26] There are also distinctions between and among the FAA and state laws as to whether the arbitrator or court decides certain issues.[27]

The procedure concerning applications to vacate an award when a party believes the arbitrator did not follow the law is beyond the scope of this article. This article focuses next on the various legal standards to vacate an award if such an application to a court is made when an arbitrator does not follow the law.

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21. *See* Citizens Bank v. Alafabco, 539 U.S. 52, 56 (2003).

22. *See* PaineWebber Inc. v. Bybyk, 81 F.3d 1193, 1202 (2d Cir. 1996).

23. N.Y. Merchants Protective Co. v. RW Adart Poly, 108 A.D.3d 554, 556–57 (N.Y. App. Div. 2013) (internal citations omitted).

24. 9 U.S.C.A. § 12.

25. N.Y. CPLR § 7511(a).

26. Conn. Gen. Stat. § 52-420(b); *see also* A Better Way Wholesale Autos, Inc. v. Saint Paul, 217 A.3d 996, 1005 (Conn. App. Ct. 2019) (holding thirty-day time limit pursuant to Connecticut General Statute § 52-420(b) applied, even though the arbitration agreement included a choice-of-law provision stating that the agreement was governed by the FAA, which contains a three-month time limitation for filing appeals).

27. For example, in New York, "the courts have inherent power to disqualify an arbitrator before an award has been rendered." Bronx-Lebanon Hosp. Ctr. v. Signature Med. Mgmt. Grp., L.L.C., 6 A.D.3d 261, 261, 775 N.Y.S.2d 279, 280 (1st Dep't 2004) (citing Astoria Med. Grp. v. Health Ins. Plan of Greater New York, 11 N.Y.2d 128 (1962)). Under the FAA, a court may not disqualify an arbitrator during arbitration proceedings. Marc Rich & Co., A. G. v. Transmarine Seaways Corp. of Monrovia, 443 F. Supp. 386, 387 (S.D.N.Y. 1978) (holding that the arbitrator is subject to judicial review after the award has been made). Additionally, in New York, the court has the authority to decide, upon application by a party, whether a claim is timely filed under the relevant statute of limitations. *See* N.Y. C.P.L.R. § 7502(b). Under the FAA, the arbitrator decides whether the claim was timely filed under the relevant statute of limitations. Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79, 85 (2002) (holding that absent an agreement to the contrary, the applicability of the time limit rule under the FAA "is a matter presumptively for the arbitrator, not for the judge").

A. *Standards for Vacating an Arbitrator's Award*

The grounds for reviewing an arbitrator's award are very limited.[28] In *Tullett Prebon v. BGC Financial*, the Appellate Division of New York noted that arbitration awards are subject to very limited review in order to avoid undermining the twin goals of arbitration, to wit, settling disputes efficiently and avoiding long and expensive litigation.[29] If a party to an arbitration proceeding *does* want to challenge an award, a court application must be made, with the rare exception that the parties' agreement provided for an appellate proceeding within the arbitration.[30]

1. The Federal Arbitration Act and State Law

The outcome of any such court application to vacate an award may depend on what law applies and which court is selected for the application. Section 10(a) of the FAA (assuming federal law applies) sets forth four statutory grounds for vacating an arbitration award:

> (1) where the award was procured by corruption, fraud, or undue means;
> (2) where there was evident partiality or corruption in the arbitrators, or either of them;
> (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or
> (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject was not made.[31]

Each statutory ground seeks to ensure an arbitral proceeding's overall fairness and impartiality.[32]

The following cases are illustrative of each of the four grounds under Section 10(a) of the FAA. First, in *Sorghum Investment Holdings Ltd. v. China Commercial Credit, Inc.*, a New York state court applying the FAA determined that an arbitrator's award was procured by fraud or undue means, pursuant to Section 10(a)(1), where the arbitrator explicitly relied on the respondent's attorney's false and misleading statements in his declaration.[33] Next, in *Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi, A.S.*, the Second Circuit vacated an award on the grounds of evident partiality under Section 10(a)(2) where the arbitrator knew of a potential conflict of interest,

28. *Arbitration Award Vacated*, FindLaw, https://corporate.findlaw.com/litigation-disputes/arbitration-award-vacated.html (last visited July 30, 2021).

29. Tullett Prebon v. BGC Fin., 111 A.D.3d 480, 482 (1st Dept. 2013); *see also* Folkways Music Publishers v. Weiss, 989 F.2d 108, 111 (2d Cir. 1993).

30. *Challenges to an Arbitration Award*, Am. Arb. Ass'n, https://www.adr.org/sites/default/files/document_repository/challenges-to-an-arbitration-award.pdf (last visited July 30, 2021).

31. 9 U.S.C. §10.

32. *See* Stephen L Hayford, *A New Paradigm for Commercial Arbitration: Rethinking the Relationship Between Reasoned Awards and the Judicial Standards for Vacatur*, 66 Geo. Wash. L. Rev. 443, 453 (1998).

33. Sorghum Inv. Holdings Ltd. v. China Com. Credit, Inc., 2019 WL 1992275 (N.Y. Sup. Ct. 2019).

but failed to investigate or disclose an intention not to investigate the conflict.[34] The Second Circuit stated that the standard for vacating an award pursuant to Section 10(a)(2) is whether a reasonable person, considering all of the circumstances, would conclude that an arbitrator was partial to one side.[35] In *Monster Energy Co. v. City Beverages*, a beverage distributor moved to vacate an arbitration award in favor of a beverage supplier who terminated the parties' distribution agreement without good cause, after finding out that the arbitrator had an ownership interest in JAMS and JAMS had a substantial business relationship with the supplier.[36] The Ninth Circuit vacated the award under Section 10(a)(2) and explained that, to support vacatur of an award pursuant to evident partiality, "the arbitrator's undisclosed interest in an entity must be substantial, and that entity's business dealings with a party to the arbitration must be nontrivial."[37] Third, for an award to be vacated pursuant to Section 10(a)(3), the misconduct must amount to a denial of fundamental fairness.[38] In *In re A.H. Robins Co.*, the United States District Court for the Eastern District of Virginia held that the arbitrator's denial of claimant making a closing argument constituted such misconduct because it prejudiced the claimant's case.[39] Fourth, in *Aspic Engineering & Construction Co. v. ECC Centcom Constructors LLC*, the Ninth Circuit held that the arbitrator exceeded his power pursuant to Section 10(a)(4) by issuing an award that was in direct conflict with the provisions of the relevant contracts on the basis that enforcing such provisions would be unjust.[40] By contrast, in *Walker v. Ameriprise Financial Services, Inc.*, the Fifth Circuit refused to vacate an award pursuant to Section 10(a)(4) where the arbitration panel dismissed an employee's claims against a franchisor as being fully adjudicated by a prior arbitration panel.[41] The plaintiff in *Walker* argued that the later arbitration panel erred in determining that the defendant met the elements of FINRA's Rule 13504(a)(6),[42] which essentially applies a res judicata standard to claims.[43] The Fifth Circuit explained that, even if it were true that the panel

34. *Applied Indus. Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi, A.S.*, 492 F.3d 132, 137 (2d Cir. 2007).

35. *Id.*

36. Monster Energy Co. v. City Beverages, LLC, 940 F.3d 1130, 1136 (9th Cir. 2019), *cert. denied*, 141 S. Ct. 164, 207 L. Ed. 2d 1100 (2020).

37. *Id.* at 1135–36.

38. *See* GFI Sec. LLC v. Labandeira, 2002 WL 460059, at *6 (S.D.N.Y. Mar. 26, 2002) (refusing to vacate an award where an arbitrator failed to follow the Federal Rules of Evidence, declined to allow the cross-examination of a witness and forced another witness to testify).

39. *In re* A.H. Robins Co., Inc., 238 B.R. 300, 315 (E.D. Va. 1999).

40. Aspic Eng' & Constr. Co. v. ECC Centcom Constructors LLC, 913 F.3d 1162, 1168 (9th Cir. 2019).

41. Walker v. Ameriprise Fin. Servs., Inc., 787 F. App'x 211, 214 (5th Cir. 2019).

42. Rule 13504(a)(6) provides that "dismissal may be granted when the arbitrators find the 'non-moving party previously brought a claim regarding the same dispute against the same party that was fully and finally adjudicated on the merits and memorialized in an order, judgment, award, or decision.'" *Walker*, 787 F. App'x at 212.

43. *Id.* at 214.

incorrectly applied the rule, such alleged "legal errors lie far outside the category of conduct embraced by §10(a)(4)."[44]

A review of the relevant case law demonstrates that vacating an arbitration award under the four grounds of Section 10(a) of the FAA is difficult, leading to results which are similar to *Walker*.[45] Many states follow the FAA. Thirteen states[46] have adopted the Uniform Arbitration Act (1956) (UAA), which was patterned after the FAA; twenty-two states and the District of Columbia[47] have adopted the Revised Uniform Arbitration Act (2000) (RUAA), which broadens statutory vacatur standards; and some states have adopted portions of the RUAA.[48] Other states, such as New York, New Jersey, and California, while not adopting the UAA or RUAA, have adopted similar statutes enforcing agreements to arbitrate controversies and provide similar grounds for vacatur.[49]

Under the UAA, upon application of a party, a court shall vacate an award where:

> (1) The award was procured by corruption, fraud or other undue means;
> (2) There was evident partiality by an arbitrator appointed as a neutral or corruption in any of the arbitrators or misconduct prejudicing the rights of any party;

44. *Id.* (citing Cooper v. WestEnd Cap. Mgmt., L.L.C., 832 F.3d 534, 547 (5th Cir. 2016)).

45. *See*, *e.g.*, Hoolahan v. IBC Advanced Alloys Corp., 947 F.3d 101 (1st Cir. 2020) (holding, inter alia, that the court of appeals will not disturb an award as long as the award draws its essence from the agreement that underlies the arbitration proceeding and the arbitrator arguably construed or applied the agreement within the scope of his authority); CM S. E. Texas Houston, LLC v. CareMinders Home Care, Inc., 662 F. App'x 701 (11th Cir. 2016) (holding that arbitrator's refusal to grant postponement of arbitration hearing when parties mutually agreed to one was not per se unreasonable, and thus did not mandate vacatur of arbitration award under the FAA); Mesa Power Grp., LLC v. Gov't of Canada, 255 F. Supp. 3d 175 (D.D.C. 2017) (explaining that arbitrator's interpretation of the word "procurement" in the North American Free Trade Agreement did not warrant vacatur of award finding that government of Canada did not violate the Agreement in awarding renewable energy contracts because the arbitrator's interpretation was based on an analysis of the text, context, and structure of treaty, other relevant treaties, and relevant precedent); Frid v. First Republic Bank, No. 12-CV-00806-JST, 2014 WL 1365933, at *4 (N.D. Cal. Apr. 7, 2014) ("Because the arbitrator was not required to make findings of fact and conclusions of law in his award, any failure to do so cannot be a basis for vacating the award."); Stone v. Bear, Stearns & Co., 872 F. Supp. 2d 435, 443 (E.D. Pa. 2012) (refusing to vacate arbitration award and explaining that the court "must afford the arbitrators' decision extreme deference" and "a petitioner seeking to vacate an arbitration award must clear a 'high hurdle'"), *judgment entered*, No. 2:11-CV-5118, 2012 WL 1946970 (E.D. Pa. May 29, 2012), *and aff'd*, 538 F. App'x 169 (3d Cir. 2013).

46. Nebraska, Virginia, Montana, Kentucky, Iowa, Missouri, Georgia, South Carolina, Delaware, Idaho, South Dakota, Indiana, and Maine. *See* Arbitration Act (1956), Uniform Law Comm'n, https://www.uniformlaws.org/committees/community-home?CommunityKey=f60b379c-6378-4d9d-b271-97522fad6f89 (last visited Aug. 3, 2021).

47. Vermont, Pennsylvania, Kansas, Connecticut, West Virginia, Florida, Michigan , Arkansas, Arizona, Minnesota, Washington, Oklahoma, Alaska, Colorado, Oregon, North Dakota, New Jersey, North Carolina, Utah, Hawaii, New Mexico, Nevada, and District of Columbia. *See* Arbitration Act (2000), Uniform Law Comm'n, https://www.uniformlaws.org/committees/community-home?CommunityKey=a0ad71d6-085f-4648-857a-e9e893ae2736 (last visited Aug. 3, 2021).

48. *See* Prefatory Note, Revised Uniform Arbitration Act, 7 U.L.A. 1 (2000); *see, e.g.*, Fla. Stat. Ann. § 682.01.

49. *See*, *e.g.*, Cal. Civ. Proc. Code § 1280 et seq.; N.J. Stat. Ann. § 2A:24-1 et seq.; N.Y. C.P.L.R. § 7501 et seq.

(3) The arbitrators exceeded their powers;
(4) The arbitrators refused to postpone the hearing upon sufficient cause being shown therefor or refused to hear evidence material to the controversy or otherwise so conducted the hearing, contrary to the provisions of Section 5, as to prejudice substantially the rights of a party; or
(5) There was no arbitration agreement and the issue was not adversely determined in proceedings under Section 2 and the party did not participate in the arbitration hearing without raising the objection . . . .[50]

The RUAA adds two additional statutory vacatur standards: (1) "misconduct by an arbitration prejudicing the rights of a party to the arbitration proceeding;"[51] and (2) "the arbitration was conducted without proper notice of the initiation of an arbitration . . . so as to prejudice substantially the rights of a party to the arbitration proceeding."[52] Unlike the UAA, the RUAA also acknowledges that "courts have developed nonstatutory grounds of manifest disregard of the law and public policy that will void an arbitration award."[53]

2. The Doctrine of Manifest Disregard of the Law

"Manifest disregard of the law" is a separate judicially created doctrine under which an unsuccessful party may seek to vacate an unfavorable arbitration award in certain courts.[54] Although at first it may appear that this doctrine will provide relief outside the federal and state statutory schemes if an arbitrator does not follow the law, it is not as fruitful as its name implies. It has been described as a "doctrine of last resort."[55] Its application has been limited only to exceedingly rare instances where the arbitrator knew the law, but ignored it.[56]

Such a narrow review of arbitration awards is nothing new. More than three hundred years ago under the Arbitration Act of 1698, England gave courts the power to confirm awards and also to vacate them, but only on limited grounds, such as when an award "was procured by corruption or other undue means."[57] As is the case today, English and American courts in the nineteenth century rarely vacated arbitration awards. One such English court that did vacate an award in 1846 found that "the arbitrator has clearly and palpably mistaken a firmly-settled rule of law . . . ."[58] Nearly thirty years later, the U.S. Supreme Court first used the term "manifest mistake of law" in *United States v. Farragut*.[59]

50. Uniform Arbitration Act, § 12, 7 U.L.A. 4 (1956).
51. Revised Uniform Arbitration Act, § 23(a)(2)(C), 7 U.L.A. 74 (2000).
52. *Id.* § 23(a)(6).
53. *Id.* § 4, cmt 5(e).
54. *See* Wilko v. Swan, 346 U.S. 427, 436–37 (1953).
55. *See* Wien & Malkin LLP v. Helmsley-Spear, Inc., 846 N.E.2d 1201, 1206 (N.Y. 2006).
56. *See* Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S, 333 F.3d 383, 389 (2d Cir. 2003); Willemijn Houdestermaatschappij, BV v. Standard Microsystems, 103 F.3d 9, 12 (2d Cir. 1997); Stempien v. Marnie Prop., LLC, 2017 WL 6016568 (Del. Ch. Nov. 3, 2017).
57. *Historic English Arbitration Act 1698*, Trans-Lex.Org, https://www.trans-lex.org/803000/_/historic-english-arbitration-act-1698 (last visited June 28, 2021).
58. Fuller v. Fenwick [1846)] 136 Eng. Rep. 282 (L.R.C.P.) 285.
59. United States v. Farragut, 89 U.S. 406, 420 (1874).

When Congress enacted the FAA in 1925, it did not mention "manifest mistake of law" or "manifest disregard of the law." Although "manifest disregard of the law" has not found its way into statutory law, it abounds in case law and has evolved over time. The U.S. Supreme Court discussed the manifest disregard standard in *Wilko v. Swan*,[60] but the Court did not adopt it. Nevertheless, over time, both federal and state appellate courts adopted the standard.

Then in 2008, the U.S. Supreme Court seemingly eliminated "manifest disregard of the law" in its landmark decision in *Hall Street Associates, L.L.C. v. Mattel, Inc.*, 552 U.S. 576 (2008). The Court held that the grounds for vacating an arbitration award under the FAA are only the four grounds enumerated in Section 10, which does not include manifest disregard. However, the Court did not decide the validity of the manifest disregard standard, but suggested that the manifest disregard of the law standard expressed in *Wilko* may have referred to the four grounds in Section 10 collectively, rather than adding to them as an independent judicially created ground, or as shorthand for the subsections authorizing vacatur when arbitrators were guilty of misconduct or exceeded their powers.[61] Because the Court in *Hall Street* did not decide the validity of the manifest disregard of the law standard[62] and later refused to decide its validity again in *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*,[63] the U.S. Circuit Courts of Appeals are split on whether the doctrine still exists.

a) Circuits Where Manifest Disregard Remains a Valid Ground to Vacate

The First, Second, Fourth, Sixth, Seventh, and Tenth Circuits have held that manifest disregard remains a valid ground for vacatur.[64] However, successfully demonstrating manifest disregard is another story. For example, in *Ebbe v. Concorde Investment Services, LLC*,[65] a plaintiff investor decided to invest money with a financial advisor named Richard Cody who was an employee of defendant Westminster Financial.[66] Unbeknownst to plaintiff, FINRA's Appeals Panel subsequently suspended Richard Cody for a year for recommending unsuitable investments and trading.[67] When the suspension began, Cody transferred plaintiff's account to his wife, Jill Cody, as plaintiff's new

60. Wilko v. Swan, 346 U.S. 427, 436–37 (1953).

61. Hall St. Assocs., L.L.C. v. Mattel, Inc., 552 U.S. 576, 585 (2008).

62. *Id.* at 584–85.

63. Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp., 559 U.S. 662, 670 (2010).

64. *See* Ebbe v. Concorde Inv. Servs., LLC, 953 F.3d 172 (1st Cir. 2019) (holding that manifest disregard of the law is a ground for vacatur); Frye v. Wild Bird Ctrs. Of Am., Inc., 714 F. Appx. 211, 213 (4th Cir. 2017) (holding the common law ground for vacating is where the award evidences a manifest disregard of the law); A. Kershaw, PC v. Shannon L. Spangler, PC, 703 F. Appx. 635, 639–40 (10th Cir. 2017) (holding the manifest disregard ground remains available); Marshall v. SSC Nashville Operating Co., LLC, 686 F. Appx. 348, 353 (6th Cir. 2017) (holding despite the Supreme Court's language in Hall Street, the manifest disregard doctrine remains a viable ground); Tully Constr. Co., Inc. v. Canam Steel Corp., 684 F. App'x 24, 26 (2d Cir. 2017) (same).

65. Ebbe v. Concorde Inv. Servs., LLC, 953 F.3d 172 (1st Cir. 2019).

66. *Id.* at 175.

67. *Id.*

investment advisor, who was an employee of defendant Concorde.[68] After noticing unusual account activity, plaintiff brought an arbitration proceeding against Richard Cody, Westminster Financial, Jill Cody, and Concorde for $800,000 in damages.[69] The arbitrator determined that Richard Cody and Jill Cody were jointly and severally liable in the sum of $286,096, but not Concorde or Westminster.[70] Plaintiff sought to vacate the award on the ground that Concorde should have been liable too under the doctrine of respondeat superior.[71]

The First Circuit explained the difficulties of satisfying the "exacting criteria" for invocation of the manifest disregard doctrine where arbitrators do not explain their awards, as they are permitted to do.[72] The court further noted that "[o]n a manifest disregard review, even a court's conviction that the arbitrator made a serious mistake or committed grievous error will not furnish a satisfactory basis for undoing the decision."[73] There must be a showing that "the arbitrator recognized the applicable law, but ignored it."[74] The First Circuit finally concluded that the arbitrator's finding was reasonable because (1) neither of the Codys appeared for the arbitration and the finding of liability against them could reasonably have been nothing more than entry of a default judgment; (2) plaintiff produced no evidence that Jill Cody violated any of Concorde's company rules; and (3) the arbitrators could have concluded that Jill Cody's torts were not committed within the scope of her employment.[75]

Even in cases where there is a reasoned award, it may not help. In *Tully Construction Co. v. Canam Steel Corp.*,[76] the Second Circuit explained that an arbitrator does not need to "delve into every argument made by the parties" and that a reasoned award is simply

> something more than a line or two of unexplained conclusions, but something less than full findings of fact and conclusions of law on each issue raised before the panel. A reasoned award sets forth the basic reasoning of the arbitral panel on the central issue or issues raised before it. It need not delve into every argument made by the parties.[77]

In *Tully Construction. Co.*, a contractor on a state construction project petitioned to confirm an arbitration award against a subcontractor over a dispute regarding timeliness of deliveries.[78] The subcontractor seeking to vacate the award alleged, inter alia, that the arbitrator failed to consider an order issued

68. *Id.*
69. *Id.*
70. *Id.* at 176.
71. *Id.* at 177.
72. *Id.* at 176 (citations omitted).
73. *Id.* at 176–77 (citations omitted).
74. *Id.* at 176 (citations omitted).
75. *Id.* at 177.
76. Tully Constr. Co., Inc. v. Canam Steel Corp., 684 F. App'x 24 (2d Cir. 2017).
77. *Id.* at 28 (citing Leeward Constr. Co., Ltd. v. Am. U. of Antigua–Coll. of Med., 826 F.3d 634, 640 (2d Cir. 2016)).
78. *Tully Constr.*, 684 F. App'x at 28.

by a New Hampshire court that included language about the parties' delivery agreement as well as a letter agreement between the parties.[79] The Second Circuit agreed with the lower court that vacatur was not warranted and that there was ample support for the arbitrator's ruling.[80]

In *Golden Krust Franchising, Inc. v. Actus Restaurant Group Inc.*,[81] the United States District Court for the Southern District of New York applied the manifest disregard for the law standard, but did not vacate the award. In that case, the franchisor filed a petition to vacate an arbitration award that granted two of its franchisees lost past profits, attorneys' fees and costs.[82] The arbitrator found that, inter alia, the franchisor violated the Florida Deceptive and Unfair Trade Practices Act (FDUTPA) for charging its family-owned stores lower royalties, food prices, and advertising fees than the other franchisees.[83] Citing to a case within the Eleventh Circuit, the franchisor argued that the arbitration award for lost past profits should be vacated on grounds of manifest disregard of the law because lost past profits are not recoverable under FDUTPA.[84] In refusing to vacate the award, the district court relied on the fact that courts in the Eleventh Circuit are split as to whether past lost profits are permissible under FDUTPA and explained that "where the arbitrator picked one side to resolve the conflicting precedent, the arbitral decision cannot be said to have exhibited manifest disregard of the law."[85]

In *Frye v. Wild Bird Centers of America, Inc.*,[86] the Fourth Circuit found that manifest disregard is established where an arbitrator "understands and correctly states the law, but proceeds to disregard the same."[87] In that case, a non-compete clause ambiguously stated that it applied "after termination" in one section of a franchise agreement and "in the event of termination or expiration of this Agreement for any reason" in a later section.[88] The court held that the arbitrator's application of the non-compete clause upon expiration, rather than termination, did not amount to the disregard or modification of unambiguous contract provisions.[89]

The Sixth Circuit held in *Marshall v. SSC Nashville Operating Co., LLC*[90] that an arbitrator did not manifestly disregard the law where he chose to weigh testimony of one witness more heavily than the vague answers of another witness in concluding that a valid non-discriminatory reason existed

79. *Id.* at 26–27.
80. *Id.* at 27.
81. Golden Krust Franchising, Inc. v. Actus Rest. Grp., Inc., No. 20-CV-7321 (KMK), 2021 WL 4974808 (S.D.N.Y. Oct. 26, 2021).
82. *Id*. at *2.
83. *Id*.
84. *Id.*
85. *Id.* (internal quotations and citations omitted).
86. Frye v. Wild Bird Ctrs. Of Am., Inc., 714 F. App'x 213 (4th Cir. 2017).
87. *Id.*
88. *Id.*
89. *See id.*
90. Marshall v. SSC Nashville Operating Co., LLC, 686 F. App'x 348 (6th Cir. 2017).

for plaintiff employee's lesser pay.[91] The court explained that manifest disregard "is not an easy standard to meet. A mere error in the interpretation or application of the law is insufficient. Rather, the decision must fly in the face of clearly established legal precedent."[92] Similarly, in the Tenth Circuit, a demonstration of "willful inattentiveness to the governing law" is required.[93] In the Seventh Circuit, the application of manifest disregard of the law is limited to two possibilities: an arbitral order requiring the parties to violate the law or an arbitral order that does not adhere to the legal principles specified by contract.[94]

Even where the doctrine of manifest disregard of the law is still recognized, vacating an award on that ground is an uphill battle. To aid in the application of the manifest disregard of the law doctrine, consider having the arbitrator confirm in a pre-hearing order which substantive law applies and then require a reasoned decision. This way, a party can later demonstrate that the arbitrator knew the law and disregarded it.

b) Circuits Where Manifest Disregard Is Not a Valid Ground to Vacate

The Ninth Circuit has held that manifest disregard does not constitute an independent ground, but rather an *extension* of the ground pursuant to FAA §10(a)(4) where an arbitrator exceeds his or her powers.[95] The Fifth, Eighth, and Eleventh Circuits similarly have abandoned the concept entirely since the Supreme Court's decision in *Hall Street*.[96]

c) Circuits Where Manifest Disregard Is Still Not Decided

The question of the validity of the manifest disregard of the law standard remains open in the District of Columbia Circuit and Third Circuit. For example, in *Crsytallex International Corp. v. Bolivarian Republic of Venez.*[97] and *Anouruo v. Tenet HealthSystem Hahnemann*[98] the courts did not take a position on whether a court may still vacate an award on the ground for a manifest disregard of the law after *Hall Street*. Instead, they gave deference to the arbitrator's award because there was no indication that the arbitrator disregarded the applicable law.[99]

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91. *Id*.
92. *Id*. at 353 (internal quotations and citations omitted).
93. A. Kershaw, PC v. Shannon L. Spangler, PC, 703 F. App'x 635, 639 (10th Cir. 2017).
94. George Watts & Son, Inc. v. Tiffany & Co., 248 F.3d 577 (7th Cir. 2001).
95. Sanchez v. Elizondo, 878 F.3d 1216, 1221–22 (9th Cir. 2018).
96. McKool Smith, P.C. v. Curtis Int'l, Ltd., 650 F. Appx 208, 211–12 (5th Cir. 2016) (holding manifest disregard is no longer a basis for vacating awards under the FAA); Medicine Shoppe Int'l, Inc. v. Tuner Invs., Inc., 614 F.3d 485, 489 (8th Cir. 2010) (holding an arbitration award may be vacated only for the reasons enumerated in the FAA); Campbell's Foliage, Inc. v. Fed. Crop Ins. Corp., 562 F. App'x 828, 831 (11th Cir. 2014) (holding in view of *Hall Street*, the judicially created bases for vacatur for manifest disregard of the law, in the Eleventh Circuit had formerly recognized is no longer valid).
97. Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela, 244 F. Supp. 3d 100, 121 n.31 (D.D.C. 2017).
98. Anouruo v. Tenet HealthSystem Hahnemann, 697 F. App'x 110, 111 n.1 (3d Cir. 2017).
99. *See id.* at 111 n.1; *Crystallex Int'l Corp.*, 244 F. Supp. 3d at 121 n.31.

(4) Application of the Manifest Disregard Doctrine

In courts which still apply the manifest disregard of the law standard, there is either a two- or three-part test. The First, Fourth, Sixth, and Tenth Circuits follow a two-part test and generally look at whether the applicable legal principle was (1) clearly defined; and (2) ignored or disregarded by the arbitrator.[100] For example, in *Arabian Motors Group, W.L.L. v. Ford Motor Co.*,[101] a foreign automobile dealer who was a party to a resale agreement with a domestic automobile manufacturer, brought a declaratory judgment action, arguing that it was not bound to arbitrate a dispute arising from the termination of the agreement. Following arbitration, the district court denied the dealer's motion to vacate on the grounds of manifest disregard of the law and granted the manufacturer's motion to confirm.[102] The Sixth Circuit affirmed, explaining that (1) the arbitrator was faced with an issue of national first impression; and (2) the arbitrator applied traditional tools of statutory interpretation without the aid of precedent that directly addressed the question.[103] Under these circumstances, "the arbitrator, at most, could have made an 'error in interpretation or application of the law,' and that is 'insufficient' to constitute a manifest disregard for the law."[104]

Coffee Beanery, Ltd. v. WW, L.L.C.105 is also illustrative. There, the Sixth Circuit applied the two-part test and held that an arbitration award finding that the franchisor was not required to disclose to a prospective franchisee that an officer had a prior felony conviction for grand larceny showed a manifest disregard of the law.[106] The Sixth Circuit explained that the applicable provision of the Maryland Franchise Act was clear in its requirement that all persons identified in the offering prospectus must disclose any prior felony that involves some misappropriation of property, and the arbitrator ignored this statute's requirement.[107]

The Second Circuit follows a three-part test, analyzing whether (1) the governing law that was allegedly ignored was "clear, and in fact explicitly applicable to the matter before the arbitrators";[108] (2) the "law was in fact improperly applied, leading to an erroneous outcome";[109] and (3) the arbitrator knew of the law's existence and its applicability to the problem

100. *See generally* Arabian Motors Grp., W.L.L. v. Ford Motor Co., 775 F. App'x 216, 219 (6th Cir. 2019); Wachovia Sec., LLC v. Brand, 671 F.3d 472, 483 (4th Cir. 2012); Legacy Trading Co. v. Hoffman, 363 F. App'x 633, 635 (10th Cir. 2010); Kashner Davidson Sec. Corp. v. Mscisz, 531 F.3d 68, 75 (1st Cir. 2008).

101. *Arabian Motors Grp.*, 775 F. App'x at 220.

102. *Id.*

103. *Id.*

104. *Id.* (citing Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jaros, 70 F.3d 418, 421 (6th Cir. 1995)).

105. Coffee Beanery, Ltd. v. WW, L.L.C., 300 F. App'x 415, 420 (6th Cir. 2008).

106. *Id.*

107. *Id.*

108. T. Co Metals v. Dempsey Pipe & Supply, 592 F.3d 329, 339 (2d Cir. 2010).

109. *Id.*

before him or her.[110] The first prong of this standard is often described as an "objective component," which requires a finding that the arbitrator has ignored well-defined and clearly applicable law, instead of merely erring.[111] This standard means that an award will not be vacated if the applicable law is ambiguous or if the resolution of the issue at hand required the application of an unclear rule of law to the factual situation.[112] The second prong is more straightforward because it recognizes that vacatur is not proper where an erroneous or proper application of the law would yield the same result.[113] The Second Circuit in *Duferco International Steel Trading v. T. Klaveness Shipping A/S*[114] referred to the third prong as a "subjective element," examining the actual knowledge of the arbitrator, and requires that, to intentionally disregard the law, an arbitrator must have known of the law's existence and its applicability to the problem presented. In *Duferco*, the court refused to vacate the underlying arbitration award and explained that, absent an arbitrator's intentional disregard of the law, it takes a "lenient subjective inquiry in recognition of the reality that arbitrators often are chosen for reasons other than their knowledge of applicable law, and that is often more important to the parties to have trustworthy arbitrators with expertise . . . ."[115]

Finally, a court would likely not second-guess an arbitrator's decision where it is possible for the arbitrator to have reached a decision based on the evidence presented. This circumstance was the case in *Renard v. Ameriprise Financial Services, Inc.*,[116] where a plaintiff financial advisor sought to vacate an arbitration award in favor of a brokerage firm that, inter alia, rejected plaintiff's tort counterclaims in the underlying arbitration proceeding. Plaintiff argued that the arbitration panel manifestly disregarded Minnesota law regarding tortious interference with business relations and the Wisconsin Fair Dealership Law.[117] The Seventh Circuit explained that, even though the panel did not issue a written decision and may have been incorrect in determining that federal laws preempted the state laws, a "[s]imple mistake of law is not enough" and "such an error falls short of a manifest disregard of the law."[118] The court further explained that the arbitrators did what the parties contracted for by resolving the issue on the laws and arguments presented to them and noted that "[i]t is not manifest disregard of a law to consider that

110. *Id.*
111. *The "Manifest Disregard of Law" Doctrine and International Arbitration in New York*, N.Y. City Bar, https://www2.nycbar.org/pdf/report/uploads/20072344-ManifestDisregardofLaw--DoctrineandInternationalArbitrationinNewYork.pdf (last visited July 30, 2021).
112. Bear, Stearns & Co. v. 1109580 Ontario, Inc., 409 F.3d 87, 92 (2d Cir. 2005).
113. Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S, 333 F.3d 383, 390 (2d Cir. 2003).
114. *Id.*
115. *Id.* at 390
116. Renard v. Ameriprise Fin. Servs., Inc., 778 F.3d 563, 568 (7th Cir. 2015).
117. *Id.* at 565.
118. *Id.* at 568.

law and its relation to other laws and then conclude that the law does not apply in the specific factual situation at issue."[119]

With a dearth of case law concerning vacating arbitration awards in the franchise context, it is more difficult to predict how courts with varying standards will approach a franchisor's or franchisee's application to vacate an unfavorable award. If, for example, in an award, an arbitrator ignored Item 4's requirement[120] that senior management disclose any personal bankruptcy filed during the past ten years, or disregarded as inconsequential a written "break even" analysis given to prospective franchisees that was not set forth in Item 19, would a court vacate that award? If the arbitrator was made aware of the Federal Trade Commission's disclosure rules[121] at the outset of the proceeding, the claimant presented evidence that the respondent violated those rules, and the arbitrator wrote a reasoned award disregarding those rules, then there is a stronger probability that courts recognizing the manifest disregard of the law doctrine would find that the award should be vacated compared to courts that do not.

IV. Conclusion

Although arbitration is often heralded as a private, faster, and cheaper alternative to court litigation, it is imperative to keep in mind that arbitrators are not necessarily obligated to follow the law. That said, choosing the right arbitrator at the outset, having choice of law provisions, both substantive and procedural, in the franchise agreement's arbitration clause, and requiring a reasoned award should militate against an arbitration award in which the law is ignored.

In particular, when drafting or reviewing an arbitration clause in a franchise agreement, consider (i) whether to expressly require that the arbitrator has franchise experience; and (ii) in addition to the substantive choice of law provision in the franchise agreement, whether there is a more beneficial choice of law to apply procedurally if an arbitration award needs to be vacated, such as the FAA—and whether to consider if the federal circuit court of appeals having jurisdiction over your dispute will apply the manifest disregard of the law standard; and (iii) whether to select a specific ADR organization, such as AAA or JAMS, to administer the arbitration, including the use and application of such organization's rules. This option will include whether the arbitrator must issue a reasoned award that should include the law relied upon in the arbitrator's decision, or if there is a right to an appeal. When conducting the arbitration it is crucial that the arbitrator be made aware of the applicable law, so if it is ignored a party may have grounds to vacate the award.

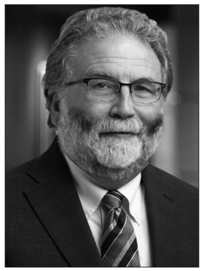
119. *Id.*
120. 16 C.F.R. § 436.5(d).
121. 16 C.F.R. pt. 436.

The arbitration clause in the franchise agreement may seem relatively unimportant until after a dispute is resolved in an unfavorable award. It is important to know long before that point what options a client may have so that steps may be taken before, during, and after the arbitration hearing to vacate the award if the arbitrator does not follow the law.

Equitable Recoupment: A Limited Remedy for Dealer or Franchise Terminations When Statutory Protection Is Absent

*James J. Long & Jevon C. Bindman**

I. Introduction


Mr. Long


Mr. Bindman

The common law doctrine of equitable recoupment provides gap-filler protection in certain instances for franchisees or dealers who do not qualify for statutory or contractual protection regarding terminations. In instances in which a franchisee is not protected by a franchise relationship statute, or when a dealer is not protected by a general dealer statute (such as the Wisconsin Fair Dealership Law[1]) or a special industry statute (such as an Agricultural Dealer Act[2] or a Heavy and Utility Equipment Dealer Act[3]), the equitable recoupment doctrine implies as a matter of law in an at-will contract a period of time that allows the terminated franchisee or dealer to recoup certain investments required by the dealer or franchise relationship. The Eighth Circuit articulated the purpose of, and basis for, this remedy almost fifty years ago: "The doctrine of recoupment is designed to remedy the inequity which arises when a manufacturer, after having required a distributor to make a sizeable investment in the furtherance of

1. Wis. Stat. § 135.01 *et seq.*
2. *E.g.*, Minn. Stat. § 325E.061 *et seq.*
3. *E.g.*, Minn. Stat. § 325E.068 *et seq.*

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a distributorship, terminates the distributor with substantial unrecovered expenditures."[4]

The remedy is limited, however, in that it only allows for recovery of unrecouped investments, unlike remedies under a franchise or special industry statute, which generally provide for recovery of future lost profits but for the wrongful termination.

The required elements of an equitable recoupment claim are

1) a contract that is terminable at will;
2) that is not terminated for "just cause";
3) for which expenditures or investments by the dealer or distributor were required; and
4) under which the expenditures or investments made by the dealer or distributor were not recouped during the relationship.[5]

A plaintiff has the burden of proof on all four elements.[6] If those elements are satisfied, then the contract will have an implied duration term imposed, equal to a reasonable amount of time for the plaintiff to "recoup his investment of time, labor and money" to that dealership, distributorship, or franchise.[7]

The authors recently completed a two and one-half-week jury trial defending against an equitable recoupment claim. In that case, the counter-plaintiff alleged that it qualified for protection from termination of a franchise relationship—but then asserted a claim for equitable recoupment when the franchise act claim was dismissed on summary judgment. This article will focus on how the case law addresses issues that arise under the elements of an equitable recoupment claim, including allowable damages under such a claim. It also provides some practical advice on how to address these issues and on traps that can arise in prosecuting and defending equitable recoupment claims. The article concludes with an examination of the related common law and UCC doctrine that implies a reasonable notice period for termination of at-will contracts. In most instances, this reasonable notice doctrine is separate and distinct from equitable recoupment, with its own limitations. In some cases, however, the two doctrines are intermingled, and this article provides advice on how to address that situation too.

4. Ag-Chem Equip. Co. v. Hahn, Inc., 480 F.2d 482, 486 (8th Cir. 1973).

5. *Id.* Some courts have also required that the distributorship be exclusive. *See, e.g.*, Healthco Int'l, Inc. v. A-dec, Inc., No. CIV. A. 87-0235-S, 1989 WL 104064, at *9 (D. Mass. Apr. 17, 1989) (citing cases). But most courts have not recognized this factor at all, and those that do generally note that a lack of exclusivity does not preclude recovery, though it may affect amount of recovery. *See* Sofa Gallery, Inc. v. Stratford Co., 872 F.2d 259, 262 (8th Cir. 1989).

6. *See Sofa Gallery*, 872 F.2d at 263 ("On remand, [the plaintiff] will bear the burden of proving the extent to which its investments have gone unrecouped.").

7. Cambee's Furniture, Inc. v. Doughboy Recreational, Inc., 825 F.2d 167, 173 (8th Cir. 1987).

II. Historical Development of Equitable Recoupment

The doctrine of equitable recoupment[8] is occasionally referred to as the "Missouri rule," as the Missouri Supreme Court appears to have first recognized recoupment as an affirmative claim in the 1894 case of *Glover v. Henderson*.[9] In *Glover*, the plaintiff was an agent hired by the defendant to sell plots of land. The plaintiff paid for his expenses out of pocket, and he received what was essentially a commission for each plot sold. After a dispute arose, the defendant terminated his contract with the plaintiff. The jury awarded the plaintiff the reasonable value of his services and expenses incurred, less payment received.[10]

The Missouri Supreme Court affirmed, reasoning that the plaintiff was entitled to recovery under the theory of quantum meruit:

> [W]here an agent is employed to perform an act which involves expenditure of labor and money before it is possible to accomplish the desired object, after the agent has in good faith incurred expense and expended time and labor, but before he has had a reasonable opportunity to avail himself of the results of this preliminary effort, it could not be permitted that the principal should then terminate the agency, and take advantage of the agent's services, without rendering any compensation therefor.[11]

Numerous jurisdictions adopted the rule articulated in *Glover* and its progeny over the following decades.[12] The rule gained a particularly strong

8. There is "a similarly-named 'recoupment doctrine,' which functions as a defense to a plaintiff's breach-of-contract claim and . . . 'can only be utilized to reduce or avoid the plaintiff's recovery.'" Glacial Plains Coop. v. Chippewa Valley Ethanol Co., No. A19-0254, 2019 WL 4409417, at *4 n.2 (Minn. Ct. App. Sept. 16, 2019) (quoting Household Fin. Corp. v. Pugh, 288 N.W.2d 701, 703–04 (Minn. 1980)). The two doctrines are separate and distinct and should not be confused or combined.

9. Glover v. Henderson, 25 S.W. 175, 177 (Mo. 1894).

10. *Id.*

11. *Id.*

12. *See*, *e.g.*, Tractor & Farm Supply, Inc. v. Ford New Holland, Inc., 898 F. Supp. 1198, 1207 (W.D. Ky. 1995) ("[R]ecoupment implies a minimum term in an at-will agreement, which is defined as the length of time in which a dealer can reasonably be expected to recoup its investment and holds that it is a breach of contract if the agreement is *terminated* before that time."); A.R. Dervaes Co v. Houdaille Indus., Inc., No. 6471, 1981 WL 7625, at *5 (Del. Ch. Sept. 29, 1981) ("[W]here substantial sums of money were expended in developing a distributorship system throughout a certain territory, it was held that the distributor was entitled to retain his franchise for such a period of time as would enable it to recoup expenditures incurred in reliance upon the agreement.") (internal quotations omitted); Florida-Georgia Chem. Co. v. Nat'l Labs., Inc., 153 So. 2d 752, 755 (Fla. Dist. Ct. App. 1963) (quoting Meyer v. Pulitzer Publ'g Co., 136 S.W. 5, 7 (Mo. Ct. App. 1911)) ("If it appears the agent, induced by his appointment, has in good faith incurred expense, devoted time, and bestowed labor in the matter of the agency without having a sufficient opportunity to recoup such outlays from the undertaking, the principal will be required to compensate him in that behalf . . . ."); Cox v. Doctor's Assocs., Inc., 613 N.E.2d 1306, 1316 (Ill. App. Ct. 1993); Nathan Elson & Co. v. H. Beselin & Son, 218 N.W. 753, 756 (Neb. 1928) ("When the obligor has expended a substantial sum of money or value . . . for the benefit of obligee, he ought, through fairness, to have a reasonable time and notice of the cancellation of the contract in order that he might have a reasonable opportunity to put his house in order."); Sw. Distrib. Co. v. Olympia Brewing Co., 565 P.2d 1019, 1024 (N.M. 1977) ("Some courts have held that even though no duration was agreed upon, an exclusive distributorship will extend for a reasonable time or until the dealer has recouped his investment.").

foothold in the Eighth Circuit, which first adopted the Missouri rule in 1939 in a case involving Missouri law,[13] and has since applied the doctrine in cases involving the laws of many states, particularly Minnesota.[14] The Fourth and Seven Circuits have also adopted the doctrine of equitable recoupment when applying Illinois and South Carolina law.[15] Only a few courts have expressly declined to apply the doctrine.[16]

III. The Required Elements of an Equitable Recoupment Claim

A. *An At-Will Contract*

Equitable recoupment only provides a remedy for a contract that is terminable at will.[17] The rationale for the terminable-at-will requirement is to protect a dealer or distributor from being terminated shortly after making a substantial investment.[18] Equitable recoupment is limited to contracts that are at will or terminable at will because, if the contract terminated after a specified period of time, courts will assume that both parties understood they had no expectation of continuing the relationship beyond that period.[19] Therefore, a termination at the end of the contract could not be contrary to either party's expectations and could not result in unfairness to the non-terminating party, as the length of the contract was an expressly bargained for term.

Equitable recoupment clearly may apply if the contract has an indefinite length.[20] But even a contract with an express duration may be eligible for equitable recoupment in certain circumstances. In *Schultz v. Onan Corp.*, the contract had a fixed termination date, but could be terminated by either party "for any reason upon sixty (60) days written notice."[21] The

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13. Terre Haute Brewing Co. v. Dugan, 102 F.2d 425, 427 (8th Cir. 1939) ("[I]f it appears that the agent, induced by his appointment, has incurred expense in the matter of the agency without having had sufficient opportunity to recoup such from the undertaking, the principal will be required to compensate him in that behalf.").

14. *See* Cambee's Furniture, Inc. v. Doughboy Recreational, Inc., 825 F.2d 167, 173 (8th Cir. 1987) ("In cases arising under Minnesota law, we held that the manufacturers breached their contracts by terminating dealerships without just cause before the dealers had a reasonable time to recoup their expenses.").

15. *See, e.g.*, Fargo Glass & Paint Co. v. Globe Am. Corp., 161 F.2d 811, 813 (7th Cir. 1947) (applying Illinois law); Jack's Cookie Co. v. Brooks, 227 F.2d 935, 938–39 (4th Cir. 1955) (applying South Carolina law).

16. *See infra* Part V.

17. Schultz v. Onan Corp., 737 F.2d 339, 347 (3d Cir. 1984); *see* Ag-Chem Equip. Co. v. Hahn, Inc., 480 F.2d 482, 487 (8th Cir. 1973) (stating the existence of a terminable-at-will agreement is "a threshold requirement to the right [of recoupment]").

18. *See Schultz*, 737 F.2d at 347 (stating that termination after the making of a substantial investment "is precisely the eventuality to which the recoupment doctrine is addressed").

19. *See* Sofa Gallery, Inc. v. Stratford Co., 872 F.2d 259, 262 (8th Cir. 1989) (stating the investment must be made "in reliance on the agreement").

20. *See* Ag-Chem Equip. Co. v. Hahn, Inc., 480 F.2d 482, 487 (8th Cir. 1973) ("[A] threshold requirement to the right is the existence of an agreement which is terminable at will. . . . [A] contract having no definite duration is terminable at will . . . .").

21. *Schultz*, 737 F.2d at 342.

Third Circuit, applying Minnesota law, held that this termination language "renders the agreement an at-will contract within the meaning of the recoupment doctrine."[22] The Court determined that it is "the 'at-will' nature of the agreement—leaving the franchisee unprotected in the event of a sudden termination without just cause—that gives rise to the recoupment doctrine."[23] The court reasoned that it is irrelevant whether the at-will nature of the agreement derives from an indefinite duration of the contract or from the ability to terminate a fixed duration contract without cause—the impact on the dealer is the same.[24]

Thus, if a contract that appears to be of fixed duration contains a termination-without-cause provision, equitable recoupment still may be applied. Other courts have criticized this approach, however, stating that if the contract specifically contemplates termination, then "recoupment becomes a device by which judges may rescue a party from its bad bargain by taking money away from the other party" who acted in reliance on the contract.[25] Plaintiff's counsel should assess, and consider arguing, that reliance on a termination-without-cause provision can give rise to an equitable recoupment claim, even if the contract has a fixed duration. The strength of this argument will depend in part on the specific jurisdiction's precedent and in part on the equities in the particular fact pattern at issue. Conversely, Defendant's counsel should lean heavily into the argument that this approach seeks to rewrite the contract by transforming a terminable on limited notice contract (which is contractual arrangement that parties may seek out) into a contract of some unidentified duration. This issue presents an example of how the limited caselaw on equitable recoupment often presents room for persuasive arguments on both sides of an issue.

B. *The Contract Was Terminated Without "Just Cause"*

All equitable recoupment cases make clear that if the contract is terminated for some type of proper cause, then the doctrine does not apply.[26] This requirement makes sense because the doctrine is an equitable remedy to prevent unfairness to the terminated party. If there was reason or justification for the termination, such that it was not unfair to the terminated party, the

22. *Id.* at 347; *see also* Tractor & Farm Supply, Inc. v. Ford New Holland, Inc., 898 F. Supp. 1198, 1207–08 (W.D. Ky. 1995) (denying summary judgment on recoupment claim where contract provided for automatic three-year extensions unless a party gave six months' notice not to renew); Gibbs v. Bardahl Oil Co., 331 S.W.2d 614, 622 (Mo. 1960) (concluding provision in contract permitting termination on thirty days' notice did not preclude agent from seeking recoupment).

23. Schultz v. Onan Corp., 737 F.2d 339, 347 (3d Cir. 1984).

24. *Id.*

25. Retail Assocs., Inc. v. Macy's E., Inc., 245 F.3d 694, 698 (8th Cir. 2001); *see also* New England Surfaces v. E.I. Du Pont de Nemours & Co., 517 F. Supp. 2d 466, 485–86 (D. Me. 2007) (criticizing *Schultz* and adopting the reasoning of *Retail Associates*), *aff'd in part, rev'd in part on other grounds*, 546 F.3d 1 (1st Cir. 2008).

26. *See, e.g.*, Cox v. Doctor's Assocs., Inc., 613 N.E.2d 1306, 1316–17 (Ill. App. Ct. 1993) (collecting cases and concluding franchisor had just cause to terminate franchise).

rationale for implying an additional duration to recoup unrecouped expenditures no longer applies.

The problem facing attorneys advising or litigating equitable recoupment claims is the lack of a clear standard and definition of the "cause" required to take the termination of an at-will contract outside of the parameters of equitable recoupment. Most cases refer to whether a termination was without "just cause."[27] Several cases use even less exacting language, such as "cause," "good cause," or "unreasonable."[28]

The problem arises in defining and applying this ambiguous so-called standard. There is little or no case law defining the term "just cause."[29] Although several courts have found that "just cause" is synonymous with "good cause,"[30] none is within the equitable recoupment context.[31] Franchise or industry-specific dealer statutes that regulate termination or failure to renew a contract almost always provide a statutory definition for "good cause," which provides at least some clarity as to the standard for those specific statutes.[32] No such definition exists for "just cause," and thus fashioning both arguments, and jury instructions, for whether the required "just cause" exists can be problematic. There is a dearth of guidance in the case law on how to address this issue. The parties and the trial court must decide whether to provide the jury a definition of just cause despite the lack of an appellate-court-approved definition (thus making the issue ripe for appeal), or whether to simply state that the standard is "just cause" and allow the jury to interpret the ordinary meaning of that term.

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27. *See* Ag-Chem Equip. Co. v. Hahn, Inc., 480 F.2d 482, 488 (8th Cir. 1973) (issue of "whether the distributorship was terminated for *just cause*") (emphasis added); *see also* Schultz v. Onan Corp., 737 F.2d 339, 346 (3d Cir. 1984) ("The doctrine of equitable recoupment applies when such a contract is terminated without *just cause* . . . .") (emphasis added); Healthco Int'l, Inc. v. A-dec, Inc., No. CIV. A. 87-0235-S, 1989 WL 104064, at *9 (D. Mass. Apr. 17, 1989) (same); *Cox*, 613 N.E.2d at 1316 (same).

28. *See* Sofa Gallery, Inc. v. Stratford Co., 872 F.2d 259, 259 (8th Cir. 1989) ("[W]here a manufacturer terminates a distributorship agreement *without cause* . . . .") (emphasis added); Cambee's Furniture, Inc. v. Doughboy Recreational, Inc., 825 F.2d 167, 173 (8th Cir. 1987) (plaintiff "entitled to a reasonable period to recoup its investment, during which the agreement may not be terminated without *good cause*"); Claussen & Son, Inc. v. Theo. Hamm. Brewing Co., 395 F.2d 388, 390 (8th Cir. 1968) ("[T]he supplier thereafter *unreasonably* terminates the contract . . . .") (emphasis added).

29. *See, e.g.*, Deli v. Univ. of Minnesota, 511 N.W.2d 46, 52 (Minn. Ct. App. 1994) ("Minnesota courts have not adopted a standard definition of 'just cause.'").

30. *See, e.g.*, Hilligoss v. Cargill, Inc., 649 N.W.2d 142, 148 (Minn. 2002) ("[I]n the context of employment terminations, "good cause," "just cause," and "cause" are interchangeable, and none carries any higher level of proof than another."); Straw v. Visiting Nurse Ass'n & Hospice of VT/NH, 86 A.3d 1016, 1024 (Vt. 2013) ("[T]here is no meaningful difference between 'good cause,' 'just cause,' and merely 'cause.'").

31. In one case, the Illinois Appellate Court concluded that a franchisee's failure to pay royalties doubled as "good cause" to terminate the franchise under the franchise statute, as well as "just cause" to preclude equitable recoupment, but the court did not address the difference between those two standards. *Cox*, 613 N.E.2d at 1316–17.

32. *See, e.g.*, Minn. Stat. § 80C.13, subd. 3(b) ("'Good cause' means failure by the franchisee to substantially comply with the material and reasonable franchise requirements imposed by the franchisor . . . .").

Moreover, it may confuse juries if they are told on the one hand that the parties may terminate the contract "at will" (i.e., without cause), yet the plaintiff is entitled to equitable recoupment if there was no "just cause" for the termination. At a trial, a jury will almost certainly have to answer a question on a special verdict form of whether the plaintiff proved that the defendant did not have "just cause" to terminate the "at will" contract. The seemingly contradictory nature of the question inherently results from the elements of equitable recoupment. The distinction that may be lost on many is that, although the contract can be terminated without cause, recoupment is an equitable remedy outside of the terms of the contract. Thus, in circumstances when the other elements of equitable recoupment are present, the doctrine applies unless there is just cause for the termination. The practical problem, however, results from no precise definition of "just cause" existing.

C. *Required Investment*

A third required element is that the manufacturer or supplier must require the "distributor to make a sizeable investment in furtherance of a distributorship."[33] Courts may decline to apply equitable recoupment if the plaintiff was not required to make a substantial capital expense. In *RJM Sales & Marketing, Inc. v Banfi Products Corp.*, for example, the district court held that equitable recoupment was inapplicable because "with the exception of some minor advertising costs, RJM's 'investment' consisted entirely of employee expense."[34]

Recoverable expenses may be incurred at the beginning of the relationship or during the relationship as continuing investments.[35] Early cases held that equitable recoupment applied only to large initial investments.[36] The Eighth Circuit in *Ag-Chem Equipment Co. v. Hahn, Inc.* rejected that argument, and the law generally now is clear that continued, unrecouped investments qualify under the doctrine.[37] Thus, equitable recoupment potentially can apply to relationships that have been ongoing for a number of years.

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33. Ag-Chem Equip. Co. v. Hahn, Inc., 480 F.2d 482, 486 (8th Cir. 1973); *see, e.g.*, Tractor & Farm Supply, Inc. v. Ford New Holland, Inc., 898 F. Supp. 1198, 1207 (W.D. Ky. 1995); Ernst v. Ford Motor Co., 813 S.W.2d 910, 919 (Mo. Ct. App. 1991). This investment is conceptually different from the requirement of a franchise fee under a franchise relationship statute. Franchise fees must be paid to the franchisor. *See, e.g.*, Hamade v. Sunoco Inc. (R & M), 721 N.W.2d 233, 244 (Mich. Ct. App. 2006). By contrast, the sizeable investment that is recoverable by equitable recoupment can simply be business-related expenditures, regardless of to whom they are made.

34. RJM Sales & Mktg., Inc. v Banfi Prods. Corp., 546 F. Supp. 1368, 1376 (D. Minn. 1982).

35. *See* Schultz v. Onan Corp., 737 F.2d 339, 349 (3d Cir. 1984)("Article 9 of the Schultz-Onan agreement specifies at great length the continuing investment obligations imposed on the distributor."); *Ag-Chem*, 480 F.2d at 488 (noting "the distributorship required a continual investment").

36. *See Ag-Chem*, 480 F.2d at 487 ("Recoupment has traditionally been confined to the recovery of preliminary expenses incurred in setting up a distributorship system, such as sums expended for initial promotion and renting a facility."); *see also Tractor & Farm Supply*, 898 F. Supp. at 1207 (questioning whether recoupment was limited to start-up costs or permitted recovery of continuing investments as well).

37. *Ag-Chem*, 480 F.2d at 488 (stating "continued investment made in the establishment and development of the . . . distributorship" was discoverable); *see also* Sofa Gallery, Inc. v. Stratford

The Eighth Circuit in *Ag-Chem* also addressed which expenses qualify as investments eligible for equitable recoupment. In that case, the plaintiff sought recovery of all expenses that were "attributable to future development," including many categories of ordinary business expenses.[38] Although the court remanded for a new trial based on the trial court's erroneous admission of evidence that failed to account for profits that offset the plaintiff's expenses,[39] the court added a "cautionary note" regarding the admission of "certain everyday expenditures."[40] The court noted that some such expenses, "such as advertising or salesmen's salaries may under certain circumstances be in the nature of a capital investment," but that "more proof is required than the mere assertion of a company official that this is the case."[41] The court also expressed extreme skepticism that expenses such as "office supplies, postage, legal and audit, and telephone" were recoverable under any circumstance.[42] The closer that the expenditure is to a capital investment, the more likely that it will qualify for recoupment, while the more that it resembles ordinary business expenses, the less likely that it is to qualify. There is significant gray area, however, as to what will and will not qualify as an expenditure that can be recouped, and plaintiff's counsel should focus on characterizing the expenditures for which plaintiff seeks recoupment as non-ordinary expenses that were investments required by the manufacturer or supplier. Defense counsel should attempt to characterize the expenses conversely as ordinary business expenses or as expenditures (such as cost of goods sold) that, by their very nature, are recouped when, or shortly after, they are incurred.

Finally, although it may appear obvious, it is important that the plaintiff clearly identify the specific investments for which it seeks recovery as unrecouped expenditures. Focusing on specific unrecouped expenditures clearly is a necessary element of proving equitable recoupment damages.[43] Moreover, demonstrating with specificity investments that were made in reliance of the continuing nature of the relationship can underscore with a jury or court the necessity of this remedy. It is much more powerful for a plaintiff to be able to point to its identification of a purchase made sixty days prior to termination of a $50,000 improvement to its warehouse—which was made

Co., 872 F.2d 259, 263 (8th Cir. 1989) ("We also disagree . . . that recoupment damages are available only for large, preliminary investments made at the outset of the distributorship.").

38. *Ag-Chem*, 480 F.2d at 488.

39. *See infra* Part IV(B).

40. *Ag-Chem*, 480 F.2d at 489–90.

41. *Id.* at 490.

42. *Id.*; *see also* McGinnis Piano & Organ Co. v. Yamaha Int'l Corp., 480 F.2d 474, 482 (8th Cir. 1973) (noting that, on remand for new trial, "care must be exercised in receiving evidence as to past expenses so that the jury does not get the impression that recovery can be had for normal operating expenses"); RJM Sales & Mktg., Inc. v Banfi Prods. Corp., 546 F. Supp. 1368, 1376 (D. Minn. 1982) (stating that the plaintiff's "'investment' consist[ing] entirely of employee expense . . . makes the recoupment doctrine inapplicable").

43. Ag-Chem Equip. Co. v. Hahn, Inc., 480 F.2d 482, 490 (8th Cir. 1973) (noting in dicta that additional proof may be required to determine whether an expenditure is "in the nature of a capital investment").

specifically for this distribution relationship and arguably has no value outside of that relationship—provides much stronger justification for a recovery than a more generic listing of categories of investments. Conversely, to the extent the plaintiff fails to identify investments with specificity, defendants should emphasize that lack of specificity as evidence of the speculative nature of the asserted damages.

D. *Investments Are Unrecouped*

A key damages concept is that a dealer or distributor may not recover investments or expenditures that have already been recouped or recovered.[44] Thus, profits obtained during the agreement are offset against those investments for purposes of determining damages in an equitable recoupment case.[45] In short, a plaintiff whose net profits over the course of the relationship exceed the amount of its investments is not eligible for equitable recoupment.[46] The plaintiff has the "burden of proving the extent to which its investments have gone unrecouped."[47]

That profits realized from investments made during the relationship are deducted from recoupment damages presents a trap for the unwary plaintiff and explains the limited applicability of this remedy in a number of circumstances. Equitable recoupment often is pleaded along with, or in the alternative to, a wrongful termination claim based upon a franchise or dealer statute requiring notice and/or good cause for termination. Violations of such statutes typically entitle the plaintiff to lost future profits, and therefore the plaintiff has an incentive to show that the relationship was profitable in order to establish a large future profits number. But if the relationship is subsequently found not to be a franchise, or the statute upon which the plaintiff relies is otherwise held to be inapplicable, the plaintiff's argument that it had obtained large profits from the relationship necessarily reduces or

44. Sofa Gallery, Inc. v. Stratford Co., 872 F.2d 259, 262 (8th Cir. 1989) ("[W]here a manufacturer terminates a distributorship agreement without cause before the dealer has recouped its investment, the dealer may recover its unrecouped expenditures.").

45. *Ag-Chem*, 480 F.2d at 489 ("[T]he existence of substantial profits may very well indicate that the expenditures made were substantially amortized through the production of realized profits during the operation of the distributorship."); *see also Sofa Gallery*, 872 F.2d at 263 (stating the plaintiff "cannot recover recoupment damages for any investments on which it has realized a profit over and above operating expenses"); Schultz v. Onan Corp., 737 F.2d 339, 349 (3d Cir. 1984) (finding error where "the court did not direct that income earned as a fruit of investments made at Onan's behest be subtracted in order to determine 'unrecouped investment'").

46. *See, e.g.*, Healthco Int'l, Inc. v. A-dec, Inc., No. CIV. A. 87-0235-S, 1989 WL 104064, at *9 (D. Mass. Apr. 17, 1989) ("[The plaintiff] has not alleged that it suffered a net loss during its 14 year tenure as a[] . . . distributor, an allegation which would be necessary to any recoupment claim."); Sw. Distrib. Co. v. Olympia Brewing Co., 565 P.2d 1019, 1024 (N.M. 1977) (granting judgment to the defendant where the plaintiff "had ample opportunity to recoup its initial and subsequent investments and the record shows that [its] investments reaped many years of profit").

47. *Sofa Gallery*, 872 F.2d at 259. Open issues exist as to how this principle should be applied in practice. For instance, the authors know of no case that addresses whether a net present value analysis should be applied in determining at trial the value of unrecouped investments made several years earlier.

eliminates recoverable equitable recoupment damages. To avoid this trap, a plaintiff must determine early in the case as to whether its most viable cause of action is wrongful termination under a statute (or the terms of the contract) or under the doctrine of equitable recoupment.

IV. What Damages Are Recoverable Under an Equitable Recoupment Claim?

A. *Reasonable Period*

A plaintiff who prevails on the above elements is entitled to a "reasonable opportunity to recoup his expenditures."[48] In other words, "[i]t is not a question of whether distributor has recouped his expenditures, but whether he has had a fair opportunity."[49] This clarification accounts for the fact that, in some circumstances, the plaintiff should have been able to recoup its expenses during the relationship, or that a relationship was unprofitable such that a full recovery of the plaintiff's investment is unwarranted.[50] In *General Tire & Rubber Co. v. Distributors, Inc.*, for example, the North Carolina Supreme Court noted that the distributorship at issue had already existed for two years and had become "increasingly unprofitable," which were factors for the jury to consider when determining how long of a recoupment period was "reasonable."[51]

Determination of "what period of time is, in fact, 'reasonable' varies with the circumstances of each case" and is unlikely to be overturned on appeal.[52] What is clear, however, is that the "reasonable" amount of time is tied to the amount of unrecouped expenses and the amount of time required to recoup those investments. In instances where the parties' relationship continued for many years before termination, courts often find that no additional period to recoup investments is warranted.[53] In *Lockewill, Inc. v. U.S. Shoe Corp.*, a shoe supplier entered into an exclusive distributorship agreement with the plaintiff, which agreement continued for over nine years.[54] The Eighth Circuit concluded that the plaintiff was entitled to a reasonable period at the beginning of the relationship to recoup its initial investment.[55] But the court concluded the trial court should have granted a directed verdict to the supplier because "reasonable men could not differ on the proposition that [after nine years] such a reasonable time or period had expired."[56]

48. *Ag-Chem*, 480 F.2d at 486.
49. Gen. Tire & Rubber Co. v. Distribs., Inc., 117 S.E.2d 479, 489 (N.C. 1960).
50. *See id.*
51. *Id.*
52. *Ag-Chem*, 480 F.2d at 486.
53. *See* Bushwick-Decatur Motors v. Ford Motor Co., 116 F.2d 675, 676 (2d Cir. 1940) (nothing that recoupment is "seemingly not applicable where the relationship has already endured for some time").
54. Lockewill, Inc. v. U.S. Shoe Corp., 547 F.2d 1024, 1029 (8th Cir. 1976).
55. *Id.*
56. *Id.*; *see also* Spencer v. Gen. Elec. Co., 243 F.2d 934, 939 (8th Cir. 1957) (concluding the plaintiff was reasonably compensated for expenses); Mech. Rubber & Supply Co. v. Am. Saw &

Whether the plaintiff's investments into the relationship have continuing value after the relationship is ended may also impact the reasonableness of a recoupment period.[57] For example, the Eighth Circuit noted in dicta on a remand for new trial that the defendant's investment in a storage room and equipment may have continued use as he was "still in the beer business, and a little paint would inexpensively change the lettering on the side of the tractor."[58] The rationale for considering whether the investment at issue has value transferable to other uses is that the plaintiff is not damaged by the termination if the investment can be productively used elsewhere by the plaintiff.

Thus, counsel should focus on, and develop the record on, the following issues concerning the investments for which Plaintiff seeks recovery:

1) Is it an initial or continuing investment?
2) Is the investment more similar to a capital expenditure or to an ordinary business expense?
3) Has the investment been recouped?
4) If the investment has not been recouped, did Plaintiff have a reasonable amount of time to recoup the investment? and
5) Does the investment have value outside of the terminated relationship?

B. *Future Lost Profits Are Not Recoverable*

Lost future profits are not recoverable under equitable recoupment.[59] The rationale behind this prohibition is that "recoupment is an equitable doctrine intended to restore the franchisee's lost investment, not to award damages at law for the going value of the business."[60]

This distinction makes sense: the doctrine of equitable recoupment has its origins in quantum meruit, which entitles a party to the reasonable value of its past services that benefit another.[61] Recovery of future lost profits goes beyond reimbursing a party for the services that it has already performed.

In *McGinnis Piano & Organ Co. v. Yamaha International Corp.*, the trial court gave a jury instruction that "*[f]uture profits, if proven to a reasonable*

Mfg. Co., 810 F. Supp. 986, 996 (C.D. Ill. 1990) ("Since it is undisputed that the parties' relationship has gone back almost 25 years, it is fatal to [the plaintiff's complaint] to fail to allege that it has not had a reasonable time to recoup its initial expenses."). One would expect these cases might have come out differently if the plaintiff had argued that it was required to make continuing investments over the course of the relationship that it did not have time to recoup.

57. *See* Terre Haute Brewing Co. v. Dugan, 102 F.2d 425, 428 (8th Cir. 1939).

58. *Id.*

59. Sofa Gallery, Inc. v. Stratford Co., 872 F.2d 259, 263 (8th Cir. 1989) ("[L]oss of future profits are not recoverable under the doctrine."); W.K.T. Distrib. Co. v Sharp Elecs. Corp., 746 F.2d 1333, 1336 (8th Cir. 1982) (holding plaintiff was "not permitted to recover damages for future lost profits").

60. Schultz v. Onan Corp., 737 F.2d 339, 348 (3d Cir. 1984).

61. Greenwich Ins. Co. v. Capsco Indus., Inc., 934 F.3d 419, 423 (5th Cir. 2019) ("[I]f one knowingly accepts services rendered by another, and the benefit and result thereof, the law implies a promise on the part of the one who so accepts with knowledge, to pay the reasonable value of such services rendered.").

certainty, may be included as part of the damages."[62] The Eighth Circuit read that instruction as "permitting the jury to add [the plaintiff's] unrecouped investment and future profits in computing damages, and this is clearly error."[63] Similarly, in *Schultz v. Onan Corp.*, the Third Circuit concluded that the trial court erred by awarding "[t]he going value of the business," which "was computed by considering the present value of projected income streams."[64] This conclusion was error because recoupment awards damages for past investments, not the present value of the business, which is based on future performance.[65]

V. Jurisdictions That Do Not Recognize the Equitable Recoupment Doctrine

Only a few courts have expressly ignored or refused to adopt the doctrine of equitable recoupment. For example, in *New England Surfaces v. E.I. Du Pont de Nemours & Co.*, the U.S. District Court for the District of Maine (applying Delaware law) refused to consider equitable recoupment, not because it disagreed with the doctrine, but because it was unaware of any Delaware case that had recognized it.[66] Similarly, the Eighth Circuit, despite being the most ardent supporter of the doctrine, declined to entertain a recoupment claim in a case applying New York law because "no New York case has expressly applied the doctrine of equitable recoupment in any context."[67]

Another court refused to apply the doctrine because the plaintiff claimed recoupment pursuant to breach of contract rather than agency or quasi-contract principles.[68] It is unclear whether other courts would maintain such strict pleading standards, given that equitable recoupment can easily be added on a motion for leave to amend, or even by the court.[69] The majority

62. McGinnis Piano & Organ Co. v. Yamaha Int'l Corp., 480 F.2d 474, 481 (8th Cir. 1973).

63. *Id.*

64. *Schultz*, 737 F.2d at 349.

65. *Id.*

66. New England Surfaces v. E.I. Du Pont de Nemours & Co., 517 F. Supp. 2d 466, 485 (D. Me. 2007). The *New England Surfaces* court apparently overlooked *A.R. Dervaes Co. v. Houdaille Industries, Inc.*, No. 6471, 1981 WL 7625, at *5 (Del. Ch. Sept. 29, 1981), which held that "where substantial sums of money were expended in developing a distributorship system throughout a certain territory, . . . the distributor was entitled to retain his franchise for such a period of time as would enable it to recoup expenditures incurred in reliance upon the agreement" (internal quotations omitted).

67. Retail Assocs., Inc. v. Macy's E., Inc., 245 F.3d 694, 698 (8th Cir. 2001) (applying New York law).

68. Mech. Rubber & Supply Co. v. Am. Saw & Mfg. Co., 810 F. Supp. 986, 995 (C.D. Ill. 1990) ("Because no agency relationship is alleged, no claim may be predicated upon the Plaintiff's incurring expenses without receiving a reasonable opportunity to recoup those expenses."); *see also* Dupage Fork Lift Serv., Inc. v. Mach. Distrib., Inc., No. 94 C 7357, 1995 WL 125774, at *5 (N.D. Ill. Mar. 15, 1995) (dismissing recoupment claim because it rested on breach-of-con tract principles rather than agency law).

69. In the authors' recent case that involved a claim of equitable recoupment, the court concluded *sua sponte* on summary judgment that the counterplaintiff had alleged facts giving rise to an equitable recoupment claim after dismissing the counterplaintiff's claim for violation of the Minnesota Franchise Act.

of jurisdictions to address the matter in the context of a distributor or franchise, however, have recognized the doctrine of equitable recoupment when the facts give rise to its application.[70]

VI. Reasonable Notice Period for Termination of an At-Will Contract

A similar but distinct doctrine is Article 3 of the requirement of the Uniform Commercial Code (UCC) of a reasonable notice period upon termination of a contract subject to the UCC. Specifically, Section 2-309 of the UCC states that "[t]ermination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party . . . ."[71] The concept of required reasonable notice of termination also is the common law of most states.[72] Thus, a party is likely required to provide some reasonable notice of termination of a contract of indefinite length regardless of whether the contract is for the sale of goods.

Whether a party provided reasonable notification of termination is typically a fact-intensive inquiry.[73] In the context of distributor agreements, "'[t]he consideration of what constitutes sufficient or reasonable notice of termination depends on the circumstances of the particular case' and 'hinge[s] closely upon the amount of time necessary to enable the distributor to look for a new source of supply.'"[74] A wide range of notice periods have been held reasonable.[75]

The reasonable notice is conceptually distinct from the reasonable duration in an equitable recoupment case.[76] Under the UCC and the common

70. See *supra* Part II.

71. U.C.C. § 2-309(3).

72. *See, e.g.*, Varni Bros. Corp. v. Wine World, Inc., 41 Cal. Rptr. 2d 740, 746 (Cal. Ct. App. 1995), *as modified on denial of reh'g* (July 7, 1995); Glacial Plains Coop. v. Chippewa Valley Ethanol Co., LLLP, 912 N.W.2d 233, 237 (Minn. 2018); Denbury Onshore, LLC v. Precision Welding, Inc., 98 So. 3d 449, 455 (Miss. 2012), *as modified on denial of reh'g* (Oct. 11, 2012); Albert v. Cowart, 682 S.E.2d 773, 778 (N.C. Ct. App. 2009); Paul Gabrilis, Inc. v. Dahl, 961 P.2d 865, 868 (Or. Ct. App. 1998).

73. *See* St. Ansgar Mills, Inc. v. Streit, 613 N.W.2d 289, 295 (Iowa 2000) (collecting cases).

74. Upsher-Smith Labs., Inc. v. Mylan Labs., Inc., 944 F. Supp. 1411, 1429 (D. Minn. 1996) (alteration in original) (quoting Aaron E. Levine & Co., Inc. v. Calkraft Paper Co., 429 F. Supp. 1039, 1050 (E.D. Mich. 1976)); *see also* Jo–Ann, Inc. v. Alfin Fragrances, Inc., 731 F. Supp. 149, 160 (D.N.J. 1989) (same); Teitelbaum v. Hallmark Cards Inc., 520 N.E.2d 1333, 1336 (Mass. Ct. App. 1988) (reasonableness of notice depending on "the ability of the party affected by the termination to obtain a substitute arrangement").

75. *See* Goodman v. Motor Prods. Corp., 132 N.E.2d 356 (Ill. Ct. App. 1956) (four months' notice of termination of a thirteen-year foreign distributorship of freezers was sufficient); Smoky Mountains Beverage Co. v. Anheuser-Busch, Inc., 182 F. Supp. 326 (E.D. Tenn. 1960) (two-weeks' notice of termination of a thirteen-year exclusive distributorship of beer was reasonable); Maytronics, Ltd. v. Aqua Vac Sys., Inc., 277 F.3d 1317, 1320 (11th Cir. 2002) (damages incurred during "a period of 5 to 7 years in the future" were beyond the reasonable notice period required by the UCC).

76. *See* Allied Equip. Co. v. Weber Engineered Prods., Inc., 237 F.2d 879, 882 (4th Cir. 1956) ("The reasonable period which the law requires prior to termination of an agency under the [doctrine of equitable recoupment] is, of course, not the reasonable notice which the manufacturer must give if he has decided to, and properly may, terminate.").

law, the purpose of the reasonable notice period is to allow the dealer or distributor to wind down the relationship in a way that minimizes losses (for example, such as time to liquidate existing inventory or to find a new product to distribute).[77] On the other hand, the purpose of an extended duration of the contract for equitable recoupment is specifically tied to the amount of time reasonably require to recoup investments that have not yet been recouped. The arguments are not mutually exclusive—plaintiffs can argue that a reasonable duration should be required to recoup investments *and* that a reasonable notice period is required to wind down the relationship. In *Cambee's Furniture*, for example, the Eighth Circuit first applied "a reasonable period to recoup its investment," and, then "[a]fter the reasonable recoupment period has expired, the distributorship agreement becomes terminable at will upon reasonable notice."[78] However, there are instances in which they are combined in a court's analysis.[79] Most courts address these two concepts separately.[80] In *McGinnis*, the Eighth Circuit held that the jury should have been given the opportunity to determine "that period of time reasonably necessary for McGinnis to recoup its investment, plus a reasonable notice prior to termination."[81] Plaintiff, therefore, should separate out into separate elements the damage that it seeks—both recoupment of its unrecouped investments and, additionally, damages incurred as a result of not being provided with reasonable notice of termination. With respect to

77. *See* Sofa Gallery, Inc. v. Stratford Co., 872 F.2d 259, 263 (8th Cir. 1989) ("Sofa Gallery was entitled only to notice sufficient to allow it to close out the Stratford product line and to minimize its losses."); Lockewill, Inc. v. U.S. Shoe Corp., 547 F.2d 1024, 1028 (8th Cir. 1976) ("The purpose of the notice is to allow the distributor a reasonable opportunity to arrange his affairs."); Component Hardware Group, Inc. v. Trine Rolled Moulding Corp., No. CIV.A. 05-891 (MLC), 2005 WL 1514190, at *40 (D.N.J. June 27, 2005) (distributor required under Section 2-309(3) to provide "enough notice so that [manufacturer] could make alternative arrangements for the sale of its grease filters and continue to operate as it had before [distributor's] termination of the parties' contract, or so that [manufacturer] could wind-down its operations").

78. Cambee's Furniture, Inc. v. Doughboy Recreational, Inc., 825 F.2d 167, 173 (8th Cir. 1987) (reversing grant of summary judgment to the plaintiff).

79. *See* Schultz v. Onan Corp., 737 F.2d 339, 348 (3d Cir. 1984) ("[T]he recoupment doctrine imputes into the contract a duration equal to 'the length of time reasonably necessary for the dealer to recoup its investment' plus a 'reasonable notice period prior to termination.'"); Ernst v. Ford Motor Co., 813 S.W.2d 910, 918 (Mo. Ct. App. 1991) (same); *see also* Tractor & Farm Supply, Inc. v. Ford New Holland, Inc., 898 F. Supp. 1198, 1207 (W.D. Ky. 1995) ("[A] claim for recoupment . . . is usually viable only when a manufacturer terminates an at-will dealership agreement without reasonable notice."); Nathan Elson & Co. v. H. Beselin & Son, 218 N.W. 753, 756 (Neb. 1928) ("When the obligor has expended a substantial sum of money or value . . . he ought, through fairness, to have a reasonable time and notice of the cancellation of the contract . . . .").

80. *See, e.g.*, *Sofa Gallery*, 872 F.2d at 262 ("In addition to implying a duty to give reasonable notice, under the doctrine of equitable recoupment Minnesota law implies 'a reasonable duration *** in franchise agreements where a dealer has made substantial investments in reliance on the agreement.") (alteration in original); McGinnis Piano & Organ Co. v. Yamaha Int'l Corp., 480 F.2d 474, 479 (8th Cir. 1973) ("Reasonableness in such situations is measured by the length of time reasonably necessary for a dealer to recoup its investment. A reasonable notice period prior to termination is also required."); Healthco Int'l, Inc. v. A-dec, Inc., No. CIV. A. 87-0235-S, 1989 WL 104064, at *9 (D. Mass. Apr. 17, 1989) (considering recoupment and notice concepts separately).

81. *McGinnis*, 480 F.2d at 480.

that second category of damages, plaintiffs should argue what would have been a reasonable amount of time to sell off its inventory and wind down the relationship.

As with equitable recoupment, lost future profits are not recoverable under a claim for lack of reasonable notice.[82] The rationale for this rule is that a dealer has no legitimate expectation of future profits in a relationship that is terminable at will.[83]

VII. Conclusion

The doctrine of equitable recoupment is no replacement for a violation of a franchise or dealer statute, which typically entitles a prevailing plaintiff future lost profits as well as attorneys' fees. But in situations where those protections are unavailable, equitable recoupment can at least return the plaintiff to the *status quo ante* and avoid inequities that may otherwise occur in contracts between parties with unequal bargaining power.

82. *Sofa Gallery*, 872 F.2d at 263 ("Sofa Gallery is not entitled to recover its lost future profits even if Stratford did breach it duty to give reasonable notice."); Smalley Transp. Co., Inc. v. Bay Dray, Inc., 612 So. 2d 1182, 1188 (Ala. 1992) ("[T]he majority rule in this country [is] that damages for a breach of a 'notice of cancellation' provision in a contract are limited to the profits or other earnings that were lost during the notice period.").

83. *Sofa Gallery*, 872 F.2d at 263.

Using Criminal Background Checks in a Franchise System

*Mark J. Burzych**

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In April 2020, a daycare worker in Maple Valley, Washington, was arrested and charged with two counts of molesting two boys under the age of ten.[1] On June 21, 2019, an employee of an Indianapolis day care center was sentenced to serve thirty years in the Indiana corrections system for child molestation.[2] Across the country, there are scores of examples of childcare center employees being arrested, charged, and convicted of child molestation.[3] If these individuals were employees of a franchised childcare system, the damage to the brand for "allowing" a pedophile to work at a childcare center would be catastrophic, both for the individual franchisee and the brand as a whole. Indeed, such an association could cripple or perhaps end a brand.

The risk of brand damage is not isolated to childcare centers. It is not uncommon for franchisors to deal with headlines associating their brands with unseemly conduct. The obvious example of this is the ex-Subway pitchman Jared Fogle, who pleaded guilty to charges of distribution of receipt of child pornography and traveling to engage in illicit sexual conduct with a minor.[4] Other headlines are equally damaging, such as, "Ex-Subway employee sentenced to life in prison for sexually assaulting co-worker,"[5]

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1. Olivia Lavoice, *Employee at Maple Valley COVID-19 Daycare Center Charged with Two Counts of Molestation*, Q13 Fox News (Apr. 29, 2020), https://q13fox.com/2020/04/29/employee-at-maple-valley-covid-19-daycare-center-charged-with-two-counts-of-molestation.
2. *Former Indianapolis Day Care Employee Sentenced to 30 Years for Child Molestation*, Fox 59 (June 21, 2018), https://fox59.com/news/crimetracker/indianapolis-day-care-employee-arrested-on-child-molestation-charges.
3. *Child Maltreatment 2018*, Dep't. of Health and Human Servs. 66 (Jan. 15, 2020), https://www.acf.hhs.gov/sites/default/files/documents/cb/cm2018.pdf.
4. Christine Hauser, *Jared Fogle, Former Subway Pitchman, Gets 15-year Prison Term*, N.Y. Times (Nov. 19, 2015).
5. Cathy Locke, *Ex-Subway Employee Sentenced to Life in Prison for Sexually Assaulting Co-worker*, Sacramento Bee (Sept. 11, 2015), https://www.sacbee.com/news/local/crime/article34976307.html.

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"McDonald's employee charged in tampering of police officer's food,"[6] and "Portland Taco Bell manager sentenced to 3 years' probation for choking pregnant employee."[7] No franchise system wants to endure this type of negative publicity, especially if there is some way to prevent it.

This article will consider the use of criminal background checks in the franchise system. This article will analyze whether (1) a franchisee employer should conduct criminal background checks on its employees; (2) a franchisor should require a franchisee to conduct criminal background checks for its franchisee employees; and (3) a franchisor should conduct and use criminal background checks in its franchisee selection process.

I. Franchisee Employers Conducting Background Checks on Potential Employees

The U.S. Equal Employment Opportunity Commission (EEOC), does not prohibit a franchisee employer from requiring a pre-employment background check that asks questions about an applicant's background during the hiring process.[8] The earlier examples provide a compelling basis for requiring pre-employment background checks of its prospective employees. One could argue that background checks are essential in protecting franchisee employers from a variety of claims and risks in the employment context. However, all employers, including franchisee employers, should understand the federal and state laws that regulate the background check process.

A. *Risk to Franchisee Employers*

Background checks can be pivotal in helping franchisee employers avoid risk and liability throughout the hiring process. A franchisee employer's failure to exercise proper due diligence could subject the employer to a variety of claims, including negligent hiring. The damage caused by insufficient hiring screening processes could result in significant damage to the brand from the fallout of a bad hiring decision, like those described earlier. Conducting a proper background check can potentially eliminate both of those problems.

1. Negligent Hiring

In the majority of jurisdictions, a franchisee employer can incur liability under a "negligent hiring" cause of action for injuries to other employees

6. Michael Hollan, *McDonald's Employee Charged in Tampering of Police Officer's Food*, Fox News (Nov. 17, 2017), https://www.foxnews.com/food-drink/mcdonalds-employee-arrested-tampering-police-food.

7. Everton Bailey Jr., *Portland Taco Bell Manager Sentenced to 3 Years' Probation for Choking Pregnant Employee*, Oregonian (Mar. 29, 2019), https://www.oregonlive.com/portland/2019/03/portland-taco-bell-manager-sentenced-to-3-years-probation-for-choking-pregnant-employee.html.

8. U.S. Equal Emp. Opportunity Comm'n, Background Checks: What Employers Need to Know (Mar. 11, 2014), https://www.eeoc.gov/laws/guidance/background-checks-what-employers-need-know [hereinafter Background Checks].

or customers that are caused by a franchisee employer's failure to exercise reasonable care when screening a potential employee.[9] Negligent hiring claims usually arise when a franchisee employer fails to conduct an adequate background check on an applicant or refuses to respond to actual knowledge (gained from a background check) of potential harm from hiring an applicant.[10] For example, in *TGM Ashley Lakes, Inc. v. Jennings*,[11] the parents of a woman strangled to death in her apartment by the building's maintenance worker brought claims against the employer for negligent hiring and retention.[12] In that case, the maintenance worker admitted to the employer's leasing manager that he had been in jail and had been in trouble with the law. However, the leasing manager did not disclose this information to supervisors and did not make any inquiry into the criminal history of the maintenance worker.[13] One of the supervisors involved in the hiring decision admitted that "N/A, not applicable" was the response to the inquiry regarding criminal history in the employment paperwork for this employee.[14] The court concluded that the man had prior "felony convictions for rape at knifepoint, armed robbery, larceny, robbery by force, and at least three residential burglaries."[15] The hiring supervisor admitted that this criminal background made the maintenance worker an unsuitable employee,[16] and, ultimately, the employer was found liable for failing to conduct an adequate criminal background check.[17]

The damages associated with negligent hiring claims can be substantial. In *Jennings*, the Georgia jury concluded that the employer failed to exercise reasonable care in screening the employee and awarded the estate of the strangled coworker just over $13,000,000 in damages.[18] This case is illustrative of the scores of other similar cases nationwide related to negligent hiring claims.[19]

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9. Nesheba M. Kittling, *Negligent Hiring and Negligent Retention: A State by State Analysis*, Am. Bar Ass'n (Nov. 6, 2010), https://www.americanbar.org/content/dam/aba/administrative/labor_law/meetings/2010/annualconference/087.authcheckdam.pdf.

10. Adriel Garcia, Comment, *The Kobayashi Maru of Ex-Offender Employment: Rewriting the Rules and Thinking Outside the Current "Ban the Box" Legislation*, 85 Temp. L. Rev. 921, 931–32 (2013).

11. Ashley Lakes, Inc. v. Jennings, 590 S.E.2d 807 (Ga. Ct. App. 2003).

12. *Id.*

13. *Id.* at 457.

14. *Id.*

15. *Id.* at 460.

16. *Id.* at 457.

17. *Id.* at 456.

18. *Id.*

19. *See* A.T v. LH Foot Massage, L.L.C., 2019 WL 5305293 (Wash. Super. Ct. July 12, 2019) (verdict and settlement summary); *see also* Keith v. Heal-Pro Home Care, 2018 WL 7982840 (N.C. Super. Ct. Mar. 26, 2018) (verdict and settlement summary); C.L. v. Kicks Tae Kwon Do & Fitness Ctrs., 2014 WL 3510181 (Mich. Cir. Ct. Feb. 10, 2014) (verdict and settlement summary); C.M. v. Icon Hum. Servs., 2011 WL 6062952 (Mich. Cir. Ct. Apr. 27, 2011) (verdict and settlement summary); Plaintiff, Pro Ami v. Newspaper Agency Corp., 2002 WL 33831800 (Utah May 2002) (verdict and settlement summary).

2. Brand Image

The risk posed to franchisees of failing to conduct proper background checks does not end at the potential legal claims. The brand itself could be adversely impacted as well. A franchisee providing day-care services for children could cause immense damage not only to itself, but the entire franchise brand, by hiring a registered pedophile without or improperly conducting a background check. The damage for a franchisee could result in the closure of the franchised business. The damage to the franchise brand could be even more detrimental.[20]

B. *Limitations on Background Checks*

Although conducting background checks is essential in making sure a franchisee employer limits its risks related to negligent hiring claims, there are limitations to the use of criminal background checks in the hiring process imposed by federal, state, and local laws and regulations.[21] At the federal level, the use of criminal background checks in the hiring process is limited by Title VII of the Civil Rights Act of 1964 (Title VII) and the Fair Credit Reporting Act (FCRA). Some states have also enacted legislation that prohibits or limits the use of criminal or credit history in the hiring process. Still other limitations can be found under state or local "ban-the-box" laws. Franchisee employers need to review these laws to ensure compliance regarding the use of criminal background checks.

1. Title VII

Under Title VII, franchisee employers may not discriminate based on race, color, national origin, sex, religion, disability, genetic information, or age.[22] Obviously, background checks should not be used for an enumerated illegal purpose. Franchisee employers can help prevent this type of discrimination by keeping all procedures surrounding a background check uniform and consistent among all applicants. No applicant should be treated differently during the background check process. In fact, according to the EEOC, it is illegal to check the background of applicants when the decision to conduct a background check is based on the person's race, national origin, color, sex, religion, disability, genetic information, or age,[23] such as a franchisee employer conducting background checks only on individual applicants who are a part of a minority ethnic or racial group rather than every individual that submits an application.

20. *See Child Advocacy Organization Calls for Boycott of McDonald's*, Quick-Service & Fast Casual Rest. News & Info. (May 2, 2006), https://www.qsrmagazine.com/news/child-advocacy-organization-calls-boycott-mcdonalds.

21. Of course, some industries, such as schools (e.g., MO. Ann. Stat. §168.133), healthcare (e.g., Me. Rev. Stat. Ann. tit. 34-B, § 225 (2016)), or childcare (e.g., 34 U.S.C. § 20351(a)(1)), are required to conduct background checks in the pre-employment process, and the failure to properly conduct such investigations can have devastating effects on the business.

22. 42 U.S.C. § 2000e-2(a)(1).

23. Background Checks, *supra* note 8.

However, Title VII violations may not always be so obvious. Franchisee employers also need to be aware of the limitations on criminal background check policies that cause a "disparate impact" or include a "blanket ban." As discussed later in this article, a franchisee employer may be able to justify a practice resulting in a disparate impact based on a "business necessity," but a blanket ban is usually prohibited.

a) Disparate Impact

Most employers' background check polices are facially neutral. According to the EEOC, if a policy has the effect of disproportionately screening out (or causing a disparate impact) on a group protected under Title VII without a business necessity, a franchisee employer could face Title VII liability.[24] The U.S. Supreme Court first recognized disparate impact in Title VII claims in *Griggs v. Duke Power Co.*[25] in the early 1970s. In *Griggs*, the Court described how Title VII "proscribes not only overt discrimination but also practices that are fair in form, but discriminatory in operation."[26] The Court observed that a practice/policy that operates to exclude minorities that has no relation to the actual job performance is prohibited.[27] About twenty years later, Congress codified the prohibition against unnecessary disparate impact into Title VII.[28]

In a more recent case, *EEOC v. Dolgen Corp., LLC*,[29] Dollar General agreed to pay $6 million to settle a race discrimination class action lawsuit brought by the EEOC.[30] According to the complaint, Dollar General had been violating Title VII by denying employment to African Americans at a significantly higher rate than white applicants, and this disparate impact was largely due to the company's broad use of criminal background checks.[31] The three-year consent decree that settled the suit required that the $6 million would be distributed through a claims process to African Americans who had lost their chance of employment at the company between the years 2004 and 2019.[32]

In addition, the consent decree required that if Dollar General uses a criminal background check during the term of the decree, the company must hire a criminology consultant to develop a new criminal background check

24. U.S. Equal Emp. Opportunity Comm'n, Enforcement Guidance on the Consideration of Arrest and Conviction Records in Employment Decisions under Title VII of the Civil Rights Act (Apr. 25, 2012), https://www.eeoc.gov/laws/guidance/enforcement-guidance-consideration-arrest-and-conviction-records-employment-decisions#sdendnote120anc.

25. Griggs v. Duke Power Co., 401 U.S. 424 (1971).

26. *Id.* at 431.

27. *Id.*

28. 42 U.S.C. § 2000e-2(k)(1).

29. EEOC v. Dolgen Corp., LLC, 2019 WL 7860601 (N.D. Ill., Nov. 18, 2019) (verdict and settlement summary).

30. *Id.*

31. Complaint at 3, EEOC v. Dolgen Corp., LLC, No. 1:13 CV 04307, 2013 WL 3010490 (N.D. Ill. 2013).

32. Consent Decree at 7, EEOC v. Dolgen Corp., LLC, 2019 WL 7169536 (N.D. Ill., Nov. 18, 2019) (No. 2002060040).

based on certain factors,[33] including the ones described in *Green v. Missouri Pacific Railroad Co.*,[34] discussed more in depth later. The decree also required Dollar General to update its reconsideration process, specifically in how the company operates when a rejected applicant asks the company to reconsider the hiring decision despite a criminal conviction.[35] The EEOC's complaint against and settlement with Dollar General should serve as notice to all employers of the need to be aware of the consequences of failing to carefully consider their use of criminal background checks.

b) Potential Defense for Employers—"Business Necessity"

Title VII, the EEOC, and the federal courts have provided employers with a potential defense to combat a disparate impact claim. If a franchisee employer can show a valid "business necessity" behind the implemented background check policy causing the disparate impact claim, the employer has not violated Title VII.[36] The business necessity defense was first introduced briefly in *Griggs*;[37] however, an actual definition of what constitutes a business necessity was not provided until the Eighth Circuit decided *Green v. Missouri Pacific Railroad Co.* about five years later. In *Green*,[38] the Missouri Pacific Railroad Company (Missouri Pacific) had a policy of refusing consideration for employment to any person who had a prior conviction, unless it was a minor traffic offense.[39] Buck Green (Green), an African American man, applied for a clerk position in Missouri Pacific's corporate office.[40] However, Green had been convicted a few years prior for refusing to be inducted in the military, and he disclosed this conviction in his application.[41] Missouri Pacific refused to hire Green because of this conviction, in accordance with its policy.[42] Green sought relief under Title VII based on the claim that the policy had a discriminatory effect, and it was not justified by a business necessity.[43]

According to the Eighth Circuit, Missouri Pacific's policy was discriminatory under Title VII because business necessity could never justify a policy where every individual who has ever been convicted of a crime is relegated to "the permanent ranks of the unemployed."[44] The case was remanded to the district court to have the policy enjoined from using convictions as an

33. *Id.* at 3.
34. Green v. Mo. Pac. R.R. Co., 549 F.2d 1158, 1160 (8th Cir. 1977).
35. Consent Decree at 4, *Dolgen*, 2019 WL 7169536 (No. 2002060040).
36. Elizabeth P. Weissert, Comment, *Get Out of Jail Free? Preventing Employment Discrimination Against People with Criminal Records Using Ban the Box Laws*, 164 U. Pa. L. Rev. 1529, 1539 (2016).
37. Griggs v. Duke Power Co., 401 U.S. 424, 431 (1971).
38. *Green*, 549 F.2d at 1160.
39. Green v. Mo. Pac. R.R. Co., 523 F.2d 1290, 1292 (8th Cir. 1975).
40. *Id.*
41. *Id.* at 1292–93.
42. *Id.* at 1293.
43. *Id.*
44. *Id.* at 1298.

absolute bar to employment.[45] On remand, the district court followed the instructions of the Eighth Circuit, enjoined Missouri Pacific's policy, and adopted a three-factor test to consider when making a hiring decision for an applicant that had a prior conviction. These three factors are as follows: (1) "the nature and gravity of the offense or offenses"; (2) "the time that has passed since the conviction and/or completion of sentence"; and (3) "the nature of the job for which the applicant has applied."[46] These three factors are now more commonly referred to as the *Green* factors.

In contrast, in *El v. Southeastern Pennsylvania Transportation Authority*,[47] a man was fired immediately after he had been hired as a paratransit driver due to a criminal background check (that was conducted during the hiring process), finding a second-degree murder charge that had occurred forty years prior.[48] Southeastern Pennsylvania Transportation Authority (SEPTA) made this employment decision based on a policy that did not allow the hiring of applicants with prior convictions for violent crimes.[49] After citing to and distinguishing the *Green* factors,[50] the Third Circuit affirmed the district court's decision in granting SEPTA's motion for summary judgement and explained that the reasoning behind the background check policy was sufficient in proving a business necessity, and the policy accurately screened out applicants who had a likelihood of committing acts of violence against the employer's customers/riders.[51] The Third Circuit even went as far as to say that "if someone with a violent conviction presents a materially higher risk than someone without one, *no matter which other factors an employer considers*, then SEPTA is justified in not considering people with those convictions."[52]

However, employers are not always this successful in proving a business necessity defense. Specifically, in *Waldon v. Cincinnati Public Schools*,[53] the state of Ohio passed legislation requiring criminal background checks on all current educational institution employees.[54] If an employee had a prior conviction, no matter the offense, it required automatic termination.[55] Pursuant to this new legislation, Cincinnati Public Schools (Cincinnati) fired ten people, nine of whom were African American.[56] Two of the terminated employees, who both had convictions that occurred decades before their employment, brought suit for racial discrimination.[57]

45. *Id*. at 1299.
46. Green v. Mo. Pacific R.R. Co., 549 F.2d 1158, 1160 (8th Cir. 1977).
47. El v. Se. Pa. Transp. Auth., 479 F.3d 232 (3rd Cir. 2007).
48. *Id*. at 235.
49. *Id*.
50. *Id*. at 243–44.
51. *Id*. at 245.
52. *Id*. (emphasis added).
53. Waldon v. Cincinnati Pub. Sch., 941 F. Supp. 2d 884 (S.D. Ohio 2013).
54. *Id*. at 886.
55. *Id*.
56. *Id*.
57. *Id*.

In denying Cincinnati's motion to dismiss, the court explained that the employees' "offenses were remote in time"; one of the "offense[s] was insubstantial";[58] and "both [employees] had demonstrated decades of good performance."[59] For those reasons, the court could not conclude that Cincinnati's policy constituted a business necessity.[60] Although this case did not cite to the *Green* factors, it nevertheless demonstrates that some type of business necessity is required to justify a background check policy that may cause a disparate impact.

c) Blanket Bans

Blanket bans are hiring policies that require an "automatic, across the board exclusion from all employment" if a person has been found to have a criminal record.[61] According to the EEOC, these types of bans do not have any type of business necessity defense and usually cause a discriminatory effect due to the disparities that arise in the incarceration and arrest rates of Title VII protected individuals.[62] The *Green* decision also had impacted blanket bans as well. In *Green*, the Eighth Circuit made it clear that "a sweeping disqualification for employment resting solely on past behavior can violate Title VII . . . ."[63] The EEOC's Enforcement Guidelines and *Green* should create doubt whenever using this type of background check policy, and the franchisee/employers should apply the *Green* factors whenever using criminal background checks as a basis for not hiring an applicant.

2. Fair Credit Reporting Act[64]

If a franchisee employer intends to conduct criminal background checks by acquiring the information through a third-party company, such as a consumer reporting agency, FCRA imposes additional federal requirements to follow before conducting the check. First, the employer must give notice to the applicant, in standalone writing separate from the application, that the information gained from the background check could be used to make an employment decision.[65] In addition, the employer must receive the applicant's written permission to conduct the background check.[66] Finally, the employer must certify to the third-party company being used that (1) the

58. *Id.* at 886 n.1 (explaining the offense that was designated as insubstantial by the court was Eartha Britton being convicted for acting as a "go-between" in the purchase and sale of five dollars of marijuana).

59. *Id.* at 889.

60. *Id.* at 890.

61. Enforcement Guidance, *supra* note 24.

62. *Id.*

63. Green v. Mo. Pac. R.R. Co., 523 F.2d 1290, 1296 (8th Cir. 1975); *see also* Field v. Orkin Extermination Co., No. Civ. A. 00-5913, 2002 WL 32345739, at *1 (E.D. Pa. Feb. 21, 2002) ("[A policy] denying employment to any person having a criminal conviction is a [per se] violation of Title VII.").

64. 15 U.S.C. § 1681.

65. *Id.* § 1681b(b)(2)(A)(i).

66. *Id.* § 1681b(b)(2)(A)(ii).

applicant has been notified and permission has been granted; (2) all of FCRA's requirements have been complied with; and (3) that the employer will not discriminate against the applicant or use the information in violation of both federal and state equal opportunity laws.[67]

FCRA also imposes requirements when a franchisee employer intends to make an adverse decision based on the background check conducted by the third-party company. Under these circumstances, before making a final adverse decision, the employer must provide a notice to the applicant that includes a copy of the report relied on when making the adverse decision.[68] The employer must include a copy of "A Summary of Your Rights Under the Fair Credit Reporting Act" as well.[69] This documentation allows for the applicant to provide any explanation for negative information listed in the report. Once the employer takes the adverse action, the employer must tell the applicant (1) that they were rejected due to the information provided in the background check; (2) the name, address, and phone number of the third-party company; (3) that the third-party company did not make the hiring decision; and (4) that they have the right to dispute the accuracy of the report and can get an additional free report from the third-party company within sixty days.[70] Importantly, none of these requirements under FCRA applies when employers conduct their own investigation.[71]

3. "Ban-the-Box" State and Local Laws

In addition to Title VII and FCRA, employers should be aware of state laws and local ordinances known as "ban-the-box" policies. These policies may vary, but they generally prohibit a franchisee employer from including a question on an employment application related to criminal history with a "yes or no" box.[72] These policies do not preclude a franchisee employer from ultimately looking into the criminal history of an applicant;[73] they simply delay that consideration to later in the screening/interview process.[74] Initially, only a few jurisdictions had implemented policies of this nature, and the primary focus was on public (government) employees.[75] However, as of September 2020, over thirty-seven states[76] have adopted ban-the-box

67. *Id.* § 1681d(a)(2).
68. *Id.* § 1681b(b)(3)(A)(i).
69. *Id.* § 1681b(b)(3)(A)(ii).
70. *Id.* § 1681m(a).
71. *Id.* § 1681a(d)(1).
72. Jonathan J. Smith, *Banning the Box but Keeping the Discrimination?: Disparate Impact and Employer' Overreliance on Criminal Background Checks*, 49 Harv. C.R.-C.L. L. Rev. 197, 211 (2014).
73. The goal is to remove the criminal history question off the original application, but employers can still inquire later during interviews or have a subsequent form filed for a background check depending on the applicable law.
74. Smith, *supra* note 72.
75. *Id.* at 213.
76. Arizona (Ariz. Exec. Order No. 2017-07 (Nov. 6, 2017)); California (Cal. Gov't Code §12952 (2017)); Colorado (Colo. Rev. Stat. § 24-5-101 (2012), Colo. Rev. Stat. § 24-5-101 (2019)); Connecticut (Conn. Gen. Stat. § 31-51i (2017)); Delaware (Del. Code Ann. tit. 19, § 711(g) (2016), Del. Code Ann. tit. 29, § 6909B (2014)); Georgia (Ga. Exec. Order No. 2-23-15

policies, and, of those thirty-seven states, seventeen[77] have implemented the policies in the private sector.[78] Many cities and counties,[79] as of September 2020, have followed suit.[80] The movement towards this type of legislation at the state and local level should provide notice to employers that care should be taken to eliminate the "yes or no" answer to any criminal history question on an employment application.

C. *Best Practices: Franchisee Employers Conducting Background Checks on Their Prospective Employees*

The largest takeaway that franchisee employers should have is that conducting criminal background checks on prospective employees may be a business necessity. Given the risks involved, including the liability incurred from

(Feb. 23, 2015)); Hawaii (Haw. Rev. Stat. § 378-2.5 (1998)); Illinois (820 Ill. Comp. Stat. 75/15 (2015), Ill. Exec. Order No. 1 (Oct. 3, 2013)); Indiana (Ind. Exec. Order No. 17-15 (June 29, 2017)); Kansas (Kan. Exec. Order No. 18-12 (May 2, 2018)); Kentucky (Ky. Exec. Order No. 2017-064 (Feb. 1, 2017)); Louisiana (La. Stat. Ann. § 42:1701 (2016), La. Stat. Ann. § 23:291.2 (2021)); Maine (Me. Stat. tit. 5, § 792 (2019), Me. Stat. tit. 26, § 600-A (2021)); Maryland (Md. Code Ann., State Pers. & Pens. § 2-203 (2018), Md. Code Ann., Lab, & Empl. §§ 3-1501 to 1505 (2020)); Massachusetts (Mass. Gen. Laws ch. 151B, § 4 (2018)); Michigan (Mi. Exec. Order No. 2018-4 (Sept. 7, 2018)); Minnesota (Minn. Stat. § 364.021 (2014)); Missouri (Mo. Exec. Order No. 16-04 (Apr. 11, 2016)); Nebraska (Neb. Rev. Stat. § 48-202 (2014)); Nevada (Nev. Rev. Stat. § 613.330 (2018)); New Hampshire (N.H. Rev. Stat. Ann. § 275-H:2 (2020)); New Jersey (N.J. Stat. Ann. § 34:6B-11 to 19 (2014)); New Mexico (N.M. Stat. Ann. § 28-2-1 to § 28-2-6) (2019)); New York (N.Y. Exec. Law § 296 (2021)); North Carolina (N.C. Exec. Law No. 158 (2020)); North Dakota (N.D. Cent. Code § 12.1-33-02.2 (2019)); Ohio (Ohio Admin. Pol'y HR-29 (2015); Ohio Rev. Code Ann. § 9.73 (2016)); Oklahoma (Okla. Exec. Order No. 2016-03 (Feb. 24, 2016)); Oregon (Or. Rev. Stat. § 659A.360 (2016)); Pennsylvania (Pa. Admin. Pol'y HR-TM001 (2017), 18 Pa. Cons. Stat. § 9125 (2017)); Rhode Island (28 R.I. Gen. Laws §§ 28-5-6, 28-5-7 (2013)); Tennessee (Tenn. Code Ann. § 8-50-112 (2016)); Utah (Utah Code Ann. § 34-52-201 (2019)); Vermont (Vt Exec. Order No. 03-15 (2015), Vt Stat. Ann. tit. § 495j (2017)); Virginia (Va. Exec. Order No. 41 (Apr. 3, 2015), Va. Code Ann. § 19.2-392.15 (2015)); Washington (Wash. Rev. Code § 49.94.010 (2018)); and Wisconsin (Wis. Stat. § 111.335 (2018)) have all adopted statewide Ban the Box laws or policies.

77. California (Cal. Gov't Code §12952 (2017)); Colorado (Colo. Rev. Stat. § 24-5-101); Connecticut (Conn. Gen. Stat. § 31–51i (2017)); Delaware (Del. Code Ann. tit. 19, § 711(g)); Hawaii (Haw. Rev. Stat. § 378–2.5 (1998)); Illinois (820 Ill. Comp. Stat. 75/15); Louisiana (La. Stat. Ann. § 23:291.2); Maine (Me. Stat. tit. 26, § 600-A); Maryland (Md. Code Ann., Lab. & Empl. §§ 3-1501 to 1505); Massachusetts (Mass. Gen. Laws ch. 151B, § 4); Minnesota (Minn. Stat. § 364.021 (2014)); New Jersey (N.J. Stat. Ann. § 34:6B-11 to 19); New Mexico (N.M. Stat. Ann. § 28-2-1 to § 28-2-6)); Oregon (Or. Rev. Stat. § 659A.360 (2016)); Rhode Island (28 R.I. Gen. Laws §§ 28-5-6, 28-5-7); Vermont (Vt Stat. Ann. tit. § 495j); and Washington (Wa Rev. Code § 49.94.010) have all implemented Ban the Box Laws in the private sector.

78. Beth Avery & Han Lu, *Ban The Box: U.S. Cities, Counties, and States Adopt Fair Hiring Policies*, Nat'l Emp. Law Project (Sept. 2020), https://www.nelp.org/publication/ban-the-box-fair-chance-hiring-state-and-local-guide/#Chart_of_Local_Fair_Chance_Policies.

79. Cities that have enacted their own Ban the Box laws include the following: Austin, Tex., Ordinance 20081016–012 (Oct. 16, 2008); Baltimore, Maryland, Council Bill 13-0301 (Apr. 2, 2014); Buffalo, New York, Code ch. 154, art. V (2013)); Chicago, Ill., Mun. Code § 2–160–010 (2014); Columbia, Mo., Code, chap. 12 art. V (2014); Kan. City, Mo., Ordinance 130230 (Apr. 4 2013); Kan. City, Mo., Ordinance 180034 (Feb. 1, 2018); L.A., Cal., Mun. Code ch. 18 art. 9 (2016); Los Angeles, Cal., Admin. Code ch. 1, div. 10, art. 22 (2016); Montgomery Cnty., Md. Bill No. 36–14 (Oct. 28, 2014); Rochester, N.Y., Mun. Code ch. 63, art. II (2014); S.F., Cal., Ordinance 171170 (Apr. 3, 2018); Seattle, Wash., Mun. Code 14.17 (2013); Spokane, Wash., Ordinance C-35564 (Nov. 27, 2017).

80. Avery & Lu, *supra* note 78.

a negligent hiring claim and the potential for severe damage to the brand image, franchisee employers need to limit any possible issues that could arise from a poor hiring decision. A criminal-background-check policy is an excellent way to accomplish this outcome.

However, as discussed above, franchisee employers must consider a number of legal limitations when crafting a background check policy. In 2012, the EEOC, in an effort to offer its insight in this process, provided enforcement guidance (Guidance).[81] This is an excellent resource to help a franchisee employer understand the best practices in creating such a policy. The Guidance also outlines the EEOC's investigative process when a Title VII complaint is filed. The Guidance does not have the force and effect of law, and it is only for the purpose of providing clarity.[82] This reality became even clearer after the Fifth Circuit ruled that the Guidance was not enforceable in the public sector in *Texas v. EEOC*.[83]

There are a few key takeaways from the Guidance that franchisee employers should keep at the forefront of their mind when drafting a background check policy. First, franchisee employers should avoid any policy that excludes people with certain criminal records, significantly disadvantages individuals of a particular Title VII protected class, and does not accurately predict who would be a safe employee. Policies including blanket bans are also inadvisable. Both kinds of policies would more than likely give rise to a disparate impact claim.

Whenever a franchisee employer conducts a criminal background check, its policy should require that each potential job applicant be evaluated pursuant to the *Green* factors, namely (1) the nature of the crime, which can include the elements and the gravity of the offense; (2) the amount of time that has elapsed since the crime had been committed; and (3) the nature of the job itself, which can include the job duties, the circumstances in which the job is run, and the environment in which the job is conducted. A franchisee employer that requires consideration of the *Green* factors in the background check policy can much more persuasively argue a business necessity defense if a disparate impact were to arise from the policy itself.

Additionally, the EEOC recommends providing an "individualized assessment" portion in a background check policy.[84] An individualized assessment allows an individual, who has been screened out of an application due to a prior conviction, to present information to the franchisee employer that the criminal background check did not correctly identify him/her or that the record was inaccurate.[85] This assessment can include presentation of information or facts about the crime or conviction as well.[86] An individualized

81. Enforcement Guidance, *supra* note 24.
82. *Id.*
83. Texas v. EEOC, 933 F.3d 433, 451 (5th Cir. 2019).
84. Enforcement Guidance, *supra* note 24.
85. *Id.*
86. *Id.*

assessment is another way that a franchisee employer can attempt to reduce potential Title VII liability through the use of its background check policy.

Finally, franchisee employers should ensure that they are complying with the requirements under FCRA and the state and local laws. Again, FCRA only applies if a franchisee employer is using a third-party company to conduct the criminal background check. If this is the case, the compliance requirements under FCRA should go directly into the background check policy. The same goes for any state or local "ban the box" laws. Several states and a plethora of local municipalities have implemented "ban the box" laws, so a franchisee employer should look to its state's legislation and its local municipality code for any requirements. If there are, those requirements should go in the background check policy too.

I. Franchisors Requiring Franchisees to Conduct Background Checks

Conducting criminal background checks has proven to be an effective way for employers to avoid negligent hiring and other related claims along with associated risk of damage to the brand. Should a franchisor require a franchisee employer to implement a background check policy in the hiring process? Before implementing a system-wide background check policy, the franchisors should consider risks that can arise under Title VII, FCRA, and the joint employer theory.

A. *Title VII*

Title VII presents no additional risks (other than those previously discussed) for a franchisor that implements a policy requiring franchisees to conduct background checks on its employees. Franchisors should be aware of the violations that "blanket bans" will bring under Title VII, and policies that create a disparate impact should be considered as well. Finally, franchisors should keep in mind the potential local and state laws that might have an impact on how the policy should look.

B. *Fair Credit Reporting Act*

FCRA does not have any specific limitations on franchisees sharing the background checks of employees with the franchisor. However, as mentioned previously, FCRA requires disclosures be made to the applicant and consent obtained from the applicant when an entity is seeking to use background check information gathered by a third-party company.[87] Franchisors, when deciding whether they should develop a policy requiring a franchisee to conduct a background check, need to consider the information included on both the notice to the applicant and the consent form.

A franchisor may consider including its entity name, in addition to the franchisee, on all notices sent to the applicant to disclose the fact that the

87. 15 U.S.C. § 1681b(b)(2)(A)(i)–(ii).

franchisor will obtain the information as well. The franchisor should make the same disclosure on the consent form. These relatively simple tactics can help franchisors avoid any potential violation of FCRA. Because FCRA does not prohibit a franchisee from sharing criminal background check information, a franchisor more than likely is allowed to require franchisees to provide the criminal background checks for their potential employees to them. However, care should be taken to avoid joint employer liability.

C. *The Issue of a Joint Employer*

Of course, any discussion of a franchisor requiring a specific franchisee employment practice raises the issue of the joint employer doctrine. Under a successful joint employer theory, the franchisor, for example, could be vicariously liable for the employment practices of its franchisees. Today, the test for determining whether one entity is a joint employer with another is governed by the National Labor Relations Board's decision in *Browning-Ferris Industries*.[88] "Under this standard, the [NLRB] may find that two or more statutory employers are joint employers of the same statutory employees if they 'share or codetermine those matters governing the essential terms and conditions of employment.'"[89] The Board concluded that a joint employer not only had to possess the authority to control the employee's terms and conditions of employment, but the joint employer also had to exercise that authority.[90] In spite of much political wrangling and machinations, any discussion of franchisor involvement in franchisee employer-employee relations, including the use of background checks, requires an analysis of the then current joint-employer case law.[91]

California is the current focal point of the development of joint employer case law. In *Patterson v. Domino's Pizza, LLC,92* the California Supreme Court considered whether "a franchisor stand[s] in an employment . . . relationship" with franchisee employees "for purposes of holding it vicariously liable for workplace injuries" caused by other employees. The court held that Domino's was not in a joint-employer relationship with its franchisees because a franchisor "becomes potentially liable for actions of the franchisee's employees, only if it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee's employees."[93] Similarly, in *Salazar v. McDonald's*,[94] the Ninth Circuit applied this "control" test to the issue of whether McDonald's was a joint employer with its San Francisco Bay area franchisee who did not account for overtime

88. 362 NLRB No. 186 (2015).
89. *Id* at 2.
90. *Id*.
91. Joint Employer Status Under the National Labor Relations Act, 85 Fed. Reg. § 11184-01 (2020).
92. Patterson v. Domino's Pizza, LLC, 333 P.3d 723, 725 (Cal. 2014).
93. *Patterson*, 333 P.3d at 739–40.
94. Salazar v. McDonald's Corp., 939 F.3d 1051 (9th Cir. 2019).

hours correctly, despite using the McDonald's point of sale (POS) system. The Ninth Circuit required that McDonald's possess and exercise "control over the wages, hours, or working conditions."[95] Importantly, the Ninth Circuit found that any control McDonald's had over it franchisees' employees was geared toward "quality control," and McDonald's did not retain a "general right of control over day-to-day aspects" of work at the franchises.[96]

To avoid joint employer liability, the franchisor must ground any requirement that the franchisee use background checks in the "quality control" of the franchisor brand, and not the "general right of control over the day-to-day aspects" of work at the franchises. Again, as discussed earlier, the use of the background checks must have a relation to the quality of the brand. For example, a franchisor providing child-related (gymnastics, swimming, coding, etc.) services certainly has a compelling quality control interest in prohibiting its franchisees from hiring child molesters. Although other crimes could certainly disqualify potential employees from employment as "quality control" brand protection for a daycare franchisor (such as murder, violent felonies, and prior child endangerment or neglect convictions), other crimes may be less relevant. So long as the franchisor can tie the requirement for background checks to the service being delivered to the customers, it is more likely to be considered a legitimate franchisor quality control measure rather than an illegal control over the day-to-day aspects of the work at the franchises.

D. *Best Practices: Franchisors Requiring Employer Franchisees to Conduct Background Checks*

Although there is not a direct issue if a franchisor requires franchisees to conduct criminal or credit background checks in the franchisee's hiring process, franchisors should understand the Title VII and FCRA considerations that apply to such a franchise system-wide policy. Any system-wide background check policy should incorporate the suggestions discussed earlier in Section I of this article for the franchisee employers. If the franchisee uses a third party to conduct background checks, the franchisor should require that it be included in the disclosure to the employee-applicant, notifying the employee-applicant that the franchisor will be receiving the background-check information as well. Franchisors should be careful to use the background checks for brand protection and not to make day-to-day employment decisions to avoid joint employer liability.

95. *Id.* at 1056.
96. *Id.*

II. Franchisor Use of Criminal Background Checks of Prospective Franchisees

Franchisors also have the ability to conduct background checks when evaluating a potential franchisee. The use of background checks when screening and evaluating a potential franchisee can assist a franchisor in determining whether the prospect is the right fit with the franchise and could potentially help protect the brand image. Unlike with franchisee employers and their employees, Title VII and the regulations enforced by the EEOC do not cover the franchisor-franchisee relationship, because these laws only apply in the employer-employee context.[97] A franchisor nonetheless should not use its background check screening process to intentionally discriminate against a franchisee prospect in a protected class from his/her right to make and enforce contracts, as such conduct could run afoul of other civil rights statutes.[98] FCRA applies, and at least one known state[99] has even gone as far as to start enacting laws that apply rules similar to those created by Title VII when a franchisor is conducting a background check on a franchisee.

A. *Fair Credit Reporting Act*

The requirements of FCRA apply to a franchisor essentially in the same way as the aforementioned franchisee employer section.[100] If a franchisor uses a background check during its franchisee application process and uses a third-party company, the franchisor must provide notice and obtain consent from the potential franchisee.[101] In the notice, the franchisor must tell the potential franchisee that the information gained could be used in the decision-making process.[102] Additionally, the franchisor must certify to the company conducting the background check that the franchisee applicant has been notified and permission has been obtained, all of FCRA's requirements have been complied with, and the franchisor will not discriminate or misuse the information against the applicant in violation with federal or state equal opportunity laws.[103]

If a franchisor decides to deny a franchisee applicant based of the information gained from the background check, the franchisor must include a notice with a copy of the background check that was used in the decision making process and a copy of "A Summary of Your Rights Under the Fair Credit Reporting Act."[104] This notice will provide the franchisee applicant an opportunity to review the report and potentially explain any negative

97. 42 U.S.C. § 2000e-2(a).

98. 42 U.S.C. § 1981(a); Tyler v. RE/MAX Mountain States, Inc., 232 F.3d 808 (10th Cir. 2000) (affirming jury verdict that franchisor's reasons for denying franchise applicant were pretext for discrimination in violation of Section 1981).

99. Cal. Civ. Code § 51.8(a) (2006).

100. *See supra* Part 1.B.2.

101. 15 U.S.C. § 1681b.

102. *Id.* § 1681b(b)(2)(A)(i)-(ii).

103. *Id.* § 1681d(a)(2).

104. *Id.* § 1681b(b)(3)(A)(ii).

information or issues with the check. Once a franchisor decides to deny a franchisee applicant, the franchisor must (1) inform the applicant that they were rejected because of the information in the report; (2) provide the name, address, and phone number of the company that conducted the background check; (3) state that the company that conducted the background check did not make the hiring decision; and (4) indicate that the applicant has the right to dispute the accuracy of the report and may obtain an additional free report from the background check company used within sixty days.[105]

B. *Potential State Law Limitations*

Franchisors should also investigate potential state anti-discrimination laws that expressly apply to franchisors and the franchisee screening process. For example, California law[106] states that "[n]o franchisor shall discriminate in the granting of franchises solely because of the race, color, religion, sex, national origin, or disability of the franchisee . . . ."[107] This law also provides that a franchisor may be liable for utilizing screening tests to intentionally discriminate against persons who are considered a protected class under California law.[108] The California statute is just one example, but franchisors should maintain vigilance related to the applicable laws within their respective states to ensure the screening and criminal background check process being used does not violate a state law.

C. *Best Practices: Franchisors Conducting Background Checks on Prospective Franchisees*

Franchisors should indeed conduct background checks on prospective franchisees. This check can help determine if a prospective franchisee is the correct fit. However, if a franchisor is using a third-party company to conduct the background check, the franchisor will need to ensure that it is complying with all of FCRA's requirements. From a federal standpoint, a franchisor does not have to worry about Title VII claims when conducting these types of criminal background checks, but some state laws are implementing requirements that are very similar. A franchisor should ensure that its use of background checks does not discriminate against applicants based on the Title VII protected classifications and does not have a disparate impact.

III. Conclusion

Franchisors can and should require franchisees to use background checks in the franchisee-employer employment decisions. However, care should be taken that the policies do not cause a disparate impact, and the policies should articulate a clear business necessity for conducting background checks

105. *Id.* § 1681m(a).
106. Cal. Civ. Code § 51.8(a).
107. *Id.*
108. *Id.* § 51(b), (e).

on franchisee employment applicants. Franchisor policies should focus on brand protection and limit the day-to-day control over the franchisee's hiring decisions. Franchisees should ensure that they are using the background checks for brand protection purposes and apply the *Green* factors in application to each applicant denied employment because of the background check results.

Addressing Issues That Arise in a Mature Franchise System

*Ted Pearce**

Mr. Pearce

As franchise brands mature, they face a series of challenges that can either push the brand higher and to the next level, or sow the seeds for ultimate destruction. For many during the mid-twentieth century, Howard Johnson's, with its unmistakable orange roof and twenty-eight flavors of ice cream, was a country-wide landmark. "Having withstood a depression, a World War, and gasoline shortages in the 70s, the chain must have done something right."[1] The once iconic brand now has all but disappeared. In the 1970s the restaurant chain grew to more than 1,000 units. But in the 1990s, the chain fell hard. Few could have predicted that its number of restaurants would dwindle down to fewer than sixty by 2001, and there is only one left today.[2] "Critics of the chain noted that for years the company was not innovating or responding to changes in the industry."[3]

This article explores the initial development of franchise systems, the signs, and consequences of maturation, and how best to meet the common challenges facing mature franchise systems. Finally, this article discusses the pros and cons of using a franchisee advisory council or independent franchisee association to assist in confronting the challenges of a maturing franchise system.

1. William Crandall & John A. Parnell, *Howard Johnson's: Rise and Fall of an American Icon*, 19(2) Hosp. Rev. 23 (2001), *available at* https://digitalcommons.fiu.edu/cgi/viewcontent.cgi?article=1347&context=hospitalityreview.

2. *Id.* at 30; *see also Howard Johnson Restaurant to Close; Only 1 Left*, WMTV (Aug. 23, 2016), https://www.wmtw.com/article/howard-johnson-restaurant-to-close-only-1-left/2553107#.

3. Crandall & Parnell, *supra* note 1, at 30.

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I. The Initial Development of a Franchise System

Most franchise systems are born out of a business concept that the developer believes is replicable beyond the initial store, restaurant, or business. The idea for a new product or service may germinate out of the fulfillment of a specific need in the marketplace. For example, specialty automotive repair shops grew and prospered out of the oil shocks of the 1970s when countless gasoline/repair facilities closed, necessitating the development of specialty automotive repair facilities.[4] The ultimate genesis of the ubiquitous salad bar may have gained its foothold as far back as the late 1960s when Norman Brinker, the founder of Brinker International, the parent company of several well-known restaurant chains, added the salad bar to his Steak and Ale restaurants to keep customers happy and busy while waiting for their entrees.[5]

Expansion through franchising has proven to be one of the most effective forms of small business expansion. As of January 2020, there were 773,600 franchise establishments across the country.[6] As noted in an article discussing the growth of franchising, "Given the [franchise] industry's past success and projected future growth, it is only natural for entrepreneurs to wonder whether their business concepts are suited to franchising."[7]

The entrepreneur who believes in the success of the new product or service must answer several questions to determine whether the concept can be successfully franchised. Beyond the legal requirements of franchise registration, the entrepreneur devising the new concept must ask (1) Does the product or service satisfy a basic consumer need or desire? (2) Can the business concept be replicated? (3) Will the business concept be profitable to the franchisee? (4) Will the franchise concept be profitable for the franchisor? and (5) Is there enough "glue" to keep the franchisee in the system after it has learned the business concept?[8]

After the franchise concept is established, the franchisor will begin the process of recruiting franchisees. This initial development phase may start slowly, but, if the concept gains traction, growth can become meteoric.[9] During this development phase, the franchisor will continue to tinker with

4. Nearly fifty years later as the move to electric vehicles gains traction, there will be new pressures on automotive specialty repair chains to adapt to these technical innovations.

5. Julie Brown-Micko, *Culinary Curiosities: How Salad Bar Allegedly Got Its Start*, FoodServiceNews (Aug. 2, 2016), https://www.foodservicenews.net/article-archive/culinary-curiosities-how-the-salad-bar-allegedly-got-its-start/article_9f1f9efe-d46b-5e65-9464-5e44e264d458.html.

6. *Business Outlook for 2020*, FranData (Int'l Franchise Assoc.) 2 (Feb. 6, 2020), https://franchiseeconomy.com/assets/26602.pdf.

7. Corby Anderson & Ted Pearce, *Franchising Is Hot, but Not for Everyone: Before Considerin—Ask Five Questions About Your Business*, JDSupra (Feb. 12, 2013), https://www.jdsupra.com/legalnews/franchising-is-hot-but-not-for-everyone-72306.

8. *Id.*

9. For example, in 1982 the Meineke Discount Mufflers had 200 units, and 800 units by 1986. Likewise, Subway had 200 units in 1981 and 5000 units by 1990 (basically doubling in size every two years). Frank Olito, *The Rise and Fall of Subway, The World's Largest Fast-Food Chain*, Insider (Nov. 3, 2020), https://www.businessinsider.com/rise-and-fall-of-subway-restaurants

the concept in ways that it believes will continue to attract new franchisees. At the same time, the franchisor must be mindful of its young franchise base's needs and provide its franchisees with ongoing training and operational support.

It is during this growth period that the franchisor will begin to add or organize its infrastructure to add personnel to assist in managing its franchise system. Expanding the franchise infrastructure may, and often does, include adding personnel to monitor the operations of the franchise system, assist franchisees in finding suitable locations or territories, and assist in the retail advertising and marketing of the products or services. As the franchise system continues to grow, the franchisor may bring some of its infrastructure requirements in-house, such as legal, franchise sales, accounting, and other business functions that previously may have been obtained from outside vendors or suppliers.

According to the Franchise Performance Group (FPG), an organization that specializes in helping brands grow by recruiting franchisees who are likely to thrive in a brand,[10] a franchisor's life cycle mirrors the economist Raymond Vernon's product life cycle. "[D]uring the introduction stage of Vernon's product life cycle, a company needs to focus on marketing to build brand awareness, engage customers to try the product, grow a customer base and gather market share. During Growth, a company runs hard, seeking to establish a dominant position and maximizing the opportunity by outpacing the competition."[11] The FPG life cycle characterizes early-stage growth from anywhere between one and twenty units.[12] At this phase of the development, a franchisor should seek to establish a sense of family and community, or "esprit de corps" with its franchisees, grounded by the symbiotic need to realize the mutual benefits from the nascent system. If, however, franchisees are resentful or unhappy, the franchisor will need to ascertain the roots of this animosity at such an early stage of development. Has the franchisor lived up to the promises it made during the franchise sales process? By the same token, does the franchisee appreciate the hard work involved in making a small business successful?

A franchise concept that has gained traction, and has the support of its franchise system, will likely continue to expand. While expanding beyond this early-stage growth, the franchisor should query whether its concept is still fresh, whether continued demand still exists for its product and/or services, and whether the market remains segmented enough such that the

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-2019-9#it-was-relatively-easy-to-buy-a-subway-franchise-so-the-company-easily-grew-throughout-the-80s-and-90s-3.

10. See Mission Statement, Franchise Performance Grp. (2020), https://franchiseperformancegroup.com/our-mission.

11. Joe Matthews, *Franchisor Life Cycles*, Franchise Performance Grp. (Aug. 30, 2017), https://franchiseperformancegroup.com/franchisor-life-cycles.

12. *Id.*

franchise system can continue to grow its market share. During this phase, the possibilities for continued unit growth will remain abundant.[13]

II. Signs of Maturity of the Franchise System

No specific time frame in the development of a franchise system signals maturity; it is a combination of a multitude of factors. One must look at the overall development of the system, the franchisees in the system, the market, and the disposition of management. The exigencies of the market, the speed of franchise system growth, and the adaptability of the management will determine when the franchise system has reached "maturity." At some point, however, every franchise system will reach maturity. A franchisor's ability to recognize the signs of maturity will help it strategize how to best handle this next evolutionary period in the franchise system. A number of key issues/occurrences trigger maturity or a need for change. These triggering events include: (1) shifting consumer preferences; (2) change in demographics; (3) purchasing power of teenagers; (4) ethnic changes; (5) changes in area population; and (6) changes in technology.[14]

A. *Mature Unit Development*

From a franchise development standpoint, maturity likely will correspond to market saturation. After a franchise system expands and saturates primary markets, the few remaining opportunities may only lie in tertiary markets or fill-in locations in already developed markets. As the franchise system becomes more fully developed, franchisors' revenues are more dependent upon royalty income. If the franchisor's royalty stream has not sufficiently developed, then the reduction of initial or development fees from a slowdown in franchise sales will result in the franchise system having less funds available for services like ongoing training, marketing, and operational support. A franchisor's general pullback from these ongoing services may well impact not only further franchise system growth, but also same-store sales of individual franchisees.

B. *Changing Market*

One noticeable sign of maturity is a change in the marketplace. These changes are frequently the result of the franchise system's unique product offering becoming commoditized. One of the great examples of this phenomenon is the frozen yogurt industry. When frozen yogurt franchises first started, they were a unique proposition; there were few if any stores selling

13. While the franchisor should continue to concentrate its efforts on domestic growth, as the franchisor becomes better known it may receive inquiries about possible international growth. International growth, while seemingly glamorous, is not without its many complexities that may strain the limited resources of the franchisor, and is beyond the scope of this article.

14. Jeffrey Brimer, David W. Oppenheim & Andra Terrell, *Transforming and Modifying the Mature Franchise System*, Am. Bar Ass'n 29th Annual Forum on Franchising, W–18, at 2–3 (Oct. 11–13, 2006).

frozen yogurt, or "fro-yo," as it became known. At the outset of this craze, franchisees opened a large number of yogurt shops in New York City as well as other places. The maturity of this franchised industry was aptly described as follows:

> [But] businesspeople kept opening new shops even as interest waned, and that's because the logistics of opening a fro-yo shop over a traditional restaurant do seem tempting: Locations don't need to be outfitted with full kitchens, employees don't require much training, and food costs are both steadier and lower than at typical restaurants. (Yogurt and toppings cost operators about 25 percent of the price they can sell them for; a restaurant is lucky if its costs are at 30 percent.) In fact, the model is so popular that the USDA says frozen-yogurt mix is among the few dairy categories to actually increase in production compared to levels from the previous year. (But more operators buying yogurt mix doesn't necessarily mean more customers are buying yogurt.)[15]

Eventually, the unique proposition of frozen yogurt became a commodity available seemingly on every street corner. As one New York City real estate broker commented, "I don't know how many more frozen yogurt places we can handle, but every time I think I'm done, you see another one . . . ."[16] A lack of differentiation further contributed to decreased demand for the product: "That yogurt mix is just one reason these shops all feel the same. Hardly anyone makes much of the fact that almost every business uses the same commercial mixes, produced by a company called YoCream, a division of Dannon."[17] As the differentiation between competitive yogurt brands became hard to spot, it became more difficult to attract a loyal customer base. Moreover, as customers' taste and demand for yogurt began to cool, the supply of yogurt stores began to outstrip the demand for the product.

Eventually, in New York City, the craze for yogurt was supplanted by green juice, a beverage made from the juices of green vegetables.[18] The value proposition for frozen yogurt franchisors and franchisees began to fade. As demand for frozen yogurt began to lag, franchise systems were left with the conundrum of how to build same store sales with a declining product. If unable to increase their sales with yogurt or other products, frozen yogurt shops would slowly be forced to close—and that is exactly what happened. For example, until TCBY reconfigured its business model to focus on self-serve stores where customers can mix and match flavors, it lost more than two-thirds of its 1,500 stores in the two decades following the initial craze in the 1980s.[19]

15. Hugh Merwin, *Fro-No: How New York City Soured on Frozen Yogurt*, N.Y. Mag. (May 15, 2014), https://www.grubstreet.com/2014/05/new-york-city-frozen-yogurt-boom-is-over.html#_ga=2.125936974.258368446.1605018760-1018389023.1605018760.

16. *Id.*

17. *Id.*

18. *Id.*

19. Daniel McGinn, *The Great Froyo Gold Rush*, Boston Globe (May 26, 2013), https://www.bostonglobe.com/magazine/2013/05/25/pinkberry-orange-leaf-and-more-charting-frozen-yogurt-gold-rush/vZZ5RMe2MVUV6u7g9Eo8tM/story.html.

C. *The Changing Economic Proposition for the Franchisee*

The key component of a successful franchise system is successful franchisees. Without a profitable franchisee base, the franchise system cannot prosper long-term. While this statement is more than obvious, all too often, in practice, franchisors either do not completely understand this proposition or refuse to change their initial business model in response to changes in the market or the franchisee economics.

For franchisees to succeed, sales must cover the expenses of the franchised units and provide franchisees with income and the ability to obtain a return on their initial investments. Ideally, the original economic model will provide long-term sustained growth for franchisees. But this arrangement is not always the case because market and economic conditions are not static and are constantly changing. As explained by Michael Seid,

> Ask any experienced and smart franchise executive—'How's business?'—and 99 out of a hundred times your discussion will be around same-store sales, average unit volumes, customer counts, cost of goods, labor rates, etc. Experienced franchisors are focused on what is required to sustain the system in good times and bad, and unit performance is at the center of their universe.[20]

A material negative change in the demand for the franchise system's core products is one of the key indicators of a maturing franchise system.[21] In the automotive aftermarket industry, the introduction of stainless-steel mufflers in the late 1980s all but eliminated the need for frequent change-out of exhaust systems. When muffler franchises were founded in the early 1970s and before, the fact that customers frequently needed to replace their mufflers or exhaust systems every three to four years was their primary value proposition. In addition, the gross profit percentage for a franchisee for the sale and servicing of exhaust systems was significant. The consumer demand for replacing an exhaust system at those intervals, and with those high margins, made for a consistent and predictable franchised business model. In the late 1980s, however, stainless steel mufflers replaced mild carbon steel, which suffered from poor corrosion resistance when exposed to road salt and exhaust condensate, and substantially reduced the frequent need for exhaust system replacement.[22] Declining revenues forced franchise systems to look to replace their lost income with other products and services such as brakes and oil changes, but these services did not provide the same or similar margins.

20. Michael Seid, *How Do Economic Downturns Generally Impact Franchising?*, MSA Worldwide, https://www.msaworldwide.com/blog/downturn_in_the_economy.

21. *See, e.g.*, Brimer, Oppenheim & Terrell, *supra* note 14, at 1 (discussing how changes in consumer preferences, for example, "the popularity of low and no-carbohydrates diets caused a significant, rapid shirt in restaurant menus").

22. The owner of the Mighty Muffler chain reported that "[s]tainless steel exhausts especially hurt the industry . . . because they don't need to be replaced." *See* Lori Lovely, *Mighty Muffler*, SHOP Mag. (Nov. 20, 2009), https://theshopmag.com/features/mighty-muffler. The Mighty Muffler owner then noted: "Seventy-five percent of Mighty Muffler's business is exhaust systems, but because the market is down, . . . the company is diversifying by getting into brakes, shocks, struts and CV axles. However, those are highly competitive markets with smaller margins." *Id.*

The longer time between exhaust system repairs, coupled with products and services not producing the same margins, resulted in the erosion of franchisee per store net profits.

With the original valuation proposition vanishing, so too did the ability of franchisees in this sector to stay in business. Fewer franchises were sold, while existing franchisees left various systems either through sale or closures. Beyond the automotive industry and the example above, a failure to address fundamental changes to a franchise system's original value proposition could result in catastrophic consequences for a franchise system in any sector.[23]

D. *Franchisee Relationship Fatigue*

The lifeblood of a franchise system is its franchisees; the more successful they are, the more successful the franchisor. In part, a franchise system's success will be a function of its franchisees staying motivated to continue to improve their performance during the term of the franchise agreement and beyond. But while their ongoing success is not automatic, over time, their actions likely will become predictable. To determine a franchisee's motivation, a franchisor will need to ask (1) how long will a franchisee remain mentally tethered to the franchise system; (2) when will a franchisee burn out; and/or (3) when will life-style satisfaction begin to de-motivate a franchisee?

Inevitably, a franchisee may tire of the business, especially if a successful franchised business requires the franchisee to manage the operations on a day-to-day basis. Moreover, when a franchisor changes the franchise system and modifies the manner by which franchisees conduct business, long-time franchisees often perceive the changes as unnecessary interference, which leads to relationship fatigue. In fact, an industry analysis reports that "[w]hile the average tenure of a franchisee in a franchise system seven years, the average tenure of a franchisor executive is three to four years. So it is likely most franchisees will have seen off at least two generations of franchisor executives."[24] Some of these past relationships will have been valued, especially where a franchisee has received significant business or personal mentoring. The trust and commitment needed to build a successful franchise

23. For example, in response to Carvel seeing its sales in franchised stores steadily declining as a result of competition from frozen desert providers who were selling their products in supermarkets and from non-traditional competitors, such as McDonalds and Burger King, who began selling frozen desserts in their restaurants, Carvel commissioned a study, which concluded that it would be in Carvel's best interests to begin distributing in supermarkets. Carvel accepted the recommendation and implemented its supermarket sales program. *See* Brimer, Oppenheim, & Terrell, *supra* note 14, at 11 (discussing Carvel Corp. v. Baker, 79 F. Supp. 2d 53, 57 (D. Conn.1997)).

24. Greg Nathan, *The Challenge of Supporting Mature Franchisees*, Int'l Franchise Ass'n (Sept. 16, 2016), https://www.franchise.org/franchise-information/franchise-relations/the-challenge-of-supporting-mature-franchisees. In his article, Nathan lays out eight considerations when working with mature franchisees, which he characterizes franchisees moving through the "Zone of Creative Tension." *See also* Engel Schmidl, *Why Is Tenure So Important to Franchisee Satisfaction and Recruitment?*, SmartCompany (Sept. 10, 2012), https://www.smartcompany.com.au/business-advice/franchising/why-is-tenure-so-important-to-franchisee-satisfaction-and-recruitment.

relationship take time and energy, and mature franchisees will have been through this process several times. Franchisor executives joining a franchise network should consider that their mature franchisees may be thinking "Here we go again."[25]

What are the signs of franchisee burn-out? While there is no exact science on this point, a franchisor should question whether a franchisee's downward trajectory of sales or increased customer complaints could be a symptom of franchisee burnout. According to the founder and CEO of Pi Slice, commenting on clinical research papers and statistics on the rise of depression and burnout in the general workforce:

> [There are] two types or burnout: circumstantial and existential. Circumstantial burnout stems from workplace challenges, neglect of personal life, and not taking some time off. Existential burnout stems from loss of meaning in one's profession, lack of self-validation, loss of understanding of professional identity, and loss of connectivity with colleagues and clients.[26]

Many franchisees who are highly motivated and passionate about their business can also be obsessive about it. It is often hard to separate them from their business. As a result, they can suffer a high degree of burnout.

Conversely, the success of a franchisee's business may also result in franchisee relationship fatigue. As the franchisee becomes more successful, the owner may reach the point where he or she has achieved lifestyle satisfaction, such that continued growth of the franchised business takes a backseat to maintaining and/or enjoying the newly won lifestyle. At that point, the franchisee no longer seeks improved operations or increased revenues, but instead becomes satisfied with the status quo. In both cases, the maturity of the franchise relationship becomes an impediment to the growth of the franchise system.

E. *Management Fatigue*

As there are life cycles of businesses, so too are there life cycles of franchise management teams. At the outset, founders typically focus on developing and tinkering with the system to make the concept as usable as possible for the franchisees and customers. However, even if franchise system founders are active in designing the system during the development stage, they may not have the skills required to grow the system or to manage the system once a certain level of complexity or complication is reached. Likewise, a management team heavily invested in the product or service that formed the basis of the franchise system may be so tethered to the business concept that it is hard to see or accept the changing marketplace and the need to change or update the products and services that served as the core for the business concept.

25. *Id.*

26. Genny Ghanimeh, *Understanding Entrepreneurial Burnout (And How to Deal with It)*, Entrepreneur Middle East (May 19, 2019), https://www.entrepreneur.com/article/333631.

Why do problems between franchisees and franchisors arise during this period? At this stage of the franchise relationship, the franchisor's and franchisee's goals can conflict with one another, which can result in a shared feeling of failure. For example, "[a] lack of trust and communication between both parties worsens this cycle."[27] Consequently, these types of issues can spur and hinder potential success. Therefore, it is worth facing these problems head-on in order to maintain a mutually beneficial relationship between the parties.

Franchisors need to be adaptive in managing their franchise system. Not only must the franchisor identify necessary modifications to the franchise system, it also must merchandise them to the franchisee community. Management of the franchise system will be evolutionary. For the franchisor executive, "[a] management style that worked well in designing the franchise system may not be successful in developing and managing the franchise system. "Franchise management will find it problematic managing a maturing franchise system if it does not understand both the market and the ever-changing relationship model."[28]

Bad management can wreak havoc on the best of franchise concepts. A good franchisor must pay attention to all aspects of its franchise system, including its overall vision for the chain, system standards, communicating with its franchisees, operational measurements, accountability, and enforcement. "Bad management can infect an organization in a thousand different places and in a thousand different ways. And even good managers can be guilty of it on occasion. Franchising offers many advantages to those desiring growth. But it's not without risk and it's certainly not easy."[29]

III. The Consequences of Maturity in a Franchise System

A. *Underperforming System*

Often, a franchise system that experiences the signs of maturity described earlier starts to underperform. Underperformance manifests itself in loss of market share, lower same store sales, higher franchisee turnover, decreasing franchise system sales, and restive franchisees, leaving the long-term prospects of the franchise system at risk. The Franchise Disclosure Document (FDD)—specifically, Item 19: Financial Performance Representations; Item 20: Outlets and Franchisee Information; and Item 21: Financial Statements—provide prospective franchisees with helpful information for evaluating the status and trends of a franchise system. Moreover, prospective franchisees who speak with existing franchisees may be left with the sense

27. AJ Beltis, 7 *Issues That Harm Franchisor, Franchisee Relationships*, 7 SHIFTS | BLOG, (Dec. 11, 2019), https://www.7shifts.com/blog/franchisor-franchisee-relationship.

28. Mark Siebert, *Why Do Franchisor's Fail?*, ENTREPRENEUR (Aug. 26, 2008), https://www.entrepreneur.com/article/196676.

29. *Id.*

that the maturing franchise system has lost its vitality and will not feel comfortable in investing in a system that appears to be on a downward trend.

B. *Restive Franchisees*

New franchisees have numerous expectations. A new franchisee's primary expectation is that it will profit from the day-to-day operations of its franchise unit. The franchisee's ultimate payoff, however, often is leveraging the value of the franchised business to create wealth (whether in fact the franchisee monetizes that investment, passes the business onto family members, or uses its investment for leverage to purchase additional franchises). When the franchise system does not meet these twin goals for franchisees, the franchisee may become either apathetic or restive. In either case, these attitudes will not bode well for the franchise system.

An apathetic franchisee may "go through the motions," but sooner or later, it will suffer from underperformance. The underperformance may force the franchisee to sell at a discount or even worse, prematurely close the franchised business if a sale is unlikely or will not provide the franchisee with enough cash to pay off its current business creditors. If there are enough underperforming franchisees within a franchise system, it can cause a downward spiral of franchise closures, thus undermining a franchisor's ability to attract new franchisees and customers. In an article discussing reasons that franchisees fail, an industry expert, Ed Teixira, says that "one of the reasons a franchisee is likely to fail is because the franchisee believes that success is easier to achieve than it really is."[30]

Equally as troubling are apathetic or restive franchisees who become so frustrated with their under-performance that they question the franchisor's ability to manage the franchise system. In that situation, franchisees may collectively confront the franchisor either informally or through an independent franchisee association.

While the presence of independent franchisee associations may benefit franchisees, the basis for an association's formation may create a relational challenge for a franchisor. Unfortunately, too many independent franchisee associations are borne out of conflict or frustration with the franchisor. Historically, franchisors feared franchisee associations because they often signified a breakdown between the franchise system and franchisees and a vote of no confidence. Franchisee associations were generally hostile to the franchise system.[31]

Franchise advisory councils (FACs)[32] are generally not meant to be confrontational. Instead, they are meant to act as a communication vehicle

30. Ed Teixeira, *5 Reasons Why Franchisees Fail*, Franchise Help, https://www.franchisehelp.com/franchisee-resource-center/5-reasons-why-franchisees-fail.

31. Rupert Barkoff, *Franchisee Associations: Nothing to Fear but Fear Itself, Usually*, Int'l Franchise Assoc. (Dec. 12, 2018), https://www.franchise.org/franchise-information/franchisee-associations-nothing-to-fear-but-fear-itself-usually.

32. A franchise advisory council is a council usually formed by the franchisor that is comprised of a number of franchisees in the franchise system that may be elected by the franchisees

between the franchisor and its franchisees. However, if franchisees believe that the FAC is merely an extension of the franchisor, they will become less supportive of this communications vehicle.

A franchise system can suffer all or some of the above-described consequences of a maturing franchise system, which, if not recognized early on, can lead to significant conflict between the franchisees and the franchisor and endanger the long-term health of the franchise system.

IV. How Can a Franchisor Best Meet the Challenges Posed by the Maturing Franchise System?

A. *Review the Product/Service Offering and the Value Proposition for the Franchisees*

Monitoring the continuing demand and relevance of its products and services, so franchisees maintain their profit potential, is one of the most elementary things that a franchisor can do to address maturation issues. If demand and relevance are decreasing, the franchisor must consider changing its product and service offering and/or adding new products and/or services that will meet the public's needs. While franchisors may be hesitant to update their business model and veer away from their original concept, a franchisor will surely suffer the consequences if it does not adapt its system to the ever-changing market.

In some franchise systems, the new products or services may already be core or supplemental products and services of competitors. In that case, the franchisor will need to differentiate itself further. Changing the franchise system's product and/or service offerings will be fraught with its own set of challenges as franchisees who are used to and comfortable with the existing product and service offering may resist change. More importantly, the franchisee may not realize the same profit margins from the new products and/or services. A franchisor's best chance at seamlessly implementing these necessary changes is to coordinate with its franchisees through a well-functioning FAC or an independent franchisee association.

The franchisor also may need to examine its value proposition to its franchisees relative to the distribution of its products and services. Can the franchisor supply its franchisees with the necessary products and services at competitive prices with nationwide distribution in a manner that will prove profitable to its franchisees? If the new products and services do not allow franchisees to profit, the franchisor may even need to consider adjusting its royalty and/or advertising contribution rate. While royalties are largely sacrosanct to a franchise model, in a maturing franchise system it may become necessary to adjust certain aspects of the franchise system through changes

or chosen by the franchisor. An FAC usually operates under the auspices of the franchisor, whereas an independent franchisee association is usually governed solely by franchisee members.

to the franchise agreement, including, when appropriate, adjustments to the royalty rate.

B. *Examine the Demographics of the Franchise System*

When addressing challenges of a mature franchise system, a franchisor should consider the demographics of its franchise system. What is the age of the units in the franchise system? What percentage of the units are owned by franchisees who have been in the system from the beginning? Are any of these franchisees suffering from relationship fatigue? If there is a growing apathy within its franchise system, the franchisor will need to decide how best to address that apathy. In some cases, particular franchisees may be unwilling to participate in the changes that the franchisor believes are necessary to address the maturation issues. Enlisting competent franchise counsel to help navigate changes to the system is very important because any changes may be limited by what is in the franchise agreement, franchise disclosure requirements, and state franchise relationship laws.[33] If the franchisor cannot convince its franchisees to implement changes to the product and/or service offering, it may need to suggest to the franchisee(s) to exit the system, ideally through a sale, as opposed to termination of the franchise relationship.

C. *Other Creative Options*

A franchisor may need to implement a series of creative solutions to combat accelerating consequences from previously unaddressed maturation issues. For a franchise system losing market share in a tightening market, co-branding (i.e., the marketing of a product or service under two or more brand names as part of a strategic alliance) is one method of freshening a franchise system. "Co-branding is used in franchising as a strategy to stimulate and rejuvenate growth, particularly in a mature franchise sector."[34] Likewise, it is critical for a franchisor to discover new marketing techniques that meet today's advertising exigencies. Older systems may have relied on television, radio, and the Yellow Pages to build its reputation. However, social media has replaced many of the more conventional means of advertising used by franchisors a generation ago. Today, a franchise system that does not employ the newest forms of marketing will be left behind in the ever-changing marketplace.

D. Authority to Implement Changes

Before implementing system-wide changes, a franchisor must ensure that it has the contractual authority to do so. As expressed in a franchise workshop on the implementation of franchise system changes, by franchise attorneys

33. For a comprehensive look at what must be considered before endeavoring to make material changes to the franchise system see generally Brimer, Oppenheim & Terrell, *supra* note 14.

34. Kerry Miles, *Co-Branding Pros and Cons*, FranchiseED (Feb. 7, 2018), https://www.franchise-ed.org.au/franchising/franchise-marketing/co-branding-pros-and-cons.

David Kaufman, Robert Zarco, and Kenneth Cutshaw, "[t]he ability of a mature franchisor to effect such system/concept changes largely derives from the reserved contract right to do so. Franchise agreement language addressing this subject is critical."[35] Moreover, the franchisor's operations manual likely requires the franchisee to abide by the systems and standards set out in the manual, as the franchisor may change from time-to-time.

On this issue, courts have historically sided with franchisors facing challenges from franchisees as to whether the franchisor's implementation of system changes violated a legal duty owed to the franchisees.[36] For example, in *In re Frusher*, the court agreed with Baskin-Robbins when it refused to provide its franchisee with its new product line because the franchisee had failed to implement systemic changes to the franchise system.[37]

However, even if the franchise agreement and operations manual provide ample authority to require franchisees to undertake systemic changes, franchisees have succeeded in challenging system-wide changes in some cases. For example, in *Amos v. Union Oil Co. of California*, the U.S. District Court for the District of Oregon found that an oil company's sudden lowering of octane in its gasoline, and a discontinuance of a popular leaded gasoline, constituted a breach of the implied covenant of good faith and fair dealing.[38]

Practically speaking, however, even if a franchisor has the legal right to enforce system-wide changes, bludgeoning franchisees with its ability to do so is like a red rag to a bull and will do more to tear the system apart than it will to support the franchisor's system-wide changes.

E. *Work with the Independent Franchisee Association or Franchisee Advisory Council*

Rather than command franchisees to comply with system-wide changes, franchisors are generally better served addressing system maturation issues through a FAC or an independent franchisee association. FACs are usually formed under the auspices of the franchisor, and its members are either appointed by the franchisor or democratically elected.[39] In some cases, however, franchisees are concerned with a lack of independence; they may believe that the FAC is nothing more than a tool of management that pays lip service to the franchisees' needs. In that case as discussed earlier, the franchisees may establish an independently run franchisee association.

35. David J. Kauffman, Robert Zarco & Kenneth A Cutshaw, *Implementing System Upgrades and Enhancements: Business And Legal Considerations*, Int'l Franchise Ass'n 44th Ann. Legal Symposium, at 1 (May 15, 2011).

36. *Id.* at 4 ("Over the years, virtually every court asked to rule on a mature franchisor's ability to modify its system and concept have sided with the franchisor.").

37. *In re* Frusher, 146 B.R. 594, 598 (Bankr. D.R.I. 1992).

38. Amos v. Union Oil Co. of Cal., 663 F. Supp. 1027 (D. Or. 1987).

39. *See* Roger Schmidt & Harris Chernow, *Managing the Organization of a Franchise Association*, Am. Bar Ass'n 32nd Annual Forum on Franchising, W–13, at 2 (Oct. 14–16, 2009) (discussing FACs).

If a franchisor is prudent enough to recognize the need for constructive communication with its franchisees, it will have already established a well-working FAC, or established a working relationship with an independent franchisee association, to foster open and direct communications for issues like system-wide changes to address maturation problems. Franchisors who manage their franchise systems without seeking franchisee input, and franchisee buy-in, will likely find franchisees resistant to unilateral pronouncements. As explained by one franchisor lawyer, "[F]ranchisors who are not pro-active in establishing these lines of communications will likely have it thrust upon them. As a franchise organization grows, franchisees will want to continue to be heard through some representative group, whatever form that may take."[40]

As discussed earlier, the consequences of unchecked maturation can be problematic and even catastrophic for a franchise system. If a franchisor is willing to engage with an FAC or an independent franchisee association, it should discuss the strengths, weakness, and threats facing the franchise system. Franchisees are often better positioned to understand the problems facing the business concept. For example, it is the franchisees who will directly hear customers complaining about prices or menu offerings or décor. While sometimes the interactions between franchisor and an independent franchisee association are acrimonious, two-way communication is essential to understanding franchisees' concerns and problems. Bilateral communications between the franchisor and the franchisee are a cornerstone of a successful franchise system. A franchisor cannot identify and solve operational problems without significant input from its franchisees. Accomplished franchise systems recognize this need and include their franchisees in many of their system-wide decisions. Take for example the A&W® Restaurants system:

> Because A&W is now almost entirely franchisee-owned, they operate on the word of those running the stores. And with that much input for change and growth, it's obvious it could take a bit of time to get everyone on the same page. "Every change A&W wants to make needs to be approved by the same people who live and run the brand on a daily basis . . . ."[41]

While meeting with discordant franchisees takes tremendous amount of resolve and patience from the franchisor, this bilateral communication may be the only way that a franchisor will truly understand endemic problems in the franchise system. Moreover, if franchisees cannot voice their concerns and make recommendations to their franchisor, they may perceive the franchisor as autocratic and not interested in the well-being of is franchisees and the overall franchise system.

40. Erik B Wulff, *Advisory Councils: Effective Two-Way Communications for Franchise Systems*, Int'l Franchise Ass'n, Franchise Relations Comm., at 5 (rev. 2005).

41. Molly Allen, *The Untold Truth of A&W*, Mashed (Aug. 8, 2019), https://www.mashed.com/161394/the-untold-truth-of-aw/?utm_campaign=clip (quoting A&W's then Chief Executive Officer Kevin Bazner).

While there is no guaranty that working with an FAC or independent franchisee association will solve maturation problems, at the very least the franchisor will understand, and have the opportunity to focus on, the issues that franchisees perceive to be the genesis of the problems facing the franchise system. Moreover, when the franchisor develops a course of action to address the maturation issues, it will need all the assistance that it can muster to convince franchisees in the system to undertake these changes. Peer pressure is often the best means of successfully merchandising changes to the franchise system, and an independent association of a franchisee's peers may be the best vehicle to help accomplish these needed changes.

When the author was general counsel for Meineke, the company worked with the independent franchisee association (Association of Muffler Dealers) for almost three years to address many of the issues relating to the changes in the marketplace. These discussions resulted in a new franchise agreement that obtained the Fair Franchising Accreditation seal from the American Association of Franchisees and Dealers. Without the cooperation, patience, and the spirit of compromise between the franchisees and the franchisor, the parties would never have developed this new franchise agreement that met the needs of both the franchisor and the franchisees.

V. Conclusion

Maturity of franchise system is inevitable. The question is not if, but when. The rapid changes in the marketplace likely will dictate when maturity occurs, but no franchise system can escape it. Unlike the Howard Johnson's and other vanishing trademarked systems of the world that became irrelevant in little more than ten years, it is critical that franchisors not only recognize the signs of a maturing system, but also develop a strategy for addressing necessary changes.

LADR Case Notes (April–June 2021) and FLJ Currents (Winter 2022)

*Bill Bryner, Jared C. Miller & Kevin M. Shelley**

RECENT CASE NOTES FROM THE FORUM ON FRANCHISING'S LITIGATION AND DISPUTE RESOLUTION DIVISION (LADR)

Mr. Bryner

Mr. Miller

Mr. Shelley

The following case summaries were originally distributed by the ABA Forum on Franchising's Litigation and Dispute Resolution Division on ABA Connect between April and June 2021. The case summaries are republished here, with minor stylistic updates to match the *Journal*'s standard style practices, so that members of the Forum have a convenient and consistent way of locating past case notes. The case notes are distributed without personal attribution, so no personal attribution is given here.

APRIL 2021 LADR NOTE

***Mount Holly Kickboxing, LLC v. FranChoice, Inc.*, No. 19-300 (MJD/ECW), 2021 WL 1117968 (D. Minn. Mar. 24, 2021)**

The United States District Court for the District of Minnesota's March 24, 2021 summary judgment order in Mount Holly Kickboxing, LLC v. FranChoice, Inc. effectively concludes as many as twelve individual actions by separate franchisees of the iLoveKickboxing.com (ILKB) system who asserted claims against a single franchise broker related to its brokerage activities on behalf of ILKB. These actions arose from similar alleged financial and operations-related misrepresentations by

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ILKB that were communicated to the franchisees by broker FranChoice, Inc. (FranChoice) in the course of FranChoice's consultation with the franchisees to select a franchise opportunity. The cases were filed in the United States District Court for the District of Minnesota between February and June 2019, with the Mount Holly action being the earliest filed. The ILKB suits broke new ground for franchisees last year when the court held that the New York Franchise Sales Act authorizes recovery against a franchise broker related to the broker's sales activities on behalf of a franchisor.

Despite the court's broad reading of the New York statute, however, on March 24, 2021, it granted summary judgment to FranChoice on all claims in the Mount Holly action, signaling a similar fate for the remaining ILKB franchisee suits. The court ultimately held that the various representations relied on by the ILKB franchisees were inactionable and could not support fraud, negligent misrepresentation, or related statutory claims as a matter of law.

Franchise consultant and broker FranChoice maintains an inventory of franchisors to whom it refers franchisee candidates. In vetting its inventory of franchisors, FranChoice reviews the franchisor's FDD, conducts interviews with the franchisor's management executives, interviews the franchisor's existing franchisees, and analyzes the franchisor's communication and documentation system for its communications with prospective franchisees. FranChoice does not re-evaluate franchisors after its initial decision to begin making referrals to them. FranChoice advertises to franchisee candidates that it does "much of the homework" for them, including "pre-screen[ing]" numerous franchisors to find those that meet FranChoice's "exacting standards." FranChoice also advises candidates, however, that they must conduct their own research, including reviewing target franchisor's FDDs and interviewing current franchisees, before making a final decision.

Plaintiffs in the Mount Holly action were Dhyan Tarver, a North Carolina resident who purchased an ILKB franchise after consultation with FranChoice, and his limited liability company, Mount Holly Kickboxing, LLC, to which he assigned the franchise. Plaintiff Tarver's relationship with FranChoice began by completing a questionnaire and conducting a ninety-minute consultation call in August 2016. Tarver was interested in a franchise opportunity that worked on an absentee owner model that would allow him to keep his separate fulltime job. FranChoice recommended ILKB as one of three possible opportunities and indicated that ILKB was suitable for absentee ownership. FranChoice then sent Tarver a "Company Investigation Procedure" document, outlining six steps for potential franchisees to investigate a franchise opportunity, and put Tarver in contact with an ILKB representative.

Tarver met with the ILKB representative, who provided Tarver a copy of the FDD. Tarver claimed that, in addition to representing the franchise's suitability for absentee ownership, ILKB represented to him that (1) the maximum cost to start the franchise would be $275,000; (2) other franchisees made monthly profits ranging from $10,000 to $20,000, and Tarver should make that much in monthly profit; (3) there were no struggling ILKB franchisees; (4) ILKB locations broke even before their grand openings; (5) ILKB handled all the marketing; (6) he would only need 200 members to break even; (7) ILKB worked well with franchisees and was very responsive; and (8) no ILKB franchises had closed. Tarver then read the FDD, which included representations about the total investment and, separately, included a "List of Terminated Franchises." Tarver participated in group validation calls with several franchisees but did not speak one-on-one with any ILKB franchisees before making his purchase decision. After attending Discovery Day at ILKB's headquarters, Tarver told FranChoice that he would be moving forward with the ILKB opportunity and, subsequently, entered into a franchise agreement with ILKB. He then formed a limited liability company, Mount Holly, to which he assigned the franchise.

Tarver invested $65,000 of his own money and borrowed more than $300,000 to start the studio. After opening, though, he struggled to maintain the franchise as an "absentee ownership" operation and found that he and his wife needed to spend significant time running the franchise business. Tarver was disappointed with ILKB's marketing, which he believed was ineffective, resulting in too few memberships. In February 2019, Tarver and his limited liability company sued FranChoice, asserting claims under the New York Franchise Sales Act, the North Carolina Unfair and Deceptive Trade Practices Act, as well as claims for fraud, and negligent misrepresentation. Plaintiffs moved for summary judgment on the North Carolina statutory claim. Defendant FranChoice moved for summary judgment on all counts.

The court first considered whether Tarver's limited liability company—formed after Tarver's execution of the franchise agreement—had standing to assert any claims in the complaint. The court held that it did because there was evidence that the representations were made to Tarver with the intent that he and a subsequently formed business entity would rely on the representations to purchase and operate the franchise. Under North Carolina law, there was reason to expect that the later-formed entity would also be relying on the representations, which was sufficient to establish Mount Holly's standing.

The court then turned to the representations underpinning Tarver's substantive claims. It noted that an actionable representation must be a statement of past or present existing fact, not a prediction of future events, that the statement must be false when made, and that the statement must be more concrete than vague or non-specific "puffery." One of Tarver's nine asserted representations failed as mere "puffery." Specifically, the court found that any representations that the franchisor "works well" with franchisees or is "very responsive" were too vague to establish a statement of existing or past fact. The court found that the remaining eight representations were sufficiently concrete to survive the puffery test.

The fatal problem as to seven of those remaining statements, however, was that Tarver did not present evidence that the statements were false when made. The court found no evidence in the record that, as of August 2016, ILKB studios were not suitable for absentee ownership; the stated startup cost of $250,000 was inconsistent with other franchisees' experiences; other franchisees had not made monthly profits ranging from $10,000 to $20,000; no franchisees were struggling at that time; no franchisees had failed to break even before their grand openings; ILKB did not handle marketing for franchisees; or the stated 200-member break-even point was inconsistent with other franchisees' experiences at that time.

Only one of Tarver's asserted representations survived both the puffery and falsity tests: that no ILKB franchises had ever closed. But because ILKB's FDD clearly and directly contradicted that representation, the court found that Tarver could not reasonably have relied on the representation and therefore could not recover despite the statement's falsity.

The above findings were dispositive of Plaintiffs' statutory and common-law claims. As to the New York Franchise Sales Act, the court did not revisit its earlier holding that Plaintiffs could state a claim for recovery against a broker who passes along misrepresentations to a franchisee candidate in connection with facilitating the sale of a franchise. But the door that the court had opened for the ILKB franchisees was subsequently closed when the court held that the representations at issue in this case were inactionable under the statute as a matter of law.

The court also addressed another interesting question pertinent to many of the ILKB suits. Specifically, in Tarver's complaint, he had alleged that his North Carolina statutory claim was based on representations that ILKB franchises were suitable for absentee ownership; that ILKB would successfully handle all marketing needs of the franchise; and that Tarver would earn $10,000 to $20,000 a month. Tarver's summary judgment motion, by contrast, sought judgment under the North Carolina Unfair and Deceptive Trade Practices Act based on various representations set out on FranChoice's website concerning the nature of FranChoice's research and investigation into the franchisors to which it refers candidates. FranChoice opposed summary judgment in part on grounds that such a claim was not pleaded in the Complaint and that Federal Rule of Civil Procedure 8(a) barred the Tarver Plaintiffs from asserting a different claim in their summary judgment motion than had been pleaded in the Complaint. FranChoice's response prompted other ILKB franchisee plaintiffs to seek to amend their complaints to clarify their claims based on FranChoice's own website. The district court had denied those requests as untimely. In any event, in resolving the summary judgment motions in the Tarver/Mount Holly case, the court ultimately held that FranChoice's website marketing statements constituted mere puffery and were, thus, inactionable as a matter of law.

The court's March 24, 2021, summary judgment order effectively resolved all other ILKB franchisee actions pending against FranChoice. Within a week of judgment being entered against the Tarver Plaintiffs, court records reflect that eleven similar actions have been closed. Thus, the Mount Holly order concludes an interesting dispute between multiple ILKB franchisees and their franchise broker—one that broke new ground for franchisees under New York law but ultimately provided no recovery for these ILKB franchisees.

MAY 2021 LADR NOTE

***MTR Capital, LLC v. Lavida Massage Franchise Development, Inc.*, No. 21CV13552 TGB EAS, 2020 WL 6536954 (E.D. Mich. Nov. 6, 2020), *motion to amend judgment denied*, 2021 WL 1626353 (E.D. Mich. Apr. 27, 2021)**

This case shows that a franchisor's failure to provide potential franchisees with an updated franchise disclosure document (FDD) can lead to "Deceptive and Unfair Trade Practices Act" liability for not just the franchisor, but also any individuals involved in updating the document, without the plaintiff ever having to establish fraud or pierce a corporate veil.

In MTR Capital, the plaintiff entered into a franchise agreement with the defendant-franchisor to operate a massage center in Florida. Due to poor performance, the franchisee closed the business after only a year and a half. The franchisee then sued the franchisor and its president and area developer claiming that they induced the plaintiff to invest by making false statements and fraudulent omissions. The plaintiff sought to recover its entire investment.

The franchisee's claims were based, in part, on the failure to receive an updated FDD. The FDD had three main problems. First, the FDD did not include any financial performance data in "Item 19." The defendants chose not to make such Item 19 disclosures because certain franchisees were not performing well and the defendants believed disclosure would reflect poorly on the brand. Second, the FDD represented that the estimated initial investment costs were $160,250 to $290,000, and the franchisee spent much more, $479,000. Third, the FDD also failed to disclose in Item 20 that certain locations had ceased operations.

The franchisee brought claims for (1) fraudulent inducement and misrepresentation; (2) negligent misrepresentation; (3) violations of Florida's Deceptive and Unfair Trade Practices Act (FDUTPA) and (4) violations of the Florida Franchise Act (FFA).

Following a bench trial, the court determined that defendants were entitled to judgment on all claims except the FDUTPA claim. With respect to the FDD's Item 20, the evidence did not support a claim for fraud/fraudulent inducement and misrepresentation, or negligent misrepresentation. The court determined that Item 20's inaccuracies occurred primarily due to the franchisor's poor recordkeeping. The evidence was not sufficient to show the franchisor intended to make a false statement or intended for the plaintiff to rely on it. Although Item 20 was not specifically discussed with respect to the FFA claim, that claim required detrimental reliance on intentional misrepresentations, and the court found no violation.

Despite the court's conclusion that the Item 20 inaccuracies were due to poor recordkeeping, the court premised its finding of an FDUTPA violation on Item 20. The court determined that the defendants' failure to provide accurate, updated information in FDD Item 20 as required by 16 C.F.R. § 436.5(t) and § 436.7(b) violated the FDUTPA and that all defendants were liable. The franchise seller was required to disclose the total number of franchised and company-owned outlets and make quarterly updates to reflect material changes. The defendants violated 16 C.F.R. § 436.5(t) and § 436.7(b) by including inaccurate or incomplete information. This was a causal factor in plaintiff's signing the franchise agreement. The court determined the damages were the $39,000 franchise fee, but not the operating losses which were caused by the plaintiff's mismanagement. The court awarded judgment for the plaintiff against all of the defendants.

Post-trial, the defendants moved to modify the judgment, contending that it was error to enter judgment against all of the "Defendants" as a group because only the corporate defendant received the franchise fee. The court rejected that argument, determining that the plaintiff alleged and proved the individual defendants' "direct participation" in the conduct alleged. Such "direct participation" did not require finding an intent to deceive; it was enough to show that the individuals knew or should have known about the "misrepresentations" in the FDD. The court observed that the individuals should have known about the rules for keeping an FDD updated and providing potential franchisees with an up-to-date copy. Because the individuals did not do so, they could be held liable just as the corporate defendant could. Notably, the court's decision did not turn on whether the individual defendants were officers or executives of the franchisor, suggesting that UDTPA liability could extend to any individuals with a role in preparing the FDD.

MTR Capital underscores the need to make sure FDD's are accurate and updated as required. However, it also provides a cautionary tale for any individuals involved with updating and presenting FDDs because it suggests that, even with no intent to deceive, those individuals could have personal UDTPA liability for the franchisor's inaccurate FDDs under a theory of "direct participation."

JUNE 2021 LADR NOTE

United States v. Holmes, No. 18-cr-00258-EDJ-1, Doc. No. 812 (N.D. Cal. June 3, 2021) (report and recommendation), *objections overruled*, 2021 WL 2711230 (N.D. Cal. July 1, 2021)

This non-franchise case addresses an issue of privilege that is relevant to franchise attorneys who represent both a corporate client and the corporation's officers or employees who have been named personally.

Elizabeth Holmes was the founder and CEO of Theranos, a biotech company that claimed it had developed a revolutionary blood-testing technology that could screen for a wide variety of medical issues, including cancer, using only a tiny amount of blood. Theranos claimed its testing technology could produce results much faster at a fraction of the cost of current technology. Theranos raised more than $700 million dollars in capital and was valued at $10 billion. In 2015, after a *Wall Street Journal* exposé questioned its technology and the underlying research, Theranos and Holmes were sued by investors, multiple state attorneys general, the Security and Exchange Commission (SEC), and the Centers for Medicaid and Medicare Services. In March 2018, Holmes settled with the SEC and relinquished her shares and any control she had in the company. In June 2018, Holmes was charged with federal wire fraud. In September of the same year, Theranos entered into an assignment for the benefit of its creditors and transferred ownership of all its rights, title, and interests to an assignee. The Theranos assignee waived privilege of several documents that Holmes claimed were subject to her individual attorney-client privilege.

At issue were thirteen documents, including communications between Holmes and attorneys with Boies Schiller, and communications between Holmes, other Theranos employees, and Boies Schiller attorneys. Boies Schiller has represented Holmes jointly with Theranos in past litigation and the firm's founding partner, David Boies, was deeply involved with the Theranos and Holmes as an attorney, investor, and member of the board, and as a personal friend and defender of Holmes.

The government moved the United States District Court for the Northern District of California for an order holding that the thirteen documents were not privileged and were admissible. The government argued that Holmes had the burden of demonstrating privilege and could only establish individual privilege over corporate communications if she could satisfy each element of the *Graf* test. Under the *Graf* test, to claim privilege over corporate communications, an individual must to show that (1) they approached counsel for the purpose of seeking legal advice; (2) when they approached counsel, they made it clear they were seeking legal advice in their individual capacity; (3) that counsel communicated with them in their individual capacity, knowing that a possible conflict could arise; (4) the conversations were confidential; and (5) the substance of the conversation did not concerns matters within the general affairs of the company.

Holmes objected and argued that the relevant test should be whether or not she had an objectively reasonable subjective belief that Boies Schiller represented her personally. Holmes noted that Boies Schiller had jointly represented Theranos and her, individually, in multiple lawsuits between 2011 and 2016 and that the firm's relationship with Holmes and Theranos "evolved organically and without reference to an engagement letter." Holmes emphasized that the firm never informed her of any limitation on the scope of its representation, that neither she nor the firm formally terminated the representation, and that it was never clear that Theranos' and Holmes' legal interests had diverged too much to continue the joint representation.

The district court disagreed and granted the motion. It held that the *Graf* test, not Holmes' subjective belief, was the appropriate test by which to determine whether she, as an individual, could claim privilege over corporate communications and that Holmes had not met her burden under that test. It concluded that Holmes had not produced any documentation showing a joint representation or individual representation such as an engagement letter or financial records showing that she, personally, had paid the firm. The court also noted that many of the communications were between Holmes, Boies Schiller attorneys, and other Theranos employees, negating any argument that the communications were confidential. Finally, the court explained that Holmes had not shown that the communications were unrelated to Holmes' official duties or the general affairs of the company.

Although *United States v. Holmes* is not a franchise case, it is not hard to imagine a case where a franchised company's officers or employees are named personally as parties along with the franchised company and the company and the individual(s) later disagree as to whether privilege applies. Franchise attorneys frequently jointly represent the franchisor or franchisee, and their respective owners, officers, or employees. What if a franchise salesperson tells "his" attorney that he unilaterally made financial performance representations in violation of company policy and the franchisor wants to attempt to rely on those communications to establish that the salesperson was acting outside of the scope of his employment in an effort to avoid direct or vicarious liability for those unauthorized statements? Does privilege apply?

Naturally, the answer is, "it depends." Several federal circuits, including the First, Second, Third, Ninth and Tenth Circuits apply the *Graf* test, which places the onus on the client to clearly state in what capacity they are seeking legal advice. The idea that the client should bear this responsibility seems fair in Holmes' case given her sophistication and role as the CEO of an (allegedly) billion-dollar company. But that test might seem less equitable if the individual were, for example, an inexperienced salesperson. However, the Fourth and the Eighth Circuits have relied on a subjective belief test that Holmes argued should apply. Courts in those circuits might have reached a different result in this case, given Holmes' long-standing relationship with and prior personal representation by the Boies Schiller firm.

The privilege ruling in *United States v. Holmes* also demonstrates the importance of clear communications between outside counsel and corporate officers who may also face individual liability. In the Holmes case, the "organic evolution" of the attorney-client relationship meant that there was no engagement letter clarifying the firm's role, whom it represented, and in what capacity. David Boies' role was further muddied because, in addition to representing both Holmes and Theranos in prior lawsuits, he invested in Theranos and served on its board of directors. Holmes' briefing singled out Boies for his multiple roles and noted that he might "face public scrutiny about the ethics of his unorthodox role at Theranos as attorney, investor, and board member."

The key takeaway for franchise attorneys is to exercise caution and rely on clear communications, such as engagement letters, to clarify whether they represent parties individually or in their corporate capacity, and, if both, the clear scope of that joint representation and what happens in the event of a conflict. Caution early in the representation can prevent bad blood.

FLJ CURRENTS

CHOICE OF FORUM

***S2 Yachts, Inc. v. ERH Marine Corp.*, Bus. Franchise Guide (CCH) ¶ 16,876, 855 F. App'x 273 (6th Cir. 2021)**

In a dispute between a Michigan manufacturer of marine vessels and one its retailers based in the Dominican Republic, the Sixth Circuit enforced the choice of forum and choice of law provisions in the parties' agreements and declined to apply a "just cause" standard for nonrenewal under Dominican Republic law, resulting in affirmance of summary judgment in favor of the manufacturer on the retailer's claims for improper failure to renew the parties' agreements.

In this case, S2 Yachts, Inc., a Michigan manufacturer of marine vessels, chose not to renew its dealer agreements with one of its retailers based in the Dominican Republic, ERH Marine Corp. ERH Marine disputed the nonrenewal, arguing that under Dominican Republic law, S2 Yachts was required to demonstrate "just cause" for the nonrenewal. S2 Yachts commenced an action in federal court in Michigan, and ERH Marine began proceedings in the Dominican Republic. After determining that Michigan was the proper forum and ruling in favor of S2 Yachts on many of the claims, the district court certified the resolved claims as a partial final judgment under Rule 54(b) of the Federal Rules of Civil Procedure, thereby permitting the parties to seek appellate review. On appeal, the Sixth Circuit concluded that Michigan was the proper forum and that Michigan law applied to the dispute. As a result, S2 Yachts prevailed under Michigan law.

The court first examined the propriety of its jurisdiction to hear this appeal under Rule 54(b). Reviewing well-settled standards under Rule 54(b), the court concluded that the district court properly certified the claims under Rule 54(b), holding that prior interlocutory orders involving the certified claims merged with the partial final judgment certified by the district court. As a result, the court concluded that it had jurisdiction over the forum dispute as well as the decision on the merits.

The court next examined what law should apply to the dispute. The agreements between the parties contained choice of law provisions selecting Michigan law. But ERH Marine contended that Dominican Republic Law 173 nonetheless applied to its claims concerning nonrenewal of the parties' agreements. Applying Michigan law, and specifically the Restatement (Second) of Conflicts of Law § 187, the court concluded that there was no significant difference between the application of the law of the two competing venues and, as a result, ERH Marine could not establish that application of

Michigan law would be contrary to a fundamental public policy of a jurisdiction that had a materially greater interest than the chosen venue. As a result, the court enforced the choice of law provision and applied Michigan law to the dispute.

The court next turned to ERH Marine's objections to the district court's assertion of jurisdiction over the action; ERH Marine contended that the district court should have refrained from exercising jurisdiction based upon *forum non conveniens*, *Colorado River* abstention, and the *Brillhart* doctrine.

The doctrine of *forum non conveniens* allows a federal court to decline jurisdiction when it serves the interests of the parties, the court, and justice to try the action in another forum. In this case, the parties' agreements contained a forum selection provision. In the context of a *forum non conveniens* analysis, such provisions control, except in unusual cases, because by agreeing to a forum selection, a party has waived the right to challenge the preselected forum as inconvenient. As a result, to prevail on a *forum non conveniens* argument when a party has agreed to a forum selection provision, the party must establish an adequate alternative forum, and the court must determine that the selected forum would be unnecessarily burdensome based only on the public interest factors. Here, the court concluded that the public interest factors weighed in favor of exercising jurisdiction and, as a result, the district court did not abuse its discretion in refusing to dismiss the suit based on the *forum non conveniens* doctrine.

The court next addressed ERH Marine's *Colorado River* abstention argument. While federal courts have a "virtually unflagging obligation" to exercise the jurisdiction given to them, in certain extraordinary and narrow exceptions, courts may use their discretion to abstain from exercising their jurisdiction. Under the *Colorado River* doctrine, where contemporaneous exercise of jurisdiction in another forum exists, a federal court may abstain from exercising jurisdiction based upon considerations of wise judicial administration, giving regard to conservation of judicial resources and the comprehensive disposition of litigation. Applying a seven-factor analysis, the court concluded that the district court did not err in electing not to abstain from exercising its jurisdiction pursuant to the *Colorado River* doctrine.

The court next addressed ERH Marine's argument against jurisdiction pursuant to the *Brillhart* doctrine. *Brillhart* abstention is appropriate when it would be uneconomical as well as vexatious for a federal court to proceed in a declaratory judgment suit where another suit is pending in a state court presenting the same issues, not governed by federal law, between the same parties. Applying a well-settled five-factor analysis, the court concluded that all five factors favored the exercise of jurisdiction under the Federal Declaratory Judgment Act and therefore concluded that the district court did not abuse its discretion in refusing to abstain.

Finally, turning to the merits of the district court's grant of summary judgment, the court noted that the parties did not dispute that their written agreements were valid contracts and that Michigan law does not require just cause to support nonrenewal of a contract after its termination date. Instead, the court noted that, in Michigan, contracts are enforced according to their terms. Because S2 Yachts fulfilled the contractual requirement that it provided ERH Marine at least ninety days' notice of nonrenewal, the court concluded that S2 Yachts complied with its obligations under both agreements between the parties and was entitled under summary judgment on the parties' respective breach of contract claims.

CHOICE OF LAW

***Mid-South AG Equipment, Inc. v. Wacker Neuson America Corp.*, Bus. Franchise Guide (CCH) ¶ 16,914, 2021 WL 2875610 (E.D. Wisc. July 8, 2021)**
This case is discussed under the topic heading "Fraud."

***Northern Bottling Co., Inc. v. PepsiCo, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,919, 5 F.4th 917 (8th Cir. 2021)**
This case is discussed under the topic heading "Contract Issues."

***S2 Yachts, Inc. v. ERH Marine Corp.*, Bus. Franchise Guide (CCH) ¶ 16,876, 855 F. App'x 273 (6th Cir. 2021)**
This case is discussed under the topic heading "Choice of Forum."

CONTRACT ISSUES

***IJLSF, LLC v. It's Just Lunch International, LLC*, Bus. Franchise Guide (CCH) ¶ 16,915, No. E071940, 2021 WL 3012850 (Cal. Ct. App. July 16, 2021)**
In this case, the California Court of Appeal held that a prospective purchaser's offer to purchase a franchise was too vague and indefinite to constitute a valid, bona fide offer that triggered certain rights and obligations pursuant to the franchise agreement. However, the appellate court found that there was evidence that the franchisor had waived its right to reject the proposed purchase on the basis of the offer being insufficiently definite and that this evidence of possible waiver precluded summary judgment.

In this case, a franchisee of a dating and matching service sought to sell its franchise in the San Francisco territory to a third party, which owned several other franchise locations in the system. The franchise agreement required the franchisee to submit proposed sales to the franchisor for approval, which approval the franchisor had agreed not to unreasonably withhold if the proposed transfer met certain requirements. The franchise agreement also permitted the franchisor the right to substitute itself as the purchaser on the same price and same terms contained in the proposed offer. Here, the franchisor sought to exercise its right of first refusal and to substitute itself as the purchaser. When the franchisee refused to sell to the franchisor, the franchisor filed suit against the franchisee for breach of contract for refusing to sell the franchise to the franchisor. The franchisee counter-sued the franchisor for breach of contact for, among other things, refusing to approve the franchisee's sale to the third-party prospective purchaser. The prospective purchaser also intervened and filed its own cross-complaint against the franchisor for tortious interference.

The franchisee moved for summary judgment on the franchisor's claims against it, arguing that the franchisor improperly exercised its right of first refusal by changing material terms of the third-party offer and by offering less value. The franchisor filed its own cross-motion for summary judgment, arguing that its exercise of its right of first refusal was proper and enforceable. The trial court held that the third-party offer had not been a valid, bona fide offer, as defined by the franchise agreement, because the offer was too indefinite and did not contain a specific dollar amount in that the purchase price was instead contingent on future revenue. On this basis, the trial court denied the franchisor's motion for summary judgment, concluding that without a valid, bona fide offer, the franchisor was not entitled to exercise its right of first refusal. Based on this finding, the trial court also granted the franchisee's motion for summary judgment, holding that the franchisee was not obligated to sell to the franchisor and had not violated the franchise agreement's transfer provision because it had not completed a sale to the third party. In a subsequent round of cross-motions for summary judgment on the franchisee's claims against the franchisor for, among other things, refusing to approve the franchisee's transfer to the third party, the trial court granted the franchisor's motion for summary judgment, holding that due to the lack of a valid, bona fide offer, the franchisor had the right to reject the transfer. The trial court did not address the franchisee's argument that the franchisor had waived its right to reject the purchase on the basis of the offer not being a bona fide offer.

The matter was appealed, and the appellate court was asked to determine whether the trial court properly concluded that the third-party purchaser's offer to purchase was not a valid, bona fide offer and whether the trial court had erred in failing to recognize evidence of waiver by the franchisor.

On the first issue, the appellate court affirmed the trial court's holding that the third party's offer was not sufficiently definite to constitute a bona fide offer, as defined by the franchise agreement, that triggered the franchisor's obligation not to unreasonably withhold approval of the transfer and the franchisor's right to exercise its right of first refusal. The court interpreted the language in the franchise agreement that an offer must be "in a dollar amount" to require a specific dollar amount, rather than an indefinite dollar amount that could vary based on future revenue. The fact that the purchase price could vary and result in a different purchase price depending on who acquired the franchise and ran the business demonstrated that the offer was too indefinite to be enforced. The court noted the franchisee's argument that the two prospective purchasers—the franchisor and the prospective third-party purchaser—run locations using very different business models and that, had the franchisor purchased the franchise, it would have resulted in lower revenue, and thus a lower purchase price. Therefore, the appellate court concluded that the franchisor did not have any ability to exercise its right of first refusal and had the right to disapprove the transfer.

The fact that the franchisor had the right to reject the transfer was not the end of the story because the appellate court also held that the trial court erred in failing to recognize the evidence that the franchisor had waived its contractual right to reject the purchase by attempting to exercise its right to match the offer and substitute itself as the purchaser. Relying on the fact that under both California and Nevada law, waiver is generally a question of fact to be determined by a jury, the appellate court observed the significant evidence that the franchisor had intentionally waived its right to reject the purchase given that the franchisor did not object to the offer and instead tried to exercise its right of first refusal. On this basis, the appellate court reversed the summary judgment rulings and remanded the case to the trial court for further proceedings.

***Northern Bottling Co., Inc. v. PepsiCo, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,919, No. 20-1065, 5 F.4th 917 (8th Cir. 2021)**

The Eighth Circuit affirmed a summary judgment ruling dismissing a soft drink bottler's claims regarding transshipping (which is the sale of carbonated beverages from one bottler's territory into another bottler's exclusive territory) against PepsiCo, Inc. (PepsiCo) because the underlying contracts between the parties created no "duty for PepsiCo to take any steps to prevent transshipping."

Plaintiff Northern Bottling Co., Inc. (Northern) had been part of PepsiCo's network of independent bottlers since 1955. In 1980, in response to congressional action in the industry, PepsiCo created the "PepsiCo Transshipment Enforcement Program" (TEP) in an effort to combat the ills of transshipping. The TEP contained various procedures for investigating instances of transshipping within the network and for fining offending bottlers found to be engaged in transshipping.

Despite PepsiCo's efforts, Northern alleged that its problems with transshipping increased beginning in 2010. Northern sued PepsiCo in 2015 in the U.S. District Court for the District of North Dakota, alleging breach of contract, violation of the covenant of good faith and fair dealing, and tortious interference with contract. The district court granted PepsiCo's motion for summary judgment, dismissing Northern's claims because, under New York common law, the underlying contracts created no duty for PepsiCo to prevent transshipping.

On appeal, Northern alleged that New York common law of contracts did not apply but, instead, that New York's Uniform Commercial Code (UCC) applied. If the UCC applied, then Northern had at least some argument that PepsiCo had a contractual duty to prevent transshipping. The Eighth Circuit ruled, however, that Northern had waived its argument regarding the UCC's applicability by not asserting that argument in the district court below. The Eighth Circuit concluded, therefore, that New York common law applied.

In applying New York common law, the Eighth Circuit determined that "[i]t [was] undisputed that the plain terms of the bottling contracts do not create an express duty for PepsiCo to prevent transshipping of products into Northern's territory." Because New York common law focuses on the express terms of the contract, the court concluded that PepsiCo had no duty under those agreements to prevent transshipping.

Northern's claim for breach of the covenant of good faith and fair dealing fared no better. The Eighth Circuit ruled that PepsiCo's creation and enforcement of the TEP—even though it had no contractual duty to Northern to take these steps—was sufficient, as a matter of law, to demonstrate that PepsiCo "acted in good faith to protect Northern's territory under the bottling agreements."

Finally, Northern's tortious interference claim also failed as a matter of law. Applying North Dakota law to this tort, the Eighth Circuit held that the claim "immediately fail[ed] because [Northern's] tort allegations are rooted in the contractual dispute between it and PepsiCo." Moreover, as a matter of causation, Northern's arguments failed to connect PepsiCo's conduct to Northern's alleged injury. Still further, the Eighth Circuit determined that "the undisputed facts show[ed] that PepsiCo took reasonable steps to educate its customers against transshipment" and that PepsiCo "took reasonable measures to enforce the TEP and to prevent transshipment of products into Northern's territory." Those steps sufficed, as a matter of law, to defeat Northern's tortious interference claim.

DEFINITION OF A FRANCHISE

***Watch & Accessory Co. v. Garmin International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,916, No. 21-C-382, 2021 WL 2822662 (E.D. Wis. July 7, 2021)**

In this dispute relating to a non-exclusive dealer agreement, the U.S. District Court for the Eastern District of Wisconsin dismissed the plaintiff's statutory dealership claims against the defendant arising from the defendant's attempt to modify the terms of the parties' dealer agreement five years into the relationship, finding that the parties' relationship did not constitute a dealership under Wisconsin law and thus that the statute did not apply.

In 2015, Plaintiff Watch & Accessory Co. (WatchCo) entered a contract with Defendant Garmin International, Inc. (Garmin) under which WatchCo became a non-exclusive dealer of Garmin watches. The contract provided that Garmin would sell its watches to WatchCo, for WatchCo to resell, at a forty-five percent discount off the manufacturer's retail price. The next year, Garmin reduced the discount to a thirty-five percent discount, to which WatchCo agreed. Over four years later, Garmin notified WatchCo that it would again be reducing the discount it was providing to WatchCo, with lower discounts applying if WatchCo sold the majority of its products online, as opposed to in brick-and-mortar stores. WatchCo filed suit against Garmin, alleging multiple violations of the Wisconsin Fair Dealership Law (WFDL), Wis. Stat. § 135.01 *et seq*.

The court granted Garmin's motion to dismiss WatchCo's claims and dismissed WatchCo's claims without prejudice, allowing WatchCo the opportunity to file an amended complaint. WatchCo's claims pursuant to the WFDL required a showing that WatchCo's dealer contract with Garmin constituted a dealership as defined by the WFDL, which prohibits the termination or substantial change to the competitive circumstances of a dealership agreement without good cause. The court dismissed WatchCo's claims because it found that WatchCo had failed to allege sufficient facts to show the existence of a dealership.

Pursuant to the WFDL, a dealership requires a showing of a contract between two or more persons, in which one party is granted the right to sell or distribute goods or services and where "there is a community of interest in the business of offering, selling or distributing goods or services at wholesale, retail, by lease, agreement or otherwise." To show a community of interest, Wisconsin law requires the existence of "a continuing financial relationship" between the parties and "interdependence" between the parties (i.e., "shared goals and a cooperative effort more significant than the typical vendor-vendee relationship").

WatchCo failed to allege sufficient facts under federal pleading standards to show that it was at least plausible that a dealership relationship existed. In particular, the parties' contract placed very few obligations on the parties besides the purchase and sale of watches at specified prices. Moreover, WatchCo's allegation that Garmin products constituted thirty percent of its sales was insufficient by itself to state a claim. While that allegation showed at most a continuing financial interest, it was not evidence of the required interdependence and shared goals element of the claim.

ENCROACHMENT

***Kazi v. KFC US, LLC*, Bus. Franchise Guide (CCH) ¶ 16,882, No. 19-cv-03300-RBJ, 2021 WL 1978754 (D. Colo. May 17, 2021)**

In a dispute between restaurant franchisor KFC US (KFC) and one of its franchisees, the U.S. District Court for the District of Colorado denied the defendant-franchisor's motion for summary judgment as to the plaintiff-franchisee's claim for breach of the implied covenant of good faith and fair dealing, finding that factual disputes precluded resolution on summary judgment.

Defendant KFC, as part of a program to encourage new restaurant growth, approved a new franchise location in Pueblo, Colorado, where franchisee Zubair Kazi (Kazi) already owned and operated a KFC franchise location. To address franchisee concerns that the new locations would negatively impact the business of existing franchisees in the same territory, KFC issued "Impact Study Guidelines" outlining how KFC would decide whether to open new locations. KFC's guidelines provided that (1) if the anticipated impact of an existing franchisee was less than ten percent KFC would approve the new location; (2) if the impact was ten to fifteen percent KFC would undertake "further review"; and (3) if the impact was over fifteen percent KFC would not approve the new location. Upon consideration of whether to open a new location in Pueblo, KFC commissioned a study by a third-party company. Kazi believed KFC's study was invalid and retained his own company to conduct a separate analysis, which yielded significantly different results. However, KFC still approved the new location, and Kazi filed a lawsuit against KFC relating to its decision to approve the new location.

Earlier in the case, the court granted KFC's motion to dismiss in part and dismissed all of Kazi's claims except for its claim for breach of the implied covenant of good faith and fair dealing and request for an injunction. *See Kazi v. KFC US, LLC*, No. 19-cv-03300-RBJ, 2020 WL 6680361 (D. Colo. Nov. 12, 2020). Following discovery, KFC then moved for summary judgment on Kazi's one remaining substantive claim for breach of the implied covenant.

Applying Kentucky law, the court observed that the covenant of good faith and fair dealing imposes on parties to a contract a duty to do everything necessary to carry out the terms of the contract. A breach of the covenant requires a showing of "deliberate and conscious bad faith." The court held that this covenant required KFC to exercise its discretion as to whether to approve new franchisees consistent with the parties' reasonable expectations. The court also held that, in this circumstance, KFC's "Impact Study Guidelines" established what would constitute a reasonable exercise of discretion. Therefore, if KFC did not comply with the guidelines, such conduct could constitute a breach of the implied covenant.

On its motion for summary judgment, KFC contended that its approval of the new franchisee was the product of a deliberate business process and that the law did not permit a jury to second-guess KFC's business judgment. In response, Kazi argued that KFC's study on the impact of the new location on Kazi's existing franchise location was flawed and that KFC knew the study was flawed, but accepted it regardless. The court found that if the evidence showed only that KFC's study could have been more accurate, KFC would have been entitled to summary judgment. However, the court held that certain circumstantial evidence supported Kazi's theory, requiring denial of KFC's motion for summary judgment. In particular, the court observed that almost every study this third-party expert had completed for KFC anticipated a low impact on existing franchisees from the opening of a new location, that KFC had refused Kazi's request to hire a bilingual surveyor for the study, and that KFC had preliminarily approved the new location just a few days after receiving survey results projecting a 13.4% impact on Kazi's location, which per KFC's guidelines had required "further review." While KFC contended that it did conduct that further review, the court held that the almost immediate approval was sufficient that a jury could find KFC did not conduct the required further review. Viewing this evidence in a light most favorable to Kazi at this stage of the case and recognizing that resolving the key questions of why and how KFC undertook its actions, required an evaluation of witness credibility, the court denied KFC's motion for summary judgment, finding that the parties' dispute must be resolved by a jury.

FRAUD

***Mid-South AG Equipment, Inc. v. Wacker Neuson America Corp.*, Bus. Franchise Guide (CCH) ¶ 16,914, 2021 WL 2875610 (E.D. Wisc. July 8, 2021)**

Applying Kentucky law, the U.S. District Court for the Eastern District of Wisconsin dismissed an equipment dealer's fraud claims against an equipment manufacturer, finding that the clear and unambiguous terms of the parties' agreement precluded any reasonable finder of fact from concluding that the dealer's alleged reliance on the manufacturer's pre-execution promises in contravention of the parties' agreement was reasonable.

Plaintiff Mid-South AG Equipment, Inc.'s (Mid-South) complaint alleged that its representatives negotiated and ultimately executed a written distributor agreement with defendant Wacker Neuson America Corp. (Wacker) under which Mid-South was authorized to sell Wacker products in Kentucky. Mid-South alleged that, during the negotiation of the agreement, a Wacker representative orally promised Mid-South that, if it could not sell the equipment, Wacker would either accept a return of and issue a refund for the equipment or facilitate a purchase of the equipment by a different Wacker dealer. After entering into the deal, Mid-South was unable to sell the equipment that it purchased from Wacker and informed Wacker that it was terminating the distributor agreement. Mid-South demanded that Wacker repurchase the equipment, which it refused to do.

Wacker asserted a number of claims in the lawsuit, including common law fraud, arising from the representations noted above. Wacker filed a motion to dismiss the fraud claim for failing to state a claim. Before addressing the merits, the court considered which law applied to the fraud claim. Under Wisconsin choice of law principles, the court presumes that the law of the forum applies unless non-forum contacts are of greater significance. In this case, the court concluded that the non-forum contacts (i.e., the contacts with Kentucky) were of greater significance because, inter alia, the alleged misrepresentation that formed the basis for the fraud claim was allegedly made in Kentucky. As a result, the court applied Kentucky law to Mid-South's fraud claim.

Turning to the merits, the court first noted that promises as to future actions are generally not actionable as fraud and, instead, representations must relate to any existing or past fact to constitute an element of fraud. However, that rule does not apply if it is alleged that the defendant induced the plaintiff to enter a contract by making representations as to future intentions that it had no intention of carrying out. Within one month of the alleged promise to repurchase or facilitate resale, the parties executed the distributor agreement that disavowed any such promise and stated that Wacker merely had the option, not the obligation, to buy back its unsold products. The court concluded that these facts reasonably inferred that the representative knew when he allegedly made the relevant promises to Mid-South that Wacker had no intention of honoring such a promise. As a result, the court concluded that dismissal was not appropriate on the basis that the alleged promise related to future actions.

However, the court next addressed the element of reasonable reliance. Under Kentucky law, although an integration clause does not foreclose a claim of misrepresentation, its existence is a factor in determining whether plaintiff's reliance was reasonable. Wacker argued that Mid-South could not have reasonably relied on its representative's alleged promise because it was expressly contradicted by the terms of the agreement, which provided that Wacker had the option, but not the obligation, to repurchase equipment upon termination of the parties' agreement. The court noted that whether reliance is justified or reasonable is a question of fact in all but the rarest of circumstances. But the court concluded that this was one of those rare cases where, because the clear and unambiguous terms of the parties' written agreement directly contradicted the alleged oral promise, such reliance was unreasonable as a matter of law. As a result, the court dismissed the dealer's fraud claim for failure to state a claim.

FTC FRANCHISING RULE

***Arruda v. Curves International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,901, No. 20-50734, 2021 WL 2654533 (5th Cir. June 28, 2021)**

Warning that courts "must be wary of transforming business-contract or fraud disputes into federal RICO claims," the Fifth Circuit affirmed the dismissal, under Federal Rule of Civil Procedure 12(b)(6), of claims brought by franchisees (Plaintiffs) under the Racketeer Influenced and Corrupt Organizations Act (RICO) for the franchisors' alleged violations of the Federal Trade Commission's (FTCA) "Franchise Rule." Because the Plaintiffs' RICO claims were their only federal claims in the case, the Fifth Circuit affirmed the district court's dismissal of this federal court action in its entirety.

Plaintiffs were former franchisees of the "Curves for Women" fitness and weight-loss system. Plaintiffs brought suit in the U.S. District Court for the Western District of Texas against their franchisors and the franchisors' private equity owner (collectively Curves), alleging numerous counts of breach of contract, together with a claim under RICO based on alleged predicate acts of mail and wire fraud. Plaintiffs' RICO theory was that Curves neglected to disclose to Plaintiffs two items of information, namely, (1) Curves's intention to prune its franchise system by more than 1,000 Curves locations; and (2) the existence of a marketing study that reflected badly on the Curves system and that predicted the close of franchise locations at a rate of more than fifteen percent per year absent significant changes. Plaintiffs alleged that the omission of these items of information from Curves's Franchise Disclosure Documents, and from a February 9, 2016, letter from Curves's private equity owner to franchisees, constituted predicate acts of mail and wire fraud sufficient to sustain a RICO claim.

Ruling on Curves's motion to dismiss, the district court disagreed. It held that Plaintiffs had not alleged facts sufficient to establish that Curves had a duty to disclose this information. It also held that Plaintiffs did not plead the predicate acts of mail and wire fraud with sufficient particularity. Once the district court dismissed the RICO claims, it declined to exercise supplemental jurisdiction of the state-law breach of contract claims and dismissed those claims as well.

The Fifth Circuit affirmed the dismissal. The court first held Plaintiffs' allegations of mail and wire fraud were subject to the heightened pleading standards of Federal Rule of Civil Procedure 9(b), which requires pleading fraud with particularity. Plaintiffs alleged that the Federal Trade Commission's Franchise Rule imposed on Curves a duty to disclose the two items of information mentioned above and that, by failing to disclose that information, Curves engaged in the predicate acts of mail and wire fraud. However, the FTCA contains no private right of action for violations of the Franchise Rule, which the Fifth Circuit found to be controlling here. Relying on RICO decisions from the Eleventh Circuit and the D.C. Circuit in analogous contexts, the Fifth Circuit held that, because Congress omitted a private right of action for damages from the FTCA, a RICO claim, which would entail treble damages, cannot be predicated on an alleged violation of the FTCA's Franchise Rule. Consequently, the Fifth Circuit opined that Curves had no duty to disclose the two items of information—at least for purposes of predicate acts under RICO—and therefore affirmed the district court's dismissal of the action.

GOOD FAITH AND FAIR DEALING

***Kazi v. KFC US, LLC*, Bus. Franchise Guide (CCH) ¶ 16,882, No. 19-cv-03300-RBJ, 2021 WL 1978754 (D. Colo. May 17, 2021)**

This case is discussed under the topic heading "Encroachment."

***Northern Bottling Co., Inc. v. PepsiCo, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,919, No. 20-1065, 5 F.4th 917 (8th Cir. 2021)**

This case is discussed under the topic heading "Contract Issues."

JURISDICTION

***S2 Yachts, Inc. v. ERH Marine Corp.*, Bus. Franchise Guide (CCH) ¶ 16,876, 855 Fed. Appx. 273 (6th Cir. 2021)**

This case is discussed under the topic heading "Choice of Forum."

STATUTORY CLAIMS

***Mall Chevrolet, Inc. v. General Motors LLC*, Bus. Franchise Guide (CCH) ¶ 16,895, 2021 WL 2581665 (D.N.J. June 23, 2021)**

The U.S. District Court for the District of New Jersey concluded that an automobile dealer's breach of its dealer agreement with its manufacturer by seeking and collecting payment from the manufacturer for warranty repairs to cars that were never present at its service facility constituted a complete defense to the dealer's claims under the New Jersey Franchise Practices Act (NJFPA). As a result, the court granted summary judgment in favor of the manufacturer on the dealer's claim alleging unlawful chargebacks in violation of NJFPA.

Plaintiff franchisee Mall Chevrolet, Inc. (Mall) commenced an action against franchisor General Motors LLC (GM) after GM sought to recover over $650,000 in payments made to Mall on warranty repair claims and then sent Mall with a notice that it was terminating Mall's automobile franchise. The court had earlier granted summary judgment in GM's favor on all claims asserted by Mall except for its claim for unlawful chargebacks pursuant to NJFPA. After further discovery, GM moved for summary judgment on that claim, arguing that New Jersey Statutes Annotated § 56:10-9 ("It shall be a defense for a franchisor, to any action brought under this Act by a franchisee, . . . that said franchisee has failed to substantially comply with requirements imposed by the franchise and other agreements ancillary or collateral thereto") prohibited Mall from pursuing its NJFPA claim of unlawful chargebacks as a matter of law.

In its prior opinion, the court had concluded that Mall had materially breached the dealer agreement by seeking and collecting payment from GM for warranty repair to cars that were never present at its service facility. Despite § 56:10-9's clear language, Mall argued that the court should not apply the defense to Mall's chargeback claim because no court had previously applied this defense to such a claim of unlawful chargebacks; application of the statutory defense would render the NJFPA's protection against unlawful chargebacks useless; and GM waived this statutory defense by failing to please it in its answer to the complaint.

After reviewing Third Circuit case law construing the statutory defense, and the legislative policy of regulating the responsibilities of both franchisee and franchisor as well as the legislative desire to protect innocent franchisees (not those who are in material breach of their franchise agreements), the court had no difficulty concluding that the statutory defense should apply to bar Mall's unlawful chargeback claim. The court concluded that Mall's arguments that the statutory defense had not been applied in this precise context, and would render the unlawful chargeback provision useless, were without precedent or merit and could not overcome application of the plain language of the statutory provision. Finally, because GM had pled that Mall's claims were barred by its own breach of the dealer agreement in its Answer, that pleading was sufficient to place Mall on notice of the statutory defense, even though GM failed to cite the particular statutory provision. As a result, the Court granted GM summary judgment on Mall's sole remaining claim under the NJFPA.

***Watch & Accessory Co. v. Garmin International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,916, No. 21-C-382, 2021 WL 2822662 (E.D. Wis. July 7, 2021)**
This case is discussed under the topic heading "Definition of Franchise."

TORTIOUS INTERFERENCE

***Northern Bottling Co., Inc. v. PepsiCo, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,919, No. 20-1065, 5 F.4th 917 (8th Cir. 2021)**
This case is discussed under the topic heading "Contract Issues."

TRANSFERS

***IJLSF LLC v. It's Just Lunch International, LLC*, Bus. Franchise Guide (CCH) ¶ 16,915, No. E071940, 2021 WL 3012850 (Cal. Ct. App. July 16, 2021)**
This case is discussed under the topic heading "Contract Issues."

VICARIOUS LIABILITY

***C.S. v. Wyndham Hotels & Resorts, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,877, No. 2:20-cv-639FtM-29MRM, 2021 WL 1854564 (M.D. Fla. May 10, 2021)**
In a lengthy, detailed ruling, the U.S. District Court for the Middle District of Florida denied motions to dismiss and allowed claims against hotel franchisees and their franchisor to proceed under the Trafficking Victims Protection Reauthorization Act (TVPRA), Florida's state Racketeer Influenced and Corrupt Organizations Act (Florida RICO), and various common law tort theories. The case arose out of allegations by a pseudonymous plaintiff named "C.S." (Plaintiff) that Plaintiff was a victim of continuous sex trafficking at a certain hotel in Naples, Florida (Hotel), during 2015 and 2016.

In this particular action—which was one of several filed by Plaintiff against various different defendants—the defendants were franchisees who operated the Hotel during the relevant time period (Franchisee Defendants) and Wyndham Hotels & Resorts, Inc. (Wyndham), the franchisor. The complaint laid out, in some degree of detail, allegations of conduct occurring at the Hotel that was allegedly "routine" and purportedly formed a part of a "human sex trafficking enterprise." The complaint also included allegations intended to allow one to infer that the Franchisee Defendants and Wyndham either knew or should have known about the sex trafficking venture.

The Franchisee Defendants and Wyndham moved to dismiss, as a matter of law, the various claims that Plaintiff asserted. In denying those motions, the court focused the bulk of its analysis on the particulars of the TVPRA, Florida RICO, and the torts of negligent hiring, supervision, and retention; negligent rescue; and aiding, abetting, harboring, confining, coercion, and criminal enterprise. The details of these specific claims are likely not of special interest to the franchising community and, therefore, in the interest of brevity, are not addressed here.

What *is* likely interesting to the franchising community, however, was the court's discussion of vicarious liability under the TVPRA. Specifically, Wyndham first argued that vicarious liability was not viable at all under the TVPRA. The court disagreed, citing decisions from other district courts in which claims against hotel franchisors under the TVPRA were allowed to proceed past the pleading stage on theories of vicarious franchisor liability.

As a fallback argument, Wyndham asserted that, even if vicarious liability of a franchisor were theoretically possible under the TVPRA, Plaintiff's allegations in this case did not suffice to give rise to the kind of agency relationship needed to trigger vicarious liability. The court again disagreed, finding that the complaint sufficiently alleged an agency relationship between Wyndham and the Franchisee Defendants during the relevant time period. In particular, the court credited Plaintiff's allegations that Wyndham "exercised control over the means and methods of how [the Franchisee Defendants] conducted business, such as by profit sharing, standardized training, standardized rules of operation, regular inspection, and price fixing."

Finally, the court also rejected Wyndham's Lanham Act argument on this point. Specifically, Wyndham argued that because U.S. trademark law requires a franchisor (licensor) to exercise some degree of quality-control supervision over its franchisee (licensee), exercising that statutorily required supervision could not form the basis for finding vicarious liability. The court was again nonplussed, identifying ways in which, according to the complaint, Wyndham participated in substantial ways in directing or managing the franchisee that went beyond Lanham Act requirements. The court found that the complaint's allegations were therefore "sufficient to support a plausible inference of an agency relationship" that would permit a finding that Wyndham was vicariously liable.