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

When I joined my firm many years ago, I had the privilege of working as an associate under former Chair of the Forum Jack Dunham and then former Editor in Chief of this publication Bethany Appleby.[1] Part of that privilege was being exposed to a plethora of different types of franchise law disputes—everything from franchisee and consumer class actions to disputes about who controlled advertising fund to the run of the mill termination cases. The conclusion that I came to while working on all of these cases was that, despite the various nuances and factual issues that can arise in franchise disputes, the baseline statutory and regulatory schemes governing franchising were reasonably stable, as were the core underpinnings of franchise case law.

I do not think that attorneys entering the franchise profession today would necessarily reach the same conclusion. The Federal Trade Commission, after seeming to prioritize other regulatory areas ahead of franchising, has changed its tune. It recently solicited comments on whether a proposed rule banning noncompete clauses for workers in some situations should apply to franchisors and franchisees themselves.[2] It is seeking public comment on a request for information on "how franchisors may exert control over

1. Really, they had the privilege of me being their associate, but I digress.
2. Statement of Chair Lina Khan Regarding the Notice of Proposed Rulemaking to Restrict Employers' Use of Noncompete Clauses (Jan. 5, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/statement-of-chair-lina-m-khan-joined-by-commrs-slaughter-and-bedoya-on-noncompete-nprm.pdf ("Second, should the rule cover noncompetes between franchisors and franchisees? The current proposal does not cover noncompetes used by franchisors to restrict franchisees, but we recognize that in some cases they may raise concerns that are analogous to those raised by noncompetes between employers and workers. We welcome the public's views on this topic, as well as data or other evidence that could inform our consideration of this issue.").

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franchisees and their workers."[3] Most federal agencies do not seek comments simply for the sake of doing so and instead do so as prelude to a rule making process. The Department of Labor and National Labor Relations Board has released notices of proposed rulemaking that could affect the employee classification.[4] California has passed a law, now subject to a referendum, that would fundamentally alter the way franchising is conducted in one of the world's largest economies.[5]

The FTC's more active interest in franchising, the continued regulatory activity of the DOL and NLRB, and California's potentially game-changing laws raise a number of questioning, including what is driving these potential regulatory changes? Is it just a result of effective lobbying by certain constituencies? Or is conduct in the franchise industry driving a desire for regulatory change? I am sure that franchisor attorneys, franchisee attorneys, representatives from the International Franchise Association, franchisees, franchisors, regulators, and labor union representatives would all have different answers. That would certainly make an interesting article in the *Journal* (hint, hint), but it is beyond my ability to address here. All I can say is that franchising could experience a significant regulatory shift in the near future and practitioners would be wise to start thinking now about how their clients can or will react to these changes.

Luckily, readers of the *Journal* will not have to brainstorm on these topics alone. First up in this issue is an excellent article titled *The California FAST Act: Suspended but High Latent Risk* by Dean Fournaris and Bob Burstein that describes how the California FAST Act came about, what it could require, and how franchisors can respond to it. Next up, David Kaufmann and Michelle Murray-Bertrand have provided a lengthy and thorough article on the proposed NLRB and DOL regulations and what they mean to franchising in *Franchising Faces Existential Threats*. (I think you all can guess from the article's title what Mr. Kaufmann and Ms. Murry-Bertrand this will happen if the DOL and NLRB rules become law.)

The issue then pivots away from the potential destruction of franchising as we know it. Instead, it provides us with an attempt to catalogue the foundational principles of franchising in David Gurnick's article *Some Maxims of Franchise Law*. I suspect this article may find its way into many briefs

3. Fed. Trade Comm'n, Solicitation for Public Comments on Provisions of Franchise Agreements and Franchisor Business Practices (Mar. 10, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/Franchise-RFI.pdf.

4. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54,641 (Sept. 7, 2022); Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62,218 (Oct. 13, 2022).

5. As of 2022, California's GDP was slightly less than 3.6 trillion dollars. *See* FRED Economic Data, Gross Domestic Product: All Industry Total in California (Mar. 31, 2023), https://fred.stlouisfed.org/series/CANGSP.

as practitioners try to convince judges who are unfamiliar with franchising about what we all already know.[6]

The issue then closes with two articles touching on important international issues. Martine de Koning and Jelle Blom bring us up to speed on important European Union regulatory changes in *The New European Block Exemption Regulation on Vertical Agreements: Renewal of the Safe Harbor for Vertical Agreements Such as Franchise Agreements and a New Era on What Is (and Is Not) Permitted on Digital Commerce Within the European Union*. Stewart Germann then provides important information on franchising in New Zealand with *Protecting Goodwill in New Zealand: Franchise Agreement Clauses Affecting Real Estate and Restraining Competition*.

Finally, we close out our issue with *LADR Case Notes (August 2022–October 2022) and FLJ Currents (Winter 2023)* by Matthew S. DeAntonio, Matthew Gruenberg, and Vanessa Wheeler.

6. I will also take a moment to note that Mr. Gurnick, who is a former editor of this publication, passed away suddenly after submitting this article. Mr. Gurnick was one of the members of the Forum who truly seemed to love franchising law and take great interest in it, so it seems fitting that his final work is an attempt to clearly state what basic legal principles support franchising.

The California FAST Act: Suspended but High Risk Remains Straight Ahead

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

I. Introduction

Mr. Fournaris

Mr. Burstein

The California Fast Food Accountability and Standards Recovery Act (FAST Act),[1] also referred to as Assembly Bill 257 (AB 257),[2] was originally due to come into effect January 1, 2023. However, it is currently suspended pending the results of a voter referendum to occur through California's November 2024 state-wide election. The referendum will give California voters the opportunity to overturn the FAST Act.[3] Even though the referendum has deferred and could potentially cancel implementation of the FAST Act, the FAST Act remains an enormous threat to the franchise model not only in California, but also nationally.[4] For this reason, high drama has

1. Cal. Lab. Code §§ 1470–1473.

2. A.B. 257, 2021–22 Reg. Sess. (Cal. 2022), https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202120220AB257.

3. Cal. Sec'y of State, Qualified Statewide Ballot Measures, https://www.sos.ca.gov/elections/ballot-measures/qualified-ballot-measures (last visited Feb. 22, 2023); *see also* Kurtis Lee, *California Voters to Decide on Regulating Fast-Food Industry*, N.Y. Times (Jan. 25, 2023), https://www.nytimes.com/2023/01/25/business/economy/california-fast-food-workers.html.

4. *See, e.g.*, H.B. 2478, 2023 Reg. Sess. (Va. 2023), https://lis.virginia.gov/cgi-bin/legp604.exe?231+ful+HB2478 (implementing provisions similar to the FAST Act); S. 3155, 246th Leg., 2023–24 Reg. Sess. (N.Y. 2023), https://www.nysenate.gov/legislation/bills/2023/S3155 (establishing franchisor joint and several liability mimicking the provisions deleted from AB 257); *see also* Peter Romeo, *Bill Introduced in Virginia That Would Mimic California's Fast Food Law*, Rest. Bus. (Jan. 26, 2023), https://www.restaurantbusinessonline.com/workforce/bill-introduced-virginia-would-mimic-californias-fast-food-law ("California's controversial new model for setting fast food wages and working conditions has been introduced in another state."); Alexia Fernández Campbell, *Gig Workers' Win in California Is a Victory for Workers Everywhere*, Vox (Sept. 11, 2019), https://www.vox.com/2019/9/11/20851034/california-ab-5-workers-labor-unions (arguing 2019 passage of California bill regarding classification of workers as independent contractors or employees could have widespread effect because "[w]here California goes, other states

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surrounded the passage of the FAST Act and the petition drive to overturn it via referendum.

In an early version of the bill, the most objectionable provisions of the FAST Act to franchisors and franchisees made franchisors responsible for ensuring franchisee compliance with California workplace laws, made franchisors jointly and severally liable for franchisee violations of such laws, and prohibited franchisors from seeking indemnification from their franchisees for franchisee compliance errors and omissions. Fortunately, California Senate amendments to AB 257 deleted these provisions after the Assembly passed the bill.[5] However, those amendments did not end the threat or the drama. After the California governor signed the FAST Act into law, there was an eleventh-hour effort by the law's proponents and the California executive branch to exploit a timing gap to allow the FAST Act to go into effect temporarily, but with possible lasting effect. The fact that the governor signed the FAST Act into law late in the calendar year meant that the final outcome of the petition for a referendum to overturn the law—with the set timelines for collecting and verifying signatures—could not have been known until after the January 1, 2023, effective date. Swift and successful court action thwarted the effort to take advantage of this timing issue.[6]

Even as AB 257 was deferred pending the outcome of the referendum, a new storyline was added to the battle on February 16, 2023, when Assembly Member Chris Holden introduced the Fast Food Franchisor Responsibility Act, also referred to as Assembly Bill 1228 (AB 1228).[7] AB 1228 is a freestanding bill that contains, with some modifications, the most objectionable provisions stripped out of the early versions of AB 257. Those same provisions would make franchisors, among other things, jointly and severally liable for franchisee violations of California workplace laws.[8]

often follow," and citing as examples mandated paid family leave, $15 minimum wage and banning natural hair discrimination); Jim Manley, *California Has a Terrible Labor Law. The Biden Administration Wants to Take It National*, The Hill (Oct. 10, 2022), https://thehill.com/opinion/finance/3677431-california-has-a-terrible-labor-law-the-biden-administration-wants-to-take-it-national (arguing the federal Protecting the Right to Organize Act was an outgrowth of California bill regarding classification of workers as independent contractors or employees).

5. A.B. 257, 2021–22 Reg. Sess. (Cal. 2022) (as amended by Senate on Aug. 25, 2022), https://leginfo.legislature.ca.gov/faces/billVersionsCompareClient.xhtml?bill_id=202120220AB257&cversion=20210AB25793AMD (go to "Compare Versions" and select "08/25/22 Amended Senate").

6. *See* Lisa Jennings, *Freeze on California's Fast Act to Remain in Place*, Rest. Bus. (Jan. 13, 2023), https://www.restaurantbusinessonline.com/operations/freeze-californias-fast-act-remain-place#; Peter Romeo, *California Decides to Implement the Fast Act on Jan. 1 Despite the Move Toward a Referendum*, Rest. Bus. (Dec. 29, 2022), https://www.restaurantbusinessonline.com/workforce/california-decides-implement-fast-act-jan-1-despite-move-toward-referendum.

7. A.B. 1228, 2023–24 Reg. Sess. (Cal. 2023), https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240AB1228.

8. Peter Romeo, *California's Fast-Food Industry Faces Another Landmark Change*, Rest. Bus. (Feb. 17, 2023), https://www.restaurantbusinessonline.com/workforce/californias-fast-food-industry-faces-another-landmark-change ("Like the Fast Act, the new bill is aimed exclusively at the limited-service sector of the restaurant business. It essentially extends culpability for infractions of state labor regulations to a fast-food restaurant's franchisor if it has one."); Lara Korte, Jeremy B. White, Matthew Brown & Ramon Castanos, *Fast Times at the California Capitol*,

After the amendments made to AB 257 during the final legislative process and the successful subsequent court action preventing AB 257's immediate implementation, a false sense of relief seems to have arisen among the greater franchise community that the worst of AB 257 has been avoided. Looking on the bright side, the final FAST Act as enacted does not contain the most noxious proposed provisions, including those that would have made franchisors both responsible for ensuring franchisee compliance with California workplace laws and jointly and severally liable for franchisee violations of such laws. Additionally, pending the November 2024 referendum results, the FAST Act may never even go into effect.

On the flip and much darker side, if the FAST Act survives the referendum and goes into effect after the November 2024 election, it will establish a new, unelected council of ten members (Council), with eight members appointed by the governor, one member appointed by the Speaker of the Assembly, and one member appointed by the Senate Rules Committee.[9] The Council would have broad regulatory powers to enact new workplace standards and regulations that would have the force of law for covered fast-food employers in California, unless the legislature enacts legislation quickly enough after notice of their adoption by the Council to prevent the standards and regulations from taking effect.[10] The Council would have express authority to set the minimum wage for covered fast-food employees up to up to $22 per hour in 2023, which is nearly seven dollars more than the state minimum wage for 2023,[11] and then to increase the minimum wage annually at the lesser of 3.5% or the rate of inflation.[12] The existence of the Council would sunset on January 1, 2029, if not extended.[13] Thereafter, on every January 1, the minimum wage for covered fast food employees would increase at the lesser of 3.5% or the rate of inflation.[14] The FAST Act, if it becomes effective, would also prohibit franchisors and franchisees as operators of covered fast-food systems from discharging or discriminating or retaliating against an employee for exercising rights established under the FAST Act.[15] It would also grant employees a cause of action to sue their employer for violating these prohibitions.[16] If the FAST Act survives the referendum and goes into

Politico (Feb. 21, 2023), https://www.politico.com/newsletters/california-playbook/2023/02/21/fast-times-at-the-california-capitol-00083726 ("*If this seems familiar, that's because it is.* The same joint liability provision was stripped out of Assembly Bill 257 last year, the legislation Holden championed to establish a state-run Fast Food Council to set working conditions in California restaurants and push wages to as high as $22 an hour.").

9. Cal. Lab. Code § 1471(a).

10. I*d.* § 1471(d)(1)(B).

11. *Id.* § 1471(d)(2)(A). The authority to raise the minimum wage up to twenty-two dollars is specific to the year 2023. However, even if the referendum to overturn it fails, the FAST Act will not come into effect until after the November 2024 election.

12. *Id.* § 1471(d)(2)(B). The statute measures inflation as the one-year rate of change of the average Consumer Price Index (CPI) for Urban Wage Earners and Clerical Workers.

13. *Id*. § 1471(m).

14. *Id*. § 1473.

15. *Id*. § 1472(a).

16. *Id*. § 1472(b).

effect, there will also be a material risk that the Council will attempt to enact and implement the same noxious provisions the Senate removed during the final legislative process. In addition, there is now the twin risk that the legislature will attempt to enact those same provisions legislatively through the slimmed-down AB 1228.

It does not appear at present that all quick service restaurant (QSR) franchisors and their counsel fully recognize or appreciate these risks. The most immediate concerns for QSR franchisors doing business in California should be the defeat of both AB 257 at the ballot box and AB 1228 in the legislature. Indeed, even without the additional provisions proposed under AB 1228, the FAST Act as-is is worthy of close examination and advance planning in the event that it becomes effective.

The purpose of this article is to raise awareness of the risks that the FAST Act presents and to examine many of the potential key impacts of the FAST Act on QSR franchisors and franchisees should it go into effect after the 2024 referendum. Part II studies the background surrounding the passage of the FAST Act as one of many legislations labor unions and their allies have promoted that impact the franchise model. Part II also includes a discussion of proposed AB 1228. Part III addresses key provisions of the FAST Act as it is currently drafted. Part IV examines the consequences of the FAST Act, including the potential for the Council to reinitiate hot-button provisions like franchisor joint and several liability for franchisee violations of California workplace laws even if AB 1228 does not become law. Finally, Part V provides a list of non-mutually exclusive planning and mitigation strategies for QSR franchisors to consider should the FAST Act go into effect or AB 1228 becomes law. In particular, this article outlines California-specific mitigation options based on (i) the possibility that AB 257 as enacted could survive the 2024 referendum vote and become the operable law in California; and (ii) the further possibility that the franchisor joint and several liability provisions (with no right for the franchisor to seek indemnification from the franchisee committing the violations) that the California Senate removed from the Assembly version of AB 257 before enactment may become law if either AB 1228 is enacted or AB 257 as enacted survives the 2024 referendum vote and the Council attempts to restore these provisions through the issuance of new workplace standards and regulations under AB 257 as well as through AB 257 enforcement actions.

II. Background Surrounding Passage of the FAST Act

A. *Legislative Efforts*

In 2018, Assembly Member Lorena Gonzalez authored[17] Assembly Bill 5 (AB 5)[18] codifying and expanding the scope of the California Supreme Court's

17. Margot Roosevelt, *New California Labor Law AB 5 Is Already Changing How Businesses Treat Workers*, L.A. Times (Feb. 14, 2020), https://www.latimes.com/business/story/2020-02-14/la-fi-california-independent-contractor-small-business-ab5.

18. A.B. 5, 2019–20 Reg. Sess. (Cal. 2019), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB5.

decision in *Dynamex Operations West, Inc. v. Superior Court*, which instituted the ABC Test for distinguishing between employees and independent contractors in California wage orders.[19] AB 5 expanded the ABC Test to the entire California Labor Code and Unemployment Insurance Code.[20] It made it more difficult to classify workers, and potentially franchisees, as independent contractors rather than employees.[21]

Assembly Member Gonzalez also sponsored AB 257,[22] which was first introduced in the California Assembly on January 15, 2021.[23] AB 257 narrowly failed to pass the Assembly on June 3, 2021, falling three votes short of a forty-one-vote majority.[24] On June 28, 2021, Assembly Member Gonzales requested ordering AB 257 to inactive file.[25] Fast-food workers staged strikes across California in November 2021 to draw attention to the effort to submit AB 257 for reconsideration to the Assembly.[26] Assembly Member Gonzalez resigned from the Assembly at the beginning of January 2022 to lead the California Labor Federation.[27] AB 257 passed the Assembly on January 31, 2022,[28] the last day possible for a bill introduced in calendar year 2021.[29]

AB 257 as the Assembly passed it included a new proposed Section 1472 of the California Labor Code. The proposed Section 1472 would have made franchisors responsible for ensuring franchisee compliance with an extensive list of California workplace laws, including standards issued by the new Council and violations of the section of the FAST Act (which were to be codified in a new Section 1473 of the California Labor Code) prohibiting discharge, discrimination, or retaliation against an employee for exercising rights established under the FAST Act.[30] It also would have made franchisors

19. Dynamex Ops. W., Inc. v. Super. Ct., 416 P.3d 1 (Cal. 2018).

20. A.B. 5 § 2, 2019–20 Reg. Sess. (Cal. 2019), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB5.

21. For a discussion of the *Dynamex* case and AB 5, see Theresa D. Koller, Norman M. Leon & Doug Luther, *Independent Contractor or Employee: The Current State of the Ever-Changing Law and Its Impact on Franchising*, Am. Bar. Ass'n 43rd Ann. Forum on Franchising W-11, at 30–41 (2020).

22. Jamie Ding & Suhauna Hussain, *California Legislature Passes Bill to Protect Fast-Food Workers*, L.A. Times (Aug. 29, 2022), https://www.latimes.com/business/story/2022-08-29/california-senate-pass-bill-fast-food-workers.

23. A.B. 257, 2021–22 Reg. Sess. (Cal. 2022), https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202120220AB257 (last visited Mar. 16, 2023).

24. AB-257 Food Facilities and Employment, Cal. Legis. Info., https://leginfo.legislature.ca.gov/faces/billHistoryClient.xhtml?bill_id=202120220AB257 (go to "History").

25. *Id.*

26. Toni Guinyard, *Fast-Food Workers Strike Across California for Better Working Conditions*, NBC L.A. (Nov. 9, 2021), https://www.nbclosangeles.com/news/local/fast-food-workers-strike-across-california-for-better-working-conditions/2753812.

27. Ken Stone, *Lorena Gonzalez Quits Assembly, Takes Top Job at California Labor Federation*, Times of San Diego (Jan. 3, 2022), https://timesofsandiego.com/politics/2022/01/03/lorena-gonzalez-to-quit-assembly-take-top-job-at-california-labor-federation.

28. AB-257 Food Facilities and Employment, *supra* note 24.

29. 2022 Tentative Legislative Calendar, Cal. State Assemb. (rev. Oct. 21, 2021), https://www.assembly.ca.gov/sites/assembly.ca.gov/files/2022_assembly_calendar_final.pdf.

30. A.B. 257 § 4, 2021–22 Reg. Sess. (Cal. 2022) (as amended by Assembly Jan. 27, 2022), https://leginfo.legislature.ca.gov/faces/billVersionsCompareClient.xhtml?bill_id=202120220AB257&cversion=20210AB25795AMD (go to "Compare Versions" and select "01/27/22 Amended Assembly") (comparing final version of AB 257 to the version the Assembly passed).

jointly and severally liable for franchisee violations of such laws with no ability to seek indemnification from the franchisee that committed the violations.[31] Proposed Section 1472 provides:

> (a) A fast food restaurant franchisor shall be responsible for ensuring that its franchisee complies with the following applicable employment and worker and public health and safety laws and orders, and any implementing regulations:
>
> (1) Chapter 5 (commencing with Section 17200) of Part 2 of Division 7 of the Business and Professions Code.
>
> . . .
>
> (7) Section 1473.
>
> (8) Standards issued by the council.
>
> (b) If a fast-food restaurant franchisee is liable for a violation of any of the laws and orders set forth in subdivision (a), or any rules or regulations implementing these laws or orders, its franchisor shall be jointly and severally liable for any penalties or fines for the violation.
>
> (c) The laws and orders set forth in subdivision (a), and any implementing rules and regulations implementing these laws and orders, may be enforced against a fast food restaurant franchisor to the same extent that they may be enforced against the fast food restaurant franchisor's franchisee.
>
> (d) A waiver of this section or Section 1473, or any agreement by a fast food restaurant franchisee to indemnify its fast food restaurant franchisor for liability under this section or Section 1473, is contrary to public policy and is void and unenforceable.
>
> (e) (1) If the terms of a franchise prevent or create a substantial barrier to a fast food restaurant franchisee's compliance with the laws, orders, rules, and regulations set forth in subdivision (a) and their implementing rules and regulations, or any changes to them, including because the franchise does not provide for funds sufficient to allow the franchisee to comply with the laws, orders, rules, and regulations, or any changes to them, the fast food restaurant franchisee may file an action against its fast food restaurant franchisor for monetary or injunctive relief necessary to ensure compliance.
>
> (2) There shall be a rebuttable presumption that any changes in the terms of a franchise that increase the costs of the franchise to the fast food restaurant franchisee create a substantial barrier to compliance with the laws and orders set forth in subdivision (a) and their implementing rules and regulations, or any changes to them.
>
> (f) If a fast food restaurant franchisee shows by a preponderance of the evidence that the terms of its franchise were a substantial factor in causing any liability the franchisee has actually incurred under federal, state, or local law, the franchisor shall be jointly and severally liable for the portion of the liability to which the terms of the franchise contributed.[32]

In large part due to the triple threat under proposed Section 1472 of (1) QSR franchisor responsibility for ensuring franchisee compliance with California workplace laws, (2) franchisor joint and several liability for franchisee violations of such laws, and (3) franchisee indemnification provisions related to such matters being deemed per se unlawful, AB 257 evoked dire warnings from the International Franchise Association (IFA), many franchise companies, and franchise law practitioners.[33] Fortunately, an August 22,

31. *Id.*
32. *Id.*
33. Press Release, International Franchise Association, IFA: FAST Act Passage Is Another Step Backwards for California Restaurants (Jan. 31, 2022), https://www.franchise.org/media

2022, amendment by the California Senate deleted proposed Section 1472 from the text of AB 257 along with approximately ninety additional changes.[34] On August 29, 2022, the California Senate passed AB 257 as amended, and Governor Gavin Newsom signed it into law on Labor Day, September 5, 2022.[35] AB 257's original effective date was January 1, 2023.[36]

B. *Voter Referendum Efforts*

Governor Newsom's signature on AB 257 did not end the battle between the proponents of the FAST Act and the franchise and restaurant industries; it merely moved the contest into another round that the California Constitution's referendum process made available. Under the California Constitution, within ninety days of a new statute's enactment, voters may petition to place the new law on the ballot to give voters a chance to overturn the law.[37]

Immediately following the enactment of the FAST Act, on September 7, 2022,[38] the IFA, the National Restaurant Association, and the U.S. Chamber of Commerce spearheaded a coalition backed by restaurant owners and business groups called Save Local Restaurants (Coalition) to place a referendum on the November 2024 ballot to allow California voters the opportunity to overturn the FAST Act.[39] The Coalition gathered and submitted over one million voter signatures by the December 5, 2022, deadline in support of the referendum, well in excess of the number needed.[40] The signature submission triggered a random sample process to confirm the validity of the signatures to ensure that the minimum number of valid signatures required had been obtained to place the referendum on the 2024 ballot.[41] The deadline

-center/press-releases/ifa-fast-act-passage-is-another-step-backwards-for-california ("AB 257 would effectively end franchise business model in California . . ."); David J. Kaufmann, *Is Socialist Franchising Coming to California?*, N.Y. L.J. (Nov. 30, 2021), https://www.law.com/newyorklawjournal/2021/11/30/is-socialist-franchising-coming-to-california ("AB-257 would destroy franchising in California, turning it into an unrecognizable government-run enterprise.").

34. A.B. 257, 2021–22 Reg. Sess. (Cal. 2022) (as amended by Senate Aug. 25, 2022), https://leginfo.legislature.ca.gov/faces/billVersionsCompareClient.xhtml?bill_id=202120220AB257&cversion=20210AB25793AMD (go to "Compare Versions" and select "08/25/22 Amended Senate").

35. AB-257 Food Facilities and Employment, Cal. Legis. Info., https://leginfo.legislature.ca.gov/faces/billHistoryClient.xhtml?bill_id=202120220AB257 (go to "History").

36. Cal. Const. art. IV, § 8(c)(1) ("Except as provided in paragraphs (2) and (3) of this subdivision, a statute enacted at a regular session shall go into effect on January 1 next following a 90-day period from the date of enactment of the statute . . . ."); Suhauna Hussain, *Judge Puts Hold on California Law That Could Have Raised Fast-Food Worker Wages*, L.A. Times (Dec. 30, 2022), https://www.latimes.com/business/story/2022-12-30/judge-puts-hold-on-california-fast-food-worker-law-ab-257.

37. Cal. Const. art. II, § 9.

38. Don Thompson, *Restaurants Move to Stop New California Fast Food Worker Law*, Associated Press (Sept. 7, 2022), https://apnews.com/article/2022-midterm-elections-california-restaurants-d97b4093142532c3edb70b085d1e1a1f.

39. Heather Haddon, *Restaurant Groups Push to Overturn California Fast-Food Wage Law*, Wall St. J. (Dec. 5, 2022), https://www.wsj.com/articles/restaurant-groups-push-to-overturn-california-fast-food-wage-law-11670247131?mod=pls_whats_news_us_business_f.

40. *Id.*

41. Mario Cortez, *Fast Food Industry Group Sues to Stop Landmark Worker Protection Law*, S.F. Chron., Dec. 29, 2022, https://www.sfchronicle.com/food/article/ab257-fast-act-lawsuit-17683761.php.

for that process was January 25, 2023, which was after the FAST Act's January 1, 2023, effective date.[42]

Notwithstanding legal precedent suggesting that implementing AB 257 on January 1, 2023, in the face of a pending referendum vote would violate the California Constitution, the authors are aware that the primary labor unions promoting the FAST Act, including the Service Employees International Union (SEIU), lobbied the governor and the executive branch to move ahead with implementing the FAST Act on January 1, 2023, pending the official completion of the random sample process. The SEIU's lobbying efforts initially appeared to be successful. For example, on December 27, 2022, the Director of the California Department of Industrial Relations, the official responsible for implementing the FAST Act, responding to a letter from counsel to the Coalition, disagreeing that the statute was frozen while the verification process was underway and stating that the department instead had an obligation to proceed with implementing the statute on January 1, 2023.[43] Thereafter, the governor's office confirmed in a statement that the governor intended to enforce the FAST Act starting January 1, 2023.[44] The authors believe that this expressed intent necessarily would have involved appointing the Council and, most troublingly, that the governor would have considered valid any action taken by the Council up until the time the Secretary of State certified the referendum signatures and confirmed the referendum would be placed on the November 2024 ballot. A possible implication of the governor's position was that, once the Council was appointed, the Council would survive and could act.

The Coalition believed that implementing AB 257 on January 1, 2023, would violate the California Constitution.[45] On December 29, 2022, in Sacramento County Superior Court, the Coalition brought suit to prevent the implementation of the FAST Act. The Coalition filed for injunctive relief on December 30, 2022.[46] On December 30, 2022, the court issued a temporary restraining order where, citing the incredibly short time frame provided to

42. Hussain, *supra* note 36.

43. Letter from Katrina Hagen, Dir., Dep't of Indus. Rels., to Kurt R. Oneto & Sean P. Welch, Nielson Merksamer (Dec. 27, 2022), https://savelocalrestaurants.com/wp-content/uploads/2022/12/AB-257-Ltr-12.27.2022-.pdf. ("If and when the referendum challenging AB 257 qualifies for the ballot [following verification of signatures], the law will be put on hold. But in the absence of clear authority providing that AB 257 is suspended merely upon submission of unverified signatures, DIR has an obligation to proceed with implementing the duly enacted statute.").

44. Suhauna Hussain, *California Restaurant Workers May Get a Raise. But a Fast-Food Group Has Sued to Block the Law*, L.A. Times (Dec. 29, 2022), https://www.latimes.com/business/story/2022-12-29/fast-food-industry-coalition-sues-to-block-california-labor-law-ab-257 ("Although industry is backing a referendum measure, the secretary of state has not certified that it has enough signatures to qualify for the ballot. . . . The state has an obligation to implement this important law unless and until that occurs.").

45. Press Release, Save Local Restaurants, Save Local Restaurants Coalition Files Lawsuit to Prevent California's Officials from Violating the State's Constitution (Dec. 29, 2022).

46. Medora Lee, *Restaurant Group Lawsuit Halts California's Jan. 1 Fast-Food Bill*, USA Today (Dec. 30, 2022), https://www.usatoday.com/story/money/business/2022/12/30/california-fastfood-bill-lawsuit/10970967002.

hear the matter, it enjoined the FAST Act's implementation until the court could decide whether to grant a preliminary injunction.[47]

Following a hearing held on January 13, 2023, the court ruled the same day that the FAST Act had to go through the referendum process before becoming effective.[48] The court held that "[i]n the absence of authority to the contrary, the Court *must* protect the people's referendum power to 'suspend operation of the law until it is approved by a majority of voters.'"[49] The court further noted that "[c]ase law is clear that a qualified referendum pending vote by the people in a general election suspends the effectiveness of a law *before* it takes effect."[50]

The California Secretary of State's office announced on January 24, 2023, that the petition for a referendum to overturn AB 257 included enough valid signatures and would be certified and placed on the November 2024 ballot.[51] In doing so, AB 257 was and remains suspended pending the outcome of the November 2024 referendum.[52]

C. *Other Recent California Developments*

In addition to AB 5 and AB 257, discussion of the 2021–22 California legislative session from a franchise law perspective would not be complete without mentioning the involvement of Assembly Member Chris Holden and Assembly Bill 676 (AB 676).[53] In 2015, Assembly Member Holden introduced Assembly Bill 525 (AB 525), which the California governor signed into law on October 11, 2015, and which became effective on January 1, 2016.[54]

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47. Save Local Restaurants v. Hagen, No. 34-2022-80004062 (Cal. Sup. Ct. Dec. 30, 2022) (order granting temporary restraining order), https://savelocalrestaurants.com/wp-content/uploads/2022/12/34-2022-80004062-Save-Local-Restaurants-v-Hagen-Order-Setting-OSC.pdf.

48. Save Local Rests. v. Hagen, Case No. 34-2022-80004062 (Cal. Sup. Ct. Jan. 13, 2023) (order granting preliminary injunction), https://savelocalrestaurants.com/wp-content/uploads/2023/01/SLR-v.-Hagen-Ruling-on-Submitted-Matter.pdf?utm_source=Text+Brief&utm_medium=text&utm_campaign=Fast+Act+Jan.

49. *Id.* at 2 (quoting Wilde v. City of Dunsmuir, 470 P.3d 590, 593 (Cal. 2020)).

50. Save Local Restaurants v. Hagen, Case No. 34-2022-80004062 (Cal. Sup. Ct. Jan. 13, 2023) (order granting preliminary injunction), https://savelocalrestaurants.com/wp-content/uploads/2023/01/SLR-v.-Hagen-Ruling-on-Submitted-Matter.pdf?utm_source=Text+Brief&utm_medium=text&utm_campaign=Fast+Act+Jan. (citations omitted); *see also* Joanna Fantozzi, *California's Controversial FAST Act Might Be on Pause Until 2024 Election*, Nation's Rest. News (Jan. 14, 2023), https://www.nrn.com/news/california-s-controversial-fast-act-might-be-pause-until-2024-election; Matthew Liedke, *Not So FAST: California Court Blocks AB 257, Sets Up Potential Referendum Vote*, Franchise Times (Jan. 18, 2023), https://www.franchisetimes.com/franchise_news/not-so-fast-california-court-blocks-ab-257-sets-up-potential-referendum-vote/article_648977a8-9770-11ed-ab2e-0b2b80235e53.html.

51. Cal. Sec'y of State, Qualified Statewide Ballot Measures, https://www.sos.ca.gov/elections/ballot-measures/qualified-ballot-measures (last visited Feb. 22, 2023) (go to "1939.22-0005" and click on "QUALIFIED: 01/24/23 (PDF)").

52. *See* Kurtis Lee, *California Voters to Decide on Regulating Fast-Food Industry*, N.Y Times (Jan. 25, 2023), https://www.nytimes.com/2023/01/25/business/economy/california-fast-food-workers.html.

53. A.B. 626, 2021–22 Reg. Sess. (Cal. 2022), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202120220AB676.

54. A.B. 525, 2015–16 Reg. Sess. (Cal. 2016), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201520160AB525 (go to "History") (codified in scattered sections of Cal.

AB 525 made significant changes to provisions of the California Franchise Relations Act (CFRA) involving termination, non-renewal, and transfer of an existing franchise business.[55] AB 525 also provided an important expansion of the remedies available to a franchisee for a franchisor's violation of the CFRA.[56] Following Assembly Member Gonzalez's resignation on January 3, 2022, Assembly Member Holden succeeded Assembly Member Gonzalez as the sponsor of AB 257.[57]

Assembly Member Holden introduced AB 676 in the California Assembly on February 12, 2021.[58] Lacking a catchy name like the FAST Act, and without the same level of risk to the franchise model as the original Assembly version of AB 257, AB 676 followed a similar path to enactment as AB 257 but without as much attention. AB 676 failed to pass the Assembly in 2021, but following amendment succeeded in passing the Assembly close to the deadline for doing so on January 27, 2022.[59] Following further amendment, AB 676 passed the Senate, Governor Newsom signed it into law on September 29, 2022, and it became effective January 1, 2023.[60]

AB 676 amended both the CFRA and the California Franchise Investment Law (CFIL).[61] The amendments to the CFRA, applicable only to franchise agreements entered into, amended, or renewed on or after January 1, 2023, or to franchises of an indefinite duration that may be terminated by the franchisee or franchisor without cause,[62] included an anti-waiver provision[63] and a restriction on the franchisor offsetting amounts owed to a franchisee against amounts owed by the franchisee upon termination or nonrenewal unless the franchisee has agreed to the amount or the franchisor has received a final adjudication of any amounts owed.[64] The amendments to the CFIL included the following: (1) an expansion of the jurisdictional scope of the CFIL to provide that a franchisor now offers or sells a franchise in California where the franchise will be operated in California, rather than where *both* the franchisee is domiciled in California *and* the franchise will be operated in the state (in addition to when the offer to sell was made in California or the offer to buy was accepted in California);[65] (2) requirements on both the prospective transferee franchisee and the franchisor to provide information relating to an application for a transfer of an existing franchise (amended in

Bus. & Prof. Code § 20000–20044).

55. *Id.*

56. *Id.*

57. A.B. 257, 2021–22 Reg. Sess. (Cal 2022), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202120220AB257 (listing Assembly Member Holden as sponsor).

58. A.B. 626, 2021–22 Reg. Sess. (Cal. 2022), https://leginfo.legislature.ca.gov/faces/billHistoryClient.xhtml?bill_id=202120220AB676 (go to "History").

59. *Id.*

60. *Id.*

61. A.B. 257, 2021–22 Reg. Sess. (Cal 2022), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202120220AB257 (codified in scattered sections of Cal. Bus. & Prof. Code §§ 20000–20044 and Cal. Corp. Code § 31000–31512.1).

62. Cal. Bus. & Prof. Code § 20041(c).

63. *Id.* § 20015(b).

64. I*d.* § 20022(h).

65. Cal. Corp. Code § 31013(a).

the legislative process to make clear that the requirements do not apply to the sale of a new franchise), and requiring the franchisor to provide a statement of approval or disapproval of the application within sixty days of receiving information and documentation setting forth the reasons for disapproval, if applicable, and apparently providing a prospective franchisee standing to bring an action challenging the reasonableness of the franchisor's decision;[66] (3) prohibitions on the franchisor failing or refusing to grant a franchise or to provide financial assistance to a franchisee or prospective franchisee that has been granted or provided to other similarly situated franchisees or prospective franchisees based solely on any protected characteristics of the franchisee or prospective franchisee, or any protected characteristics of the neighborhood or geographic area where the franchisee is located or where the proposed franchise would be located, as such characteristics are defined under the California Unruh Civil Rights Act;[67] (4) an express disclaimer of protection from civil liability by implication;[68] and (5) a declaration that disclaimers of representations, violations of the CFIL, or reliance on franchise disclosure documents including through franchise disclosure questionnaires and acknowledgment statements are all void and unenforceable.[69]

In the 2023–24 California legislative session, Assembly Member Holden also introduced AB 1228. AB 1228 has been designated by the SEIU as a high priority[70] and could be seen as an effort to push back against the QSR industry and its allies, who successfully suspended the effectiveness of the FAST Act pending the referendum process.[71]

The recently proposed AB 1228 provides for a new stand-alone Section 2810.9 to be added to the Labor Code, which would serve to fill in and replace what the deleted Section 1472 of the originally proposed AB 257 would have provided concerning franchisor joint and several liability, but with some differences, using the same definition of covered QSR franchisors and franchisees contained in AB 257 as enacted.

Proposed Section 2810.9 reads in relevant part:

> (a) A fast food restaurant franchisor shall share with its fast food restaurant franchisee all civil legal responsibility and civil liability for the fast food restaurant

66. *Id.* § 31126.

67. *Id.* § 31212 (incorporating Cal. Civ. Code § 51(b), (e)).

68. *Id.* § 31306.

69. *Id.* § 31512.1. The goal of § 31512.1 is now also achieved under the more detailed North American Securities Administrators Association, Inc. Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments applicable to all franchise registration states, including California. *See* N. Am. Sec. Adm'rs. Ass'n, NASAA Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments (Sept. 18, 2022) (unpublished policy statement), https://www.nasaa.org/wp-content/uploads/2022/09/NASAA-Franchise-Questionnaires-and-Acknowledgments-Statement-of-Policy-9-18-2022.pdf.

70. Peter Romeo, *California's Fast-Food Industry Faces Another Landmark Change*, Rest. Bus. (Feb. 17, 2023), https://www.restaurantbusinessonline.com/workforce/californias-fast-food-industry-faces-another-landmark-change.

71. Lara Korte, Jeremy B. White, Matthew Brown & Ramon Castanos, *Fast Times at the California Capitol*, Politico (Feb. 21, 2023), https://www.politico.com/newsletters/california-playbook/2023/02/21/fast-times-at-the-california-capitol-00083726.

franchisee's violations of any of the following laws and orders or their implementing rules or regulations:

(1) Chapter 5 (commencing with Section 17200) of Part 2 of Division 7 of the Business and Professions Code.

. . .

(4) Orders, including emergency and executive orders, issued by the Governor regarding employment standards, worker health and safety, or public health and safety.

(5) Orders issued by a county or municipality regarding employment standards, worker health and safety, or public health and safety.

(b) (1) The laws, orders, rules, and regulations in subdivision (a) may be enforced against a fast food restaurant franchisor, including administratively or by civil action, to the same extent that they may be enforced against the fast food restaurant franchisor's franchisee.

(2) No civil action may be commenced against a fast food restaurant franchisor under this section prior to 30 days after written notice of the alleged violation of any of the laws and orders set forth in subdivision (a), or their implementing rules or regulations, has been given to the fast food restaurant franchisor by a person commencing the action. That time period shall be extended to 60 days if a fast food restaurant franchisor, within 30 days of receiving a written notice, makes a written request to the noticing person for additional time to complete an investigation.

(3) A fast food restaurant franchisor shall not be liable in a civil action under this section if the fast food restaurant franchisor cures the alleged violation within the applicable time period in paragraph (2). For purposes of this subdivision, "cure" means that the fast food restaurant franchisor abates each violation alleged and ensures that its fast food restaurant franchisee is in compliance with the underlying laws, orders, rules, or regulations specified in the notice, and that any fast food restaurant workers against whom a violation was committed are made whole.

(c) A waiver of this section, or any agreement by a fast food restaurant franchisee to indemnify its fast food restaurant franchisor for liability under this section, is contrary to public policy and is void and unenforceable.

(d) (1) If the terms of a fast food restaurant franchise prevent or create a substantial barrier to a fast food restaurant franchisee's compliance with the laws and orders set forth in subdivision (a) and their implementing rules and regulations, or any changes to them, including, but not limited to, because the franchise does not provide for funds sufficient to allow the fast food restaurant franchisee to comply with the laws, orders, rules, and regulations, or any changes to them, the fast food restaurant franchisee may file an action against its fast food restaurant franchisor for monetary or injunctive relief necessary to ensure compliance.

(2) There shall be a rebuttable presumption that any changes in the terms of a franchise that increase the costs of the franchise to the fast food restaurant franchisee create a substantial barrier to compliance with the laws and orders set forth in subdivision (a) and their implementing rules and regulations, or any changes to them. . . .[72]

Comparing the proposed Section 2810.9 of AB 1228 against the deleted Section 1472 of AB 257 on a paragraph by paragraph basis reveals some key takeaways. One is that a proposed responsibility to ensure compliance followed with possible joint and several liability under the old Section 1472

72. A.B. 1228, 2023–24 Reg. Sess. (Cal. 2023), https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240AB1228.

of the originally proposed AB 257 would be replaced with direct joint liability from the outset under the new Section 2810.9 of the recently proposed AB 1228. But, under the new proposal, no civil action could be commenced against a fast food restaurant franchisor under the new Section 2810.9 of the recently proposed AB 1228 prior to the franchisor having been given thirty days advanced written notice of the violation or order, which could be extended to sixty days if the fast food restaurant franchisor, within thirty days of receiving the written notice, makes a written request to the noticing person for additional time to complete an investigation. The former Section 1472 of the originally proposed AB 257 had no such notice requirement.

In addition, a fast-food restaurant franchisor will not be deemed liable in a civil action under the new Section 2810.9 of the recently proposed AB 1228 if the fast-food restaurant franchisor "cures" the alleged violation within the applicable time period (the thirty- or sixty-day notice window referenced above). "Cure" would mean that (1) the fast-food restaurant franchisor abates each violation alleged and ensures that its fast-food restaurant franchisee is in compliance with the underlying laws, orders, rules, or regulations specified in the notice, and (2) any fast-food restaurant workers against whom a violation was committed are made whole. The old Section 1472 of the originally proposed AB 257 had no such opportunity to cure/explicit "defense" for cure.

It is difficult to envision how AB 1228 would work, let alone seamlessly and well, given the anticipated conflicting party interests and incentives, short timelines, and independent notice, opportunity to cure and default/termination requirements under the CFRA. Quite simply, it would appear at first blush that the so-called opportunity to cure/safe harbor features under AB 1228 would prove to be illusory to QSR franchisors. Under AB 1228, a franchisee would have its own incentives to say that the franchisor's practices and conduct were the cause of the violation, not the franchisee's failure to obey the law or adhere to its franchise contract, and could invoke proposed Section 2810.9(d) to bring a damages or injunctive relief action against the franchisor alleging that the terms of the franchise prevented or created a substantial barrier to the franchisee's compliance. It is difficult to fathom how a QSR franchisor could take advantage of the opportunity to cure/safe harbor features under AB 1228 under the best of circumstances, let alone while simultaneously navigating the CFRA on a contentious and expedited track and attempting to coordinate with a franchisee who will have conflicting incentives and may be asserting or at least preserving its own claims against the franchisor.

III. Key Provisions of the FAST Act

A. *Coverage*

The FAST Act applies only to fast-food restaurants that are part of a "fast food chain" consisting of 100 or more establishments nationally that share a common brand or that are characterized by standardized options for decor, marketing, packaging, products, and services.[73] As defined, a "fast food restaurant" is an establishment that is part of a fast-food chain and, in its regular business operations, primarily provides food or beverages (1) for immediate consumption on or off premises, (2) to customers who order and pay for food before eating, (3) with items prepared in advance or with items prepared or heated quickly, and (4) with limited or no table service.[74] Establishments that as of September 1, 2022, operate bakeries that produced bread as defined under Part 136 of Subchapter B of Chapter I of Title 21 of the Code of Federal Regulations for sale on site are exempted from coverage of the FAST Act and not considered fast-food restaurants, provided the establishment sells the bread as a stand-alone menu item and continues to operate the bakery.[75] The FAST Act also exempts from coverage restaurants located and operated within a "grocery establishment" as defined in subdivision (d) of Section 2502 of the California Labor Code if the grocery establishment employs the restaurant workers.[76]

B. *Fast Food Council (the "Council")*

1. Council Responsibilities

The FAST Act establishes a ten-member Council tasked with creating standards on minimum wages, maximum working hours, training, and other working conditions applicable to fast-food restaurant workers.[77] The Council will hold meetings or convene public hearings at least every six months to hear public comment on issues of fast-food restaurant health, safety, and employment conditions.[78] The Council will also hold sessions every three years to review and establish minimum standards concerning pay and working conditions like safety and training.[79] From these meetings, the Council will issue standards.[80] The standards will be sent to the California Legislature by January 15 of each year and will automatically become effective as new state regulations unless lawmakers specifically enact legislation preventing them from taking effect.[81] If the Legislature does nothing with respect to a specific standard, it would go into effect no sooner than October 15 of the same year.[82] The FAST Act expressly states that the Council may not create new paid time-off benefits, such as paid sick leave or paid vacation, nor promulgate regulations regarding predictive scheduling, as added by Senate amendment to AB 257.[83] A standard promulgated by the Council will not

73. Cal. Lab. Code § 1470(a) (defining "fast food chain"); *id.* §§ 1471–1473 (applying provisions of statute to fast food chains).
74. *Id*. § 1470(c).
75. *Id.* § 1470(i).
76. *Id.* § 1470(j).
77. *Id.* § 1471(a)(1), (b), (d)(1)(A).
78. *Id.* § 1471(g).
79. *Id.* § 1471(f).
80. *Id.* § 1471(d(1)(A).
81. *Id.* § 1471(d)(1)(B).
82. *Id.*
83. *Id.* § 1471(d)(7), (8).

supersede a standard covered by a valid collective bargaining agreement if the agreement expressly provides for the wages, hours of work, and working conditions of the employees, and a regular hourly rate of pay not less than thirty percent more than the state minimum wage for those employees, if the agreement provides equivalent or greater protection than the standards established by the Council and if state law on the same issue authorizes an exception for employees covered by a collective bargaining agreement.[84]

2. Council Membership

The most obvious impact of AB 257 is the formation of the ten member Council. The Council will be controlled by a combination of worker advocates and state representatives. Four of the seats are reserved for industry representatives: two representatives of fast-food restaurant franchisors and two representatives of fast-food restaurant franchisees.[85] Another four seats are reserved for worker advocates: two representatives of fast-food restaurant employees and two representatives of advocates for fast-food restaurant employees.[86] The final two seats are reserved for one representative from the Department of Industrial Relations and one representative from the Governor's Office of Business and Economic Development,[87] both of whom doubtlessly would be more sympathetic to labor than businesses. The governor will appoint eight members of the Council. The Speaker of the Assembly and the Senate Rules Committee will appoint the two representatives of advocates for fast-food restaurant employees.[88] The governor will designate the chairperson of the Council.[89]

3. Local Councils

A county or a city with a population of greater than 200,000 may establish a local council.[90] Due to Senate amendments to AB 257, the local councils now will be advisory only, will hold hearings, and will make recommendations only for state but not local regulations, which the state Council is not required to consider.[91] Over twenty cities and nearly thirty counties in California meet the criteria for formation of a local council.[92]

84. *Id.* § 1471(k)(3).
85. *Id.* § 1471(a)(1).
86. *Id.*
87. *Id.*
88. *Id.* § 1471(a)(2).
89. *Id.* § 1471(a)(4).
90. *Id.* § 1472(i).
91. *Id.*
92. Steven M. Bernstein, Benjamin M. Ebbink, Alden J. Parker & Tyler Woods, *California Passes Bill on Fast-Food Employment Standards*, SHRM (Sept. 6, 2022), https://www.shrm.org/resourcesandtools/legal-and-compliance/state-and-local-updates/pages/fast-food-worker-california.aspx.

C. *New Cause of Action for Discharge, Discrimination, or Retaliation*

The FAST Act will provide covered fast-food restaurant employees with a new avenue to sue their employers. The FAST Act prohibits a fast-food restaurant operator from discharging, discriminating against, or retaliating in any way against an employee because (1) the employee made a complaint or disclosed information, or the employer believes the employee disclosed or may disclose information, to the franchisor, a supervisor or another employee with authority to investigate, discover, or correct violations or noncompliance, to the media, to the Legislature, to a watchdog or community organization, or to a governmental agency, regarding employee or public health or safety; (2) the employee instituted, testified in, or otherwise participated in a Council, local council, or other proceeding relating to employee or public health or safety; or (3) the employee refused to perform work because the employee had reasonable cause to believe the practices or premises of the fast-food restaurant would violate worker or public health or safety laws, regulations, the Labor Code, any occupational safety or health standard, or any safety order of the division or standards board, or would pose a substantial risk to health or safety of the employee, other employees, or the public.[93] Employees will have a cause of action for violations of this provision and, if successful, will be entitled to reinstatement, treble lost wages and work benefits, and reasonably incurred attorney's fees and costs.[94] The FAST Act creates a rebuttable presumption of unlawful discrimination or retaliation for any adverse action taken against the worker within ninety days of a fast-food restaurant operator acquiring knowledge of the worker exercising any of these protected rights.[95]

D. *Franchisor Joint and Several Liability—Deleted but Certainly Not Forgotten*

As detailed earlier, the triple threats contained in proposed § 1472 of the version of AB 257 the Assembly passed—(1) QSR franchisor responsibility for ensuring franchisee compliance with California workplace laws; (2) franchisor joint and several liability for franchisee violations of such laws; and (3) franchisee indemnification provisions related to such matters being deemed per se unlawful—were deleted by Senate amendment.[96] Those provisions in the early version of § 1472 were a significant threat to QSR franchisors, and their removal was a material win for fast food franchisors and the industry generally. Even without those triple threats, however, the passage of AB 257, as amended, remains a loss for the fast-food industry and especially for California-based fast-food franchisees.

Even without the express statutory authority of the early version of § 1472, there are possible avenues for the Council to attempt to impose joint and several liability or other onerous restrictions or obligations on QSR franchisors, even if they do not have company-owned units operating in

93. Cal. Lab. Code § 1472(a).
94. *Id.* § 1472(b).
95. *Id.* § 1472(c).
96. *See supra* Part II.A.

California. Notwithstanding the amendment to delete express joint and several liability for QSR franchisors, the Council could try to take the position that AB 257 empowers it to enact joint and several liability and to impose other onerous standards on QSR franchisors through enforcement directed at their franchisees and enforcement actions directed at the QSR franchisors themselves. Although such a tactic would most certainly be met with equal, if not greater resistance and would lead undoubtedly to extensive additional legal challenges, the proponents of AB 257's tactics to attempt to enforce the FAST Act and form the Council even while the referendum process was still pending should leave little doubt about the lengths the supporters of the law will take to accomplish their goals.

Although it is well beyond the scope and purpose of this paper to provide a potential roadmap as to exactly how the Council may attempt to re-spring franchisor joint and several liability for franchisee violations of California workplace laws upon QSR franchisors, it is important to remember as a starting point that the Legislature expressly considered and rejected many of these same types of provisions. Nonetheless, it is not hard to imagine the Council, whose membership will be weighted in favor of union and worker interests, attempting to use its so-called mandate under the FAST Act to either reimpose provisions like franchisor joint and several liability—which were likely too sensitive politically for the governor and the Senate to support and therefore were rejected—or even other new measures adverse to QSR franchisors. It is also not hard to imagine the Labor Commissioner attempting to use its enforcement powers to do the same.

Should the FAST Act survive the referendum process, the scope and limits of the Council's authority and the Labor Commissioner's authority under AB 257 could most certainly be the subject of future heated debate and litigation. Should the FAST Act survive the referendum process, QSR franchisors should expect not just that the Council might, but that the Council will, attempt to impose liability and other onerous restrictions and obligations on QSR franchisors. Similarly, the Labor Commissioner should be expected to liberally interpret the powers expressly granted to proceed against QSR franchisors. The Council and Labor Commissioner could force QSR franchisors to make tough decisions regarding the relative costs and benefits of complying with potential Council mandates or Labor Commissioner enforcement actions, not knowing all the while whether a court will ultimately deem the Council or the Labor Commissioner to be so empowered or to have exceeded its authority.

IV. Possible Consequences of the FAST Act

AB 257 alone, and especially in combination with the previously enacted AB 5,[97] the contemporaneously enacted AB 676, and the proposed AB 1228,

97. To some extent, franchisors are already facing significant potential risk under AB 5, which became law in 2019. As discussed *supra* Part II.A, AB 5 significantly changed the criteria for determining whether an individual or business is properly classified as an independent

could threaten the continuing vitality of franchising in California for QSR franchisors and franchisees. The main benefits to franchisors of the franchise model generally are the ability to (1) expand a system to build out and operate unit level franchised businesses quickly using other people's money and credit; (2) insulate the franchisor from liability and losses arising from the unit-level operation of the franchised businesses because the liability and losses are allocated in the first instance to the franchisee, who is an independent contractor; and (3) attract and retain highly motivated and qualified franchisees, who as franchised operators provide the entrepreneurial and managerial oversight and magic that makes the most successful franchised brands thrive on a unit level, even when compared to the same brand's company-owned units.

At this stage of the franchise industry's development, the benefit of being able to grow with other people's money is of varying importance depending on the brand and its financial resources. Although using their own capital to fuel growth may not be their preferred capital allocation, the most successful and well-capitalized brands are not necessarily reliant on franchisees' capital to fuel unit-level growth. Rather, if pressed, the most successful and well-capitalized brands could make all or most of the initial investment required to develop and operate their brands' future sites.

In contrast, the benefit of being insulated from unit-level liability has been and remains a highly relevant and strong benefit of the franchise model for virtually every franchisor. As a result of AB 5's enactment making it more difficult to classify workers as independent contractors and not employees—and most certainly if AB 257 survives the referendum in 2024 and also becomes law—franchisors doing business in California will no longer have a reasonable basis to assume that they will enjoy the same level of insulation from unit-level franchised operations that they enjoyed under the pre-AB 5 status quo. AB 5 alone already presents new and not yet fully determined risks that franchisees will be considered their franchisor's employees, rather than independent contractors, with resultant additional possible exposure for wage and hour and related claims premised on misclassification. Should AB 257 survive the pending referendum, AB 257 would impose additional unit level liability for franchised QSR operations in California for certain employee-related practices and liabilities. Accordingly, it is fair to say that AB 5 and AB 257 in combination could eliminate the benefit of insulation from unit-level liability for QSR franchisors doing business in California.

If the first two benefits of franchising listed earlier are somewhat irrelevant to some franchisors and rendered moot, respectively, QSR franchisors would have to consider whether it was worthwhile to continue franchising in California in order to attract and retain highly motivated and qualified franchisees who provide a unique entrepreneurial contribution to their franchise systems. At the same time, those same QSR franchisors would have to

contractor and could potentially result in franchisors being deemed employers of their franchisees and of their franchisees' employees.

consider whether an alternative model, like an innovative company-owned model, would provide a similar benefit at lower cost and risk. The question at hand for the most successful and well-capitalized QSR brands at that time could very well be whether AB 5 alone, and especially in possible combination with AB 257 and possibly AB 1228, will render the remaining relevant benefit of franchising in California (i.e., the attraction and retention of highly motivated franchisees and their contributions on a unit level) as being outweighed by the risks of continuing to franchise in California, and whether continuing to franchise as a QSR franchisor in California versus using other potential methods of distribution will still provide a net benefit.

Although the answers to those very big picture questions remain to be determined, AB 257 alone, and especially in combination with AB 5 and possibly AB 1228 if it is enacted, could undoubtedly result in a series of seemingly unintended negative consequences for the QSR industry in California, and its various stakeholders including franchisors, franchisees, franchisees' employees, and the consuming public. Should it survive the referendum, the likely negative impact of AB 257 as enacted on covered QSR franchisors and franchisees would be substantial, let alone if the Council restores the franchisor joint and several liability and no-right-to-franchisee-indemnification provisions the Senate removed from the Assembly version of the bill. Indeed, even without the potential franchisor joint and several liability (with no right for the franchisor to seek indemnification from the franchisee committing the violations), AB 257 as enacted would likely result in (1) increased minimum and real wages for fast food workers; (2) increased regulation of working conditions beyond minimum wage, including health and safety, security, time off, and targeting workplace discrimination and harassment for fast-food workers; (3) increased employment litigation and compliance complexity and costs; (4) increased efforts at collective bargaining with additional worker safeguards; and (5) expected industry-wide price increases and reduced restaurant unit level hours of operation and profitability. The seemingly unintended, but nevertheless completely predictable secondary and tertiary consequences for the QSR industry in California should AB 257 become effective are likely to further include (i) a reduction in the number of QSR franchisor offerings in California; (ii) a consolidation of QSR franchisors offering franchises in California; (iii) a reduction in the number of QSR franchisees being offered franchises in California; (iv) a consolidation of QSR franchisees operating franchises in California; (v) an overall reduction in opportunity for new franchisees in California, especially within and among diverse and under-served communities; (vi) an overall reduction in the presence and overall access to QSR franchised businesses in California, especially within and among diverse and under-served communities; (vii) a push for rapid technological innovation and implementation on a restaurant unit-level; and (viii) an overall reduction in QSR franchised business employment on both a gross and per employee basis, with a disparate impact upon members of diverse and under-served communities.

Some describe AB 257 as a step toward sectoral bargaining, which is inconsistent with federal labor law in the United States but is common in Europe.[98] Sectoral bargaining is where unions negotiate working standards that apply to workers in an entire industry, not just one company.[99] David Weil, former Administrator of the Wage and Hour Division in the Obama administration, well known for views considered hostile to franchising in that role due to the joint employer standards he promoted during his tenure, sees benefit to workers from the FAST Act, because fast-food industry workers are considered less likely to complain to try to improve their conditions because of their vulnerability.[100] But he also seems to acknowledge a downside of sectoral bargaining, that devoting resources to the fast-food industry could draw resources from enforcement in other industries were workers are also vulnerable, like janitorial, home care, and agriculture.[101] The remedy would seem to be in line with the perceived goal of the SEIU and other unions, and that is to expand sectoral bargaining and the concept of special industry councils across multiple industries, once they have established the practice in the fast-food industry.

Perhaps recognizing the possibility of the legislature violating the legislative version of the Hippocratic oath and actually doing more harm than good, the California Department of Finance opposed the FAST Act in June 2022, citing the expense to enforce it and noting that it could raise long-term costs across industries.[102] The department also was concerned that the FAST Act could lead to a fragmented regulatory and legal environment for employers, pointing out that imposing stricter standards on some sectors could exacerbate delays in enforcement.[103] Raising wages for employers of fast-food restaurants covered by the FAST Act could also have an impact

98. Sean P. Redmond, *California Legislature Passes Radical AB 257 Fast-Food Bill*, U.S. Chamber of Com. (Sept. 1, 2022), https://www.uschamber.com/employment-law/unions/california-passes-radical-ab-257-fast-food-legislation ("In an industry like fast food, one challenge is that individual restaurants owned and operated by franchisees are legally separate corporations, so AB 257 aims to reduce the necessity of organizing by circumventing the process with diktats from bureaucrats. . . . [T]he broader goal remains: labor unions and their political allies want to impose a form of sectoral bargaining that runs afoul of American labor policy."); Rachel M. Cohen, *California Aims to Transform How Fast Food Workers Are Treated*, VOX (Sept. 6, 2022), https://www.vox.com/policy-and-politics/2022/8/15/23296481/fast-food-ab257-california-sectoral-labor-unions ("In many European countries, unions negotiate working standards that apply to workers across an entire industry, not just one company. This approach, known as "*sectoral bargaining*," is particularly useful for protecting workers toiling in industries that rely heavily on part-time staff, contractors, and subcontractors. Sectoral bargaining is prohibited by federal labor law in the US, but the bill in California is a similar idea, and a step that a labor-friendly state can take on its own.").

99. Noam Scheiber, *California Governor Signs Bill to Regulate Fast-Food Industry*, N.Y. Times (Sept. 5, 2022), https://www.nytimes.com/2022/09/05/business/newsom-california-fast-food-wages.html.

100. *Id.*

101. *Id.*

102. Lee, *supra* note 52.

103. Editorial, *California Makes a Ham-Handed Attempt to Regulate the Fast-Food Industry*, Wash. Post (Sept. 13, 2022), https://www.washingtonpost.com/opinions/2022/09/13/california-fast-food-regulation-inflation/?wpisrc=nl_sb_smartbrief.

on wages for industries and restaurants not covered by the FAST Act, as non-covered employers competing for workers may need to raise their wages to stay competitive with a twenty-two dollar per hour minimum wage.

Similarly, the IFA has cited research that the Council's ability to raise the minimum wage up to twenty-two dollar per hour for covered fast-food employees—representing a more than forty percent increase over the 2023 California minimum wage of $15.25—could increase labor costs by fifty percent to sixty percent and in turn lead to a twenty percent increase in food prices.[104] Like all price increases, AB 257-related price increases are expected to impact minority and lower income communities harder, the very communities the proponents of AB 257 argue are represented in high numbers as fast-food restaurant workers whom they aim to benefit through higher wages and new workplace rules. The IFA also expressed concern that the only limitations on the Council were restrictions on issuing rules regarding paid time-off and scheduling, but otherwise the Council would be unrestricted, including with respect to workplace standards, training, and safety standards.[105] In addition to the increase in operating costs and food prices, the IFA believes the FAST Act will reduce economic opportunities, entrepreneurial opportunities, and a loss of jobs.[106] The IFA also believes existing laws could provide protections workers are seeking if they were enforced.[107]

The Society for Human Resource Management stated the FAST Act could lead to more employee lawsuits against employers, increased prices as restaurants pass costs to the consumers, and automation of fast-food jobs.[108] An impact survey by the Employment Policies Institute, a nonprofit with ties to the restaurant industry, also predicts the FAST Act will have a negative impact on the owners of franchised businesses and drive franchised systems out of the California market.[109] On the other hand, the Chair of the UC Berkeley Labor Center stated the FAST Act could likely lead to improved wages for 550,000 fast-food workers in California, a greater voice by workers in addressing working conditions, and reductions in workplace injury and violence, resulting in improvements in worker health, improved health and educational outcomes for workers' children, increased productivity, and fewer sick days, with a small increase in consumer prices.[110]

104. Liedke, *supra* note 50.
105. *Id.*
106. *Id.*
107. *Id.*
108. Sarah Brady, *Will California Really Implement A $22 Minimum Wage?* Forbes Advisor (Oct. 25, 2022), https://www.forbes.com/advisor/personal-finance/ab-257-22-dollar-minimum-wage-california.
109. *Id.*
110. *Id.*

V. Mitigation Strategies for Franchisors to Address the FAST Act

With the stakes especially high, QSR franchisors have several non-mutually exclusive options for mitigating against the potential implementation of AB 257, and its possible combination with AB 5 and AB 1228 should it become law. The authors provide a high-level overview of each of these options and discuss some of their respective advantages and disadvantages.

A. *Do Nothing and Wait and See*

One possible approach to the pending AB 257 referendum vote for QSR franchisors with exposure to the California market is to do nothing and wait and see what happens in November 2024. The pros of this approach include maintaining the status quo and avoiding potentially unnecessary system disruption and new current expenses, especially if AB 257 fails to survive the November 2024 referendum vote. The cons include the fact that there may already be a need for QSR franchisors with exposure to the California market to do something to mitigate against risk. AB 5 and AB 676 have already become law, and their consequences are not fully known. AB 1228 has just been introduced as a back-up plan advocated by labor proponents should AB 257 not survive the referendum vote. Moreover, although there is always hope AB 257 will be defeated in the referendum vote and not be implemented, hope alone is not a plan. Should AB 257 survive the referendum vote, a QSR franchisor that chooses now to do nothing may suffer from a lack of preparation and planning. It also may be more expensive and rushed to implement an effective strategy later.

B. *Join the Referendum Effort to Defeat AB 257 and Its Copycat Clones*

Another possible approach is to join the referendum effort to defeat AB 257 and also work to defeat its copycat clones and AB 1228. The IFA, the National Restaurant Association, and the U.S. Chamber of Commerce are backing the Save Local Restaurants Coalition to attempt to overturn AB 257 in the November 5, 2024, referendum vote. Franchisors, franchisees, suppliers to the franchise industry, consumers, and other parties interested in defeating AB 257 may reach out to these groups and the Coalition for information. Although AB 257, AB 1228, and the recently introduced copycat acts in Virginia and New York target only fast-food restaurant franchisors,[111] the proponents of this type of legislation are certain to expand to other sectors if they succeed in the fast-food channel.

111. *See supra* note 4.

C. *Take Immediate Actions to Mitigate and Defend Against AB 5 and Similar State (and Potential Federal) Misclassification Claims Irrespective of Whether AB 257 Survives the November 2024 Referendum and AB 1228 Is Enacted Into Law*

Both within and outside of California, and irrespective of whether AB 257 survives the November 2024 referendum or AB 1228 is enacted into law, franchisors face a growing number of claims both in California and in other states alleging that their franchisees are not truly independent contractors or franchisees, but rather are misclassified employees of the franchisors along with the franchisees' employees. California and other states already have enacted laws making it more difficult for franchisors to defend against such claims. For example, AB 5, which is not specific to QSR franchisors or even the franchise industry, potentially impacts all independent contractor relationships in California (unless specifically exempted). AB 5 codified the ABC Test established in *Dynamex Operations West, Inc. v. Superior Court*[112] as follows:

> [A] person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that all of the following conditions are satisfied:
>
> (A) The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
>
> (B) The person performs work that is outside the usual course of the hiring entity's business.
>
> (C) The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.[113]

In planning and evaluating potential responses to the effectiveness of AB 257 and possible enactment of AB 1228 in California, it must be noted that many leading QSR franchisors have already been considering and taking action for some time to mitigate and defend against AB 5 and other existing and prospective franchise model risks throughout the country. Mitigation measures to defeat the elements of the ABC Test include the following: (1) separating multiple business lines into separate entities, leaving the franchisor as an entity that solely offers, sells, and supports franchises; (2) establishing and then clearly announcing that company-owned stores are operated by entities separate from the franchisor entity; (3) requiring franchisees to form legal entities prior to entering into a franchise agreement and prohibiting individual or sole proprietor franchise ownership; (4) requiring franchisees to display notices advising their employees, customers, and contractual counterparties that each franchisee is an independent franchisee of the franchisor; subject to applicable law; (5) adding franchisor-favored representations and warranties that address the ABC Test; (6) reviewing and

112. Dynamex Ops. W., Inc. v. Super. Ct., 416 P.3d 1 (Cal. 2018).
113. Cal. Lab. Code §2775(b)(1).

modifying indemnification clauses and contracts generally to reduce risk; (7) removing the franchisor's logos from wage statements, checks, and other business paraphernalia; (8) modifying the franchise system where possible to have all funds flow from the franchisee to the franchisor; (9) eliminating required franchisor-provided back-office support (such as billing). and implementing systems to make such support optional and adopting systems that allow franchisees a real choice to use third-party services; (10) reviewing technology and the role it can play both positively and negatively with regard to system structure and connectedness; and (11) reviewing operations manuals to reduce or eliminate unnecessary controls and to keep only those items that the franchisor must have to maintain brand standards. The franchisor may also want to adopt and use arbitration clauses for dispute resolution and eliminate class claims to the greatest extent possible.

The pros of this approach include getting out in front of a potential liability and risk wave irrespective of whether AB 257 or AB 1228 hits. This approach also attempts to reduce and isolate the risks generated by AB 5 and other similar laws as well as the potential *res judicata* effect of bad rulings to a segregated franchising entity. Some efforts at risk management may allow for adoption of different approaches and methods in California alone. Others, like restructuring and business system modifications, may require a national approach.

The cons of this approach include the fact that any actions that a franchisor attempts to insulate itself from increased employment-based risks are not guaranteed to work, because it is challenging to overcome the applicable standards when one rigidly applies them in a franchise context. Additionally, franchisors, and particularly larger franchisors, are likely to remain enforcement and litigation targets. Other actions may be potentially detrimental to the business. For example, although prominent independent contractor labels are great for liability, they may impair a brand's efforts to appear seamless and uniform in a national branding or accounts context. Finally, addressing and attempting to mitigate the AB 5 misclassification issue would not necessarily impact or mitigate the risk of AB 257's and AB 1228's provisions, which are targeted at the QSR industry and are California-specific for the time being, subject to the progress of the recent copycat acts in Virginia and New York, for example.

D. *Run to the Roar: Modify California Program and Practices to Provide More Assistance in Employment Areas Should Franchisor Joint and Several Liability Be Imposed Under AB 257 or AB 1228*

Although counterintuitive, an argument can be made that if AB 257 survives the referendum vote and franchisor joint and several liability is imposed in the administration of the law either by the Council or the Labor Commissioner,[114] or if AB 1228 is enacted, QSR franchisors could run to the danger

114. *See supra* Part III.D.

or lion's roar in California by providing their franchisees, directly or indirectly, with more assistance and support in employment-related matters with the aim of increasing overall compliance and reducing overall risk.

The pros of this approach include that if the franchisor is going to be saddled with certain employment liability anyway, the franchisor could decide to occupy more of the field regarding its California franchisees' employment practices and compliance efforts in the hope of increasing compliance and reducing overall liability. The risk of doing so could be further mitigated by using unaffiliated third parties and vendors to provide the additional support and guidance. Although not necessarily a best practice for all or perhaps even any QSR franchisors, this counterintuitive approach must at least be recognized, if not evaluated, as an option. Adopting this approach would require most QSR franchisors to reverse course on the franchisee employment matters and measures that they have taken in recent years, at least in California. Rather than trying to avoid the appearance of control in response to increasing joint employer risk, QSR franchisors in California could instead choose to provide more support and guidance to their franchisees regarding their employment and compliance practices, either directly or indirectly, to reduce the risk of franchisee failures and compliance errors.

The cons of this approach are material and warrant careful consideration. For starters, when fully implemented, the burden of greater potential franchisor liability across all theories and fronts when employment compliance lapses occur could still outweigh the benefit of less overall claims and greater overall compliance. Moreover, adopting this approach could very well increase the overall risk and liability for a QSR franchisor in areas not mandated by AB 257 or AB 1228, for example, in traditional employment matters and vicarious liability for tort claims. Implementing this option in California only could also prove difficult. Indeed, it would be very difficult for one brand to segment and implement one set of franchise practices in California and another for the rest of the country. Adopting this approach could lead to a bleeding of the California practices and legal results into other non-California venues. This phenomenon could require, at a minimum, the creation of a new California-only franchisor entity and operation (NewCo) to implement this option.

E. *Form NewCo to Act as California Franchisor Moving Forward and to Assume Existing Franchise Agreements and Relationships*

Another option that will undoubtedly get some serious consideration, especially if AB 257 survives the referendum vote and/or if AB 1228 is enacted, is for brands to form a NewCo to act as the California franchisor moving forward and, to the extent possible, assume all the brand's existing California franchise agreements and relationships. The pros of this approach include that it would attempt to isolate the California-based risks presented by AB 5, AB 257, and possibly AB 1228 and the potential preclusive effect of bad rulings in California to a NewCo. This approach also may allow for adoption of different practices and methods in California versus the rest of the country, subject to the progress of copycat acts.

The cons of this approach include that forming and using a NewCo for California franchising to insulate the primary franchisor is not guaranteed to work because the primary franchisor, particularly if it is a larger franchisor, would remain a target, especially if the NewCo were an affiliate of the primary franchisor. Forming and using a NewCo for California franchising only would be an expensive and complicated proposition for most brands. The NewCo would be franchising and expanding in California under the burdensome provisions and liability exposure of AB 5, and, if it survives the referendum vote, AB 257, and possibly AB 1228. It would be administratively complex and expensive for a franchisor to run two domestic franchise systems in terms of franchise sales, ongoing support, and vendor relationships. There are also franchise registration and initial capitalization requirements to consider. If the primary franchisor was qualified for the large and experienced franchisor exemption from registration in California, the NewCo may not qualify for the California large and experienced franchisor registration exemption, which could slow down registration of the franchise offering by NewCo in California and implementation of the new franchise structure in California. Additionally, the registration process by the NewCo in California would be very public facing compared to a simple exemption notice filing in California if the franchisor previously qualified for exemption.

F. *Withdraw From California Market, Stop Franchising and Development of Company Stores in California, and Wind Down Existing Franchise Relationships (With or Without a NewCo as Franchisor to Manage Existing Franchises During Wind Down)*

Another option for QSR franchisors to consider, especially if AB 257 goes into effect and AB 1228 is enacted, is to withdraw from the California market, stop franchising and development of company-owned units in California, and wind down existing franchise relationships (with or without a NewCo as franchisor to manage existing franchises during the wind down). Although this option is undoubtedly extreme, there is an economic cost-benefit tipping point for every market, including a QSR market as lucrative as California. For non-California based start-up and emerging QSR franchisors, that cost-benefit tipping point is undoubtedly much lower than for national brands with substantial existing California presences. The pros of this approach, especially for non-California based start-up and emerging QSR franchisors, include avoiding potentially catastrophic California-specific compliance costs and liability consequences should AB 257 and AB 1228 go into effect. This approach could be limited to stopping the grant of new franchises only, not total market withdrawal.

The cons of this approach are many fold. Abandoning a vast and lucrative market territory like California on the whole would have an enormous and likely unacceptable financial impact on brands with material existing

California presences. Moreover, running from the problem may not be a solution for mature systems. Similar laws may be adopted in additional states as evidenced by the copycat acts introduced in New York and Virginia, for example. Finally, it could take years to implement and unwind a substantial franchise program, let alone in a market as big as California. It could be much easier and practicable to stop new franchising than to completely unwind and withdraw the brand from the California market.

G. *Create and Adopt a New Non-Franchised Model for New Restaurants and Convert Existing Restaurants as Opportunities Arise*

Another option for QSR franchisors to consider, especially if AB 257 goes into effect and AB 1228 is enacted, would be to shift their California presences to a company-operated, non-franchised model. QSR franchisors with a California presence could cease offering new franchises in California and attempt to convert existing restaurants over time to company-operated restaurants. The pros of this approach could include attempting to capture the entrepreneurial spirit and energy of the franchise model through a new model that could incorporate a variety of financial incentives for unit-level restaurant managers. This approach would allow the QSR brand to have more control over the areas of operations generating franchisor liability exposure under AB 257 and could help to avoid the provisions of AB 676 that target the franchise sales and transfer process. This approach would also allow the applicable QSR franchisor to test an alternative model and hedge its bets should California prove to be a bellwether for the future.

The cons of this approach are multiple. Exposure to more unit-level operations may not be an attractive proposition for many QSR franchisors. It would also take time and substantial resources to adopt a company-owned model for California moving forward, let alone to convert existing franchisees to the new model. Some franchisees may choose not to voluntarily convert, and the franchisor likely would be restrained from forcing an involuntary change upon existing franchisees given the terms of the franchise agreement and the California Franchise Relations Act. Thus, the approach could prove to be an incomplete solution with company stores expanding in California while franchised restaurants would be operating under the burdensome provisions and liability exposure of AB 5, and, if applicable, AB 257 and AB 1228.

There is no silver bullet strategy to eliminate all risks associated with the actions the Council may take under AB 257 or the express franchisor joint and several liability provisions under AB 1228 should it be enacted. The authors have attempted to provide some general options for QSR franchisors' consideration. These potential approaches are not mutually exclusive. QSR franchisors could consider and implement them either separately or in combination. Furthermore, QSR franchisors might consider implementing one or more options initially and then move to other options (again, separately or in combination) over a longer time period. QSR franchisors could consider the more aggressive options set forth in Parts V.F and V.G if, for example, the Council signals an intent or takes action to try to restore the joint and several liability (with no right for the franchisor to seek indemnification from the franchisee committing the violations) or if AB 1228 seems likely to be enacted (which may trigger another referendum effort).

VI. Conclusion

Although the FAST Act has been suspended until late 2024 when California voters will decide its fate and some of its most noxious features have been eliminated through amendment during the legislative process, QSR franchisors should not be lulled into inaction regarding their own efforts to defeat and, if necessary, mitigate against the effects of the FAST Act. Should it survive the referendum, the likely negative impact of AB 257 as enacted on covered QSR franchisors and franchisees would be substantial, let alone if the franchisor joint and several liability (with no right for the franchisor to seek indemnification from the franchisee committing the violations) is restored. The unelected Council's potential restoration of the franchisor joint and several liability provisions could drive the risks up materially further. If, under AB 257, the Council is somehow able to restore the franchisor joint and several liability provisions that were a part of the Assembly version of AB 257, the likely negative impact to QSR franchisors in California would be substantial. The potential restoration of joint and several liability through Council action will become moot however, if AB 1228 is enacted.

It is not too late for QSR franchisors to join the fight to defeat AB 257 or too early to plan to mitigate the impact of the FAST Act should it ever become effective. Even if the FAST Act never becomes effective, the cumulative effect of existing and potential future California legislation, including AB 1228, deserves risk mitigation strategies for California and beyond. As measures negatively impacting the franchise model spread across states like California and potentially beyond, planning not only becomes more difficult and time consuming, but also more necessary.

Franchising Faces Existential Threats

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The U.S. Department of Labor and the National Labor Relations Board have loaded a two barreled shotgun—and are aiming it straight at franchising.

On September 6, 2022, the National Labor Relations Board (NLRB) released a Notice of Proposed Rulemaking[1] (NLRB NPR) which proposes to rescind and replace the current rules for determining who can be deemed a "joint employer" under the National Labor Relations Act (the NLRA).[2] Then, on October 13, 2022, the U.S. Department of Labor (DOL) published its own Notice of Proposed Rulemaking[3] (DOL NPR) addressing who must be classified as an employee as opposed to an independent contractor under the Fair Labor Standards Act (FLSA).[4]

The goal of these proposed forthcoming regulations is rather transparent: bolster union membership by having franchisees classified as employees, rather than independent contractors, and have franchisors deemed joint employers of their franchisees' employees, such that unions can negotiate with those franchisors the salaries that their franchisees must pay their employees. While both proposed regulations were subject to a brief comment period, it is almost certain they will be adopted verbatim (perhaps with some inconsequential modifications).

The danger posed to franchisors by the dual thrusts of the DOL and the NLRB is clear. If franchisors are deemed the employers of their franchisees (which would also make them the employers of their franchisees' employees) pursuant to the DOL's rulemaking, or if those franchisors are deemed to be the joint employers of their franchisees' employees under

1. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641 (Sept. 7, 2022).
2. 29 U.S.C. § 151 *et seq.*
3. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218 (Oct. 13, 2022).
4. 29 U.S.C. § 201 *et seq.*

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the NLRB's proposed rule, then franchisors will find themselves liable (or jointly liable) for compensation owed by franchisees to their franchisees' employees as well as for their franchisees' violation of labor laws; responsible (or co-responsible) for Social Security, FICA, Affordable Care Act, workers' compensation, and unemployment insurance contributions; and, conceivably, responsible (or jointly responsible) for all acts, errors, or omissions that take place at a franchised outlet under the doctrine of *respondeat superior*.

Quite a stunningly destructive thrust against franchisors whose franchisees, for over a half century, have been almost universally deemed by every court considering the issue to be independent contractors and certainly not employees of their franchisors (or, again, with a few exceptions, the joint employers of their franchisees' employees). Such a radical realignment of the economics of franchising could certainly trigger the contractual doctrine of "frustration of purpose" under which an entirely unanticipated event makes continued performance under a contract, such as a franchise agreement, entirely untenable, justifying termination of same. This article provides an overview of the proposed rules and how the franchise community can or should respond to these rules.

I. The National Labor Relations Board Notice of Proposed Rulemaking on the Joint Employer Standard

A. *Background*

The National Labor Relations Act[5] (NLRA) was enacted on July 5, 1935, in the midst of the Great Depression, on the premise that employers were denying employees the right to organize or to accept collective bargaining results, and which the NLRA's "Findings and Declaration of Policy" state had the intent or effect of burdening or obstructing commerce; diminishing employment and wages; and impairing the efficiency, safety or operation of the instrumentalities of commerce.[6] NLRA was amended three times: in 1947,[7] 1959[8] and 1974,[9] all in a fashion immaterial to the subjects addressed in this article.

Section 153 of the NLRA[10] established the NLRB, a five member panel empowered under Section 160 of the NLRA to "prevent any person from engaging in any unfair labor practice" with the power to issue complaints, conduct hearings and issue findings and final orders (including preliminary and final injunctive relief).[11] Section 158 of the NLRA sets forth a list of

5. 29 U.S.C. § 151 *et seq.*
6. *Id.* § 151.
7. *Id.* §§ 141–197, which is commonly referred to as the "Taft-Hartley Act."
8. *Id.* §§ 401–531, which is commonly referred to as the "Landrum-Griffin Act," and is also known as the "Labor-Management Reporting and Disclosure Act of 1959."
9. Act of July 26, 1974, Pub. L. No. 93–360, 88 Stat. 395.
10. 29 U.S.C. § 153.
11. *Id.* § 160.

"unfair labor practices,"[12] and pertain to violations of rights afforded workers under Section 157 of the Act: the right to self-organize; form, join, or assist labor organizations; bargain collectively; and engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection.[13]

Interestingly, the NLRA does not offer an actual definition of the term "employer." Instead, Section 152 merely states that the term "employer" includes "any person acting as an agent of an employer, directly or indirectly. . . ."[14] In contrast, Section 152(3) defines the term "employee" as including "any employee, and shall not be limited to employees of a particular employer, unless the Act explicitly states otherwise. . . ."[15]

Importantly, Section 156 of the NLRA confers upon the NLRB the authority to make, amend, and rescind rules and regulations necessary to carry out the provisions of the Act.[16] Most salient to this article is that, since it was formed in 1935, the NLRB did not ever—not once—promulgate a regulation addressing the issue of who can be deemed a "joint employer" under the NLRA. Instead, when adjudicating cases under the NLRA addressing the joint employer issue, the NLRB ostensibly relied on common law judicial precedent.[17]

Moving to more recent history, for thirty years following the NLRB's 1984 twin regulatory decisions establishing the standard for who could be characterized as a "joint employer"[18]—that is, two or more distinct entities nevertheless legally charged as co-employers of the same employee—the law was clear that only if an entity exercised actual control over another entity's employee (as opposed to merely possessing a reserved but an unexercised right to exert control), then that entity could be deemed that employee's "joint employer" and, as a result, accrue joint legal responsibility for employee compensation, taxes, labor law violations, and other legal mandates and restrictions imposed on employers.[19]

But that decades-old doctrine was reversed by the NLRB during the Obama administration when it issued a regulatory decision in 2015 in the now legendary case of *Browning-Ferris Industries of California, Inc. d/b/a BFI Newby Island Recyclers and FRP-II, LLC*.[20] That case held that two or more entities could be deemed joint employers of the same employee if they

12. *Id.* § 158.
13. *Id.* § 157.
14. 29 U.S.C. § 152.
15. *Id.* § 152(3).
16. *Id.* § 156.
17. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641, 54645–54656 (Sept. 7, 2022).
18. The two primary cases expounding this principle are Laerco Transp., 269 N.L.R.B. 324 (1984) and TLI, Inc., 271 N.L.R.B. 798 (1984).
19. *See*, *e.g.*, AM Prop. Holding Corp., 350 N.L.R.B. 998, 999–1003 (2007); Airborne Express, 338 N.L.R.B. 597 (2002); Flagstaff Med. Ctr., 357 N.L.R.B. 659 (2011).
20. Browning-Ferris Industries of California, Inc., 362 N.L.R.B. 1599 (2015).

merely possessed reserved authority to control the terms and conditions of employment, even if such reserved authority was never exercised.[21]

Thereafter, under the Trump administration, the NLRB on February 25, 2020 released its own regulation[22] on the joint employer issue, specifying that to be a joint employer an entity had to possess and exercise substantial direct and immediate control—not just possess a reserved right to control—over one or more essential terms and conditions of employment.[23] The NLRB's new joint employer rule in essence discarded its previous *Browning-Ferris* standard and reverted it to the pre-*Browning-Ferris* joint employer rule under which a business could not be deemed a joint employer if it merely contractually reserved—but did not exercise—a right to control, directly or indirectly, terms and conditions of employment.[24]

But then, in a stunning and unanticipated development, on September 8, 2020, the U.S. District Court for the Southern District of New York granted summary judgment to seventeen states and the District of Columbia on their claim that the Department of Labor's newly adopted joint employer standard, as detailed above, conflicted with the Fair Labor Standards Act and was arbitrary and capricious as to vertical joint employer liability (the very sort of joint employer liability at issue in franchising).[25] In a forty-two page opinion, Judge Gregory Woods set aside the NLRB's joint employer standard, heavily relying on judicial and administrative decisions and philosophies that were prominent during the Obama administration, even repeatedly using the "fissured workplace"[26] approach, which is relied on by those advocating to have franchisors deemed the joint employers of their franchisees' employees.[27] This decision was seemingly never appealed.

B. *The Proposed NLRB Joint Employer Regulation*

On September 6, 2022 (Labor Day), the NLRB released the NLRB NPR addressing the standard for determining joint employer status under the NLRA.[28] As noted earlier, while it is not explicitly stated in the NLRB NPR, the readily apparent goal of this forthcoming regulation is to bolster union membership by having franchisors declared joint employers of their franchisees' employees, such that unions can organize all United States employees of a franchise network and collectively bargain with the franchisors of those networks regarding the salaries, benefits, and other attributes of employment that their franchisees must grant their employees. In other words, and

21. *Id.* at 1613–14.

22. Joint Employer Status Under the National Labor Relations Act, 85 Fed. Reg. 11184 (Feb. 26, 2020).

23. *Id.* at 11185–11186, 11194–11198, 11236.

24. *Id.*

25. New York v. Scalia, 490 F. Supp. 3d 748 (S.D.N.Y. 2020).

26. David Weil, The Fissured Workplace (2014).

27. Catherine Ruckelshaus et al., Who's The Boss: Restoring Accountability for Labor Standards in Outsourced Work 7–15 (2014).

28. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641 (Sept. 7, 2022).

by example, unions would want this proposed regulation so that they can bargain with McDonald's Corp. (a franchisor) concerning the wages and benefits which McDonald's franchisees must grant their employees. Legislation increasing union membership is a top priority for labor unions due to the steady, decades long decline in union members. According to the Pew Research Center, the share of U.S. workers who belong to a union has fallen by half since 1983, when twenty percent of American workers were union members, while just above ten percent belonged to unions in 2021.[29]

The NLRB's press release announcing its proposed joint employer regulation transparently advances the regulation's goal of advancing union membership, as the NLRB Chairman Lauren McFerran stated: " [T]he Board must ensure that its legal rules for deciding which employer should engage in collective bargaining serve the goals of the National Labor Relations Act."[30]

The NLRB NPR states that the proposed regulation "would codify the Board's long-standing joint-employer standard . . . . "[31] In the authors' opinion, this statement is quite ironic. What the NLRB is seeking to accomplish through its proposed new regulation is not a reversion to the 1984 standard that was consistently applied until the end days of the Obama administration. Instead, the proposed NLRB regulation is a complete abandonment of the 1984 standard. The NLRB NPR again emphasizes its ultimate goal of "promoting collective bargaining" and stating that that objective is "best served when two or more statutory employers that each possess some authority to control or exercise the power to control employees' essential terms and conditions of employment are parties to bargaining over those employees' working conditions."[32]

The proposed NLRB joint employer rule itself is quite brief—one printed page.[33] However, the NLRB's NPR, fifty-one pages long,[34] attempts to justify the forthcoming joint employer rule and, critically, sets forth the NLRB's views, interpretations, and guidance regarding how its new regulation should be interpreted and applied by the NLRB and, at its urging, by the courts and

29. Ted Van Green, *Majority of Adults See Decline of Union Membership As Bad for the U.S. and Working People*, Pew Rsch. (Feb. 18, 2022), https://www.pewresearch.org/fact-tank/2022/02/18/majorities-of-adults-see-decline-of-union-membership-as-bad-for-the-u-s-and-working-people/#:~:text=The%20share%20of%20U.S.%20workers,workers%20were%20in%20a%20union.

30. Press Release, NLRB Issues Notice of Proposed Rulemaking on Joint Employer Standard (Sept. 6, 2022), https://www.nlrb.gov/news-outreach/news-story/nlrb-issues-notice-of-proposed-rulemaking-on-joint-employer-standard.

31. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641, 54645 (Sept. 7, 2022).

32. *Id.*

33. Standard for Determining Joint Employer Status, 87 Fed. Reg. 54663 (Sept. 7, 2022).

34. While twenty-three pages on the "printed version," the tiny font (size 10 or smaller) pdf file now downloadable at federalregister.gov (last visited Jan. 26, 2022), it is approximately fifty-one printed pages when printed directly from the federalregister.gov website, which is a slightly larger and more readable font size (https://www.federalregister.gov/documents/2022/09/07/2022-19181/standard-for-determining-joint-employer-status).

administrative bodies.[35] As always, the devil is in the details, and the NLRB guidance and interpretations set forth in its NPR existentially threaten the very foundations of franchising.

As well, the NLRB NPR, while citing nearly a hundred cases purportedly supporting the NLRB's forthcoming regulation, utterly ignores scores of federal and state franchise cases holding that a franchisor is not the joint employer of its franchisees' employees.[36] In fact, just a little over a week before the NLRB NPR was released, the U.S. District Court for the Eastern District of Pennsylvania held in *Bosley v. Rawden Joint Ventures Corp.*,[37] that McDonald's Corporation is not such a joint employer, and explained that

> there are no facts that suggest McDonald's had authority to hire or fire [the subject employee], promulgate work rules and assignments, or set conditions of employment for [the subject employee]. Nor is there any evidence that McDonald's supervised him on a day-to-day basis or had authority to discipline him. And finally, there is no evidence to suggest that McDonald's controlled [the subject employee's] employee records. Simply put, there is no evidence that McDonald's exercises significant control over [the employee].[38]

This *Rawden* decision is representative of the countless number of similar decisions handed down by the judiciary over the past half century.[39] Yet not

35. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641 (Sept. 7, 2022).

36. See *generally id.* (specifically Section IV).

37. Bosley v. Rawden Joint Ventures Corp., 2022 WL 3701171 (E.D. Pa. Aug. 26, 2022).

38. *Id*. at *5.

39. The classic formulation of this principle was found in *Cislaw v. Southland Corp*., 6 Cal. Rptr. 2d 386, 391 (Ct. App. 1992) where the court held that "the franchisor's interest in the reputation of its entire system allows it to exercise certain controls over the enterprise without running the risk of transforming its independent contractor franchisee into an agent." Again, in *Kaplan v. Coldwell Banker Residential Affiliates, Inc*., 69 Cal. Rptr. 2d 640, 642 (Ct. App. 1997), the court made clear that the bedrock principle of franchising is that franchisors and franchisees operate under an independent contractor relationship; indeed, "if the law was otherwise, every franchisee who independently owned and operated a franchise would be the true agent or employee of the franchisor." For other representative examples of these voluminous cases, see Saleem v. Corporate Transp. Grp., Ltd., 2014 WL 4626075 (S.D.N.Y. Sept. 16, 2014) (holding that franchisee was properly classified as an independent contractor under the Fair Labor Standards Act); Leach v. Kaykov, 2013 WL 214383 (E.D.N.Y. Jan. 20, 2013) (holding that the franchisee operated its own enterprise as an independent contractor under the franchise agreement); Walker v. Pac. Pride Servs., Inc., 2007 WL 4209445, at *5 (N.D. Cal. Nov. 27, 2007) (finding that, under the circumstances, provisions of the franchise agreement which "limits the nature of the franchise to one of an independent contractor, rather than agency". . . "confirms the nature of the relationship"); Sensormatic Sec. Corp. v. Sensormatic Elecs. Corp., 455 F. Supp. 2d 399 (D. Md. 2006) (franchisee is independent contractor and not franchisor's agent); Amoco Oil Co. v. Gomez, 924, 125 F. Supp. 2d 492, 509 (S.D. Fla. 2000) ("The contracts in this case establish a franchiser/franchisee or independent contractor relationship."); Perry v. Burger King Corp., 924 F. Supp. 548 (S.D.N.Y. 1996) (holding that the nature of the franchisor-franchisee relationship combined with the language of the franchise agreement demonstrated that the franchisee was an independent contractor); Howell v. Chick-Fil-A, Inc., 1993 WL 603296 (N.D. Fla. Nov. 1, 1993) (holding that the franchisee was an independent contractor and not the employee of the franchisor); Madison v. Hollywood Subs, Inc., 997 So. 2d 1270 (Fla. Dist. Ct. App. 2009) (holding that the franchisee was an independent contractor and not an agent of the franchisor, based in part, on the language of the franchise agreement); Ortega v. Gen. Motors Corp., 392 So. 2d 40 (Fla. Dist. Ct. App. 1980) (holding that under the dealer franchise agreement, the dealer was an independent contractor, and not an agent of the manufacturer); Quijada Corp. v. Gen.

one of them is cited, quoted, or their existence even acknowledged in the NLRB NPR. Instead, the NLRB engaged in cherry-picking and cited only judicial precedent purportedly supporting the NLRB's regulatory thrust.[40]

The NLRB NPR features five factors to be considered (with Section 103.40[g] of the proposed regulation noting that a party asserting that an entity is a joint employer has the burden of establishing such by a preponderance of the evidence). Each of the factors is identified and discussed below.

1. Joint Employer Factor One—Common Law Agency Principles

Section 103.40 of the proposed NLRB joint employer regulation states: "An employer, as defined by Section 2(2) of the National Labor Relations Act . . . is an employer of particular employees, as defined by Section 2(3) of the Act, if the employer has an employment relationship with those employees under common-law agency principles."

Here is where difficulties begin. For as noted above, Section 2(2) of the National Labor Relations Act (29 U.S.C. § 152) does not define the term "employer." It simply states that the term "employer" includes any person acting as an agent of an employer.[41] The NLRB NPR seeks to address this vacuum by citing, of all things, such "primary articulations" as the 1958 *Restatement (Second) of Agency*; an 1877 publication entitled *A Treatise on the Law of Master and Servant Covering the Relation, Duties and Liabilities of Employers and Employees*;[42] and the 1941 edition of *American Jurisprudence*.[43]

The closest the NLRB NPR comes to defining who exactly is an "employer" is its citation to and quotation of the aforementioned 1958 *Restatement (Second) of Agency* which defines the term "master" (that's how old it is) as "a principal who employs an agent to perform service in his affairs and who controls or has the right to control the physical conduct of the other and the performance of the service."[44] Again, one immediately grasps that the NLRB NPR does not at all reference the extensive body of

Motors Corp., 253 A.2d. 538 (D.C. 1969) (finding that the distributor was an independent contractor); Miller *ex rel.* Bailey v. Piedmont Steam Co., 528 S.E.2d 923, 927 (N.C. Ct. App. 2000) ("The fact that the parties formally agreed that [franchisee] was an independent contractor and not an agent of [franchisor] is an indicia of the parties' intent that no agency relationship be formed."); Smith v. Foodmaker, Inc., 928 S.W.2d 683 (Tex. App. 1996) (awarding summary judgment for the franchisor on the basis that the franchisee was an independent contractor and not an agent of the franchisor); Martin, Jr. v. Southland Corp., Bus. Franchise Guide (CCH) ¶11,091 (Cal. Ct. App. 1996) (holding that "the franchisor's interest in the reputation of its entire system allows it to exercise certain controls over the enterprise without running the risk of transforming its independent contractor franchisee into an agent."); Lobdell v. Sugar 'N Spice, Inc., 658 P.2d 1267, 1274 (Wash. Ct. App. 1983). ("The status of a franchisee is unique and more akin to that of a limited independent contractor.").

40. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641, 54642–54644 (Sept. 7, 2022).

41. 29 U.S.C. § 152.

42. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641, 54645 (Sept. 7, 2022).

43. *Id*.

44. *Id*. at 54646.

prevailing NLRB adjudicatory decisions between 1984–2020 governing who may be deemed a joint employer.

2. Joint Employer Factor Two—Sharing or Co-Determining Employees' Essential Terms and Conditions of Employment

The proposed rule's second factor for determining whether two or more entities are joint employers is set forth in Section 103.40, which states, "[T]wo or more employers of the same particular employees are joint employers of those employees if the employers share or co-determine those matters governing employees' essential terms and conditions of employment." The primary support that the NLRB identifies for this contention is, quite paradoxically, the *Browning-Ferris* decision—the very decision which upset thirty years of NLRB adjudicatory precedent.[45]

3. Joint Employer Factor Three—Definition of Sharing or Co-Determining Employees' Essential Terms and Conditions of Employment

Section 103.40 of the proposed NLRB regulation elucidates what the immediately preceding subsection meant with regard to employers sharing or co-determining "those matters governing employees' essential terms and conditions of employment." Defining that phrase, the proposed regulation states that it means "for an employer to possess the authority to control (whether directly, indirectly, or both), or to exercise the power to control (whether directly, directly, or both), one or more of the employees' essential terms and conditions of employment."

And here is where the great danger lies for franchising. Because in elucidating on this definition, the NLRB NPR states that "evidence that a putative joint employer possesses the authority or exercises the power to control one or more of the employees' essential terms and conditions of employment is relevant to the joint employer inquiry, regardless of whether such control is direct or indirect."[46] The primary support that the NLRB cites for this contention? The 2015 *Browning-Ferris* decision (which, again, reversed thirty years of NLRB decisional precedent) and the District of Columbia Circuit Court of Appeals reversal of the 2015 decision, which reversed and remanded the NLRB's "articulation and application of the indirect control element."[47]

The NLRB NPR then summarily sweeps away as wrongly decided the NLRB precedents (*TLI* and *Laerco*, addressed above) and their progeny over the course of thirty years as having "wrongly depart(ed) from the common

45. *Id.*
46. *Id.*
47. Browning-Ferris Industries of California, Inc. v. NLRB (BFI), 911 F.3d 1195 (D.C. Cir. 2018).

law. . . . "[48] This approach, which is dismissive to large swaths of NLRB and judicial precedent, appears repeatedly in the NLRB NPR.

4. Joint Employer Factor Four—What Are the "Essential Terms and Conditions of Employment?"

Section 103.40 of the NLRB's proposed joint employer regulation defines what the NLRB considers the "essential terms and conditions of employment." According to the NLRB, these will generally include (but are not limited to) "wages, benefits, and other compensation; hours of work and scheduling; hiring and discharge; discipline; workplace health and safety; supervision; assignment; and work rules and directions governing the manner, means, or methods of work performance."

The danger to franchisors triggered by this definition is clear: in our myriad years of experience in practicing franchise law, many (if not virtually all) franchisors, in an effort to assist their franchisees, suggest compensation rates for various strata of franchisee employees. For example, in the quick serve restaurant (QSR) scenario, a franchisor will often suggest salary ranges for a franchised restaurant manager; assistant manager; counter servers; line cooks; and other personnel. (Of course, each franchise sector features different employee positions addressed by the pertinent franchisors.) Many (if not most) franchisors also offer staff scheduling guidance to assist franchisees in accommodating daily, seasonal, holiday, weekday/weekend and special event variations in customer demand and traffic. As to workplace health and safety, virtually all franchisors in their operations manuals/brand standards prescribe certain activities, inspections, and other measures to help ensure the health and safety not only of franchisee employees but, most certainly, the public. As for the final element—work rules and directions governing the manner, means, or methods of work performance—those are precisely what franchisor operations manuals/brand standards are meant to impart to franchisees to foster franchise unit uniformity and customer satisfaction.

All such franchisor directions, guidance, requirements, restrictions, and prohibitions are meant to benefit franchisees and enable them to operate efficiently, optimally, and in a fashion that reflects the standards of quality associated by the public with the subject franchisor's trademark/service mark. Obtaining access to such critical operating standards is one of the key reasons that franchisees join a franchise system. For example, an individual opening his/her own QSR restaurant or hotel with no knowledge or experience, no branded trademark, and no one to turn to for guidance is in an entirely different situation than a franchisee. The franchisee, up front, receives all of the necessary know-how, confidential information, and brand standards necessary to build, open, and operate a restaurant or hotel in a knowledgeable, cohesive, and well-informed manner based on knowledge

48. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641, 54645–54646 (Sept. 7, 2022).

transfer from the franchisor (that has either years or even many decades of operational experience on which to base its standards and recommendations).

But, once again, neither the NLRB NPR nor the proposed rule itself distinguishes these attributes of franchising from the typical employer-employee relationship, an omission which—given the vast distinctions between an employer and an employee, on the one hand, and a franchisor and its franchisees, on the other hand—seems not only intentional but also inexcusable considering the potential impacts of the proposed rule.

5. Joint Employer Factor Five—How Will It Be Determined Whether an Employer Possesses the Authority to Control One or More of the Employees' Terms and Conditions of Employment?

Section 103.40(e) of the proposed NLRB regulation is the most threatening to the franchise paradigm. It states that an employer "[p]ossessing the authority to control [one or more of the employees' terms and conditions of employment] is sufficient to establish status as a joint employer, regardless of whether control is exercised. Exercising the power to control indirectly is sufficient to establish status as a joint employer, regardless of whether the power is exercised directly."[49]

It is in this fashion that the NLRB proposes to scrap thirty years of its very own joint employer standard as enunciated in *TLI, Inc.*[50] and *Laerco Transportation*.[51] These cases, followed for over three decades, advanced the NLRB's guideline that a putative joint employer's control over employment matters must be direct and immediate—indirect control, or an unexercised contractual reservation of a right to control, was insufficient.[52] Now, instead, the proposed NLRB regulation adopts the "logic" of *Browning-Ferris*, which itself upended thirty years of precedent established by *TLI* and *Laerco*.[53] But even worse, as noted by the "Dissenting View of Members Kaplan and Ring,"[54]

> [T]he proposed rule also radically expands the circumstances in which joint-employer status can be found, going well beyond common-law limits and anything contemplated by the Board's decision in *BFI*. . . . [T]he proposed rule makes a never-exercised contractual reservation or right to control, or indirect control of or influence over, a single term or condition of employment deemed "essential," *determinative* of joint-employer status.[55]

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49. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641, 54658 (Sept. 7, 2022).

50. TLI, Inc., 271 N.L.R.B. 128 (1984), *enforced sub nom.* General Teamsters Local Union No. 326 v. NLRB, 772 F.2d 894 (3d Cir. 1985).

51. Laerco Transp., 269 N.L.R.B. 324 (1984).

52. *Id.*

53. TLI, Inc., 271 N.L.R.B. 128 (1984), *enforced sub nom.* General Teamsters Local Union No. 326 v. NLRB, 772 F.2d 894 (3d Cir. 1985); *Laerco Transp.*, 269 N.L.R.B. 324.

54. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54641, 54651–54653 (Sept. 7, 2022).

55. *Id.* (emphasis in original).

The NLRB NPR seemingly affirms this most troubling element of the proposed NLRB Rule by stating:

> [T]he Board believes that the policies of the [National Labor Relations] Act, together with the expansive common-law employer-employee relationship defined by the judiciary, make it appropriate for the Board to give determinative weight to the existence of a putative joint employer's authority to control the essential terms and conditions of employment, *whether or not such control is exercised, and without regard to whether any exercise of such control is direct or indirect, such as through an intermediary.*[56]

The NLRB's basis for this assertion? Once again, citation to a 1922 American Law Report (A.L.R.) annotation; the 1933 first *Restatement of Agency*; the first edition of *American Jurisprudence*; and what the NLRB contends are "innumerable judicial decisions and secondary authorities," an assertion only supported by one 2014 California case and the *Restatement (Second) of Agency*, *Corpus Juris Secundum*, and *American Jurisprudence*.[57] No other judicial decisions are cited or discussed.[58] So it is that this most crucial element of the proposed NLRB regulation is advanced in a virtual judicial precedential void and in contravention of the NLRB's own decisional law that has prevailed for over thirty years.

The threat posed to franchising by Section 103.40(e) of the proposed NLRB Rule is readily apparent. By its very nature, franchising vests in franchisors the authority to control indirectly through brand standards (which is enough under the proposed rule) one or more of the terms and conditions of employment for the employees of their franchisees. As noted above, it is through franchisor training that franchisees learn and thereafter impart to their employees what their assignments are and how they should be performed; what health and safety measures must be observed; what shifts will be established for those employees; and, most certainly, the rules and directions governing the manner, means, and methods of employee work performance. These are all imparted to franchisees through franchisor training and operation/brand standards manuals. But under the above-quoted language of Section 103.40 of the proposed rule, only one of the foregoing will be sufficient to determine joint employer status. Further, because such requirements, restrictions, scheduling, and supervision elements are imparted only indirectly to employees (that is, through franchisor training of its franchisees), the "indirect control" element of Section 103.40 of the proposed rule is likewise seemingly satisfied. Again, it appears that the NLRB structured this particular requirement in an intentional manner to subsume franchising.

The NLRB NPR goes even further in identifying "mandatory subjects" of collective bargaining that implicate the terms and conditions of employment: the scheduling of employee breaks; work rules; and, employee dress

56. *Id*. at 54648 (emphasis added).
57. *Id*. at 54649.
58. *Id*.

code.[59] Of course, franchisors impart to franchisees, who must observe, the rules governing work to be performed at franchised outlets; the requirements, restrictions and prohibitions that franchisees (and their employees) must follow regarding health and safety issues; and, almost universally, employee dress codes.

As noted, the NLRB makes plain in the NLRB NPR that the goal of this proposed new regulation is to foster unionization[60]—particularly, the authors believe, the unionization of franchise network employees (the overwhelming majority of which are employed by franchisees) such that unions can negotiate with franchisors regarding the salaries their franchisees must pay their employees. And it is through Section 103.40(e) of the proposed rule that the NLRB seeks to accomplish this goal.

C. *The Reaction to the NLRB NPR*

The reaction to the NLRB NPR was swift—and, in many instances, not terribly kind. The *Wall Street Journal* Editorial Board was straightforward:

> The Biden Administration's regulatory machinery is up and running, and no business except perhaps marijuana and green energy is safe. The latest target is the franchise business model, as the National Labor Relations Board (NLRB) said Tuesday it plans to broaden the definition of joint employment. Under the new rule, workers and contractors at certain establishments would be counted as employees of the parent company. That would rewrite the rules for thousands of franchise businesses like McDonald's or Best Western. . . . The rule would strengthen the hand of Big Labor. Reclassifying contractors as franchise employees could force many parent companies to negotiate with unions, rather than requiring unions to negotiate with local owners.[61]

The *Wall Street Journal* opined a week later: "The Administration is proving it's an equal-opportunity jobs killer," noting that about twenty million Americans work as independent contractors.[62]

The NLRB NPR triggered 12,948 comments as of January 26, 2022.[63] Many of the comments criticized the proposal as having "the potential to destroy the franchise model"[64] and seeming to be "purposely designed to eliminate franchise businesses altogether."[65]

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59. *Id.* at 54647.

60. *Id.* at 54644–54645.

61. *The NLRB's War on Franchises, Part II*, Wall St. J. (Sept. 7, 2022), https://www.wsj.com/articles/the-war-on-franchises-part-ii-national-labor-relations-board-joint-employment-proposed-rule-11662588822.

62. *Biden Goes After Gig Workers*, Wall Str. J., Oct. 12, 2022, at A-19 (Oct. 12, 2022).

63. Notice of Proposed Rule on the Standard for Determining Joint-Employer Status, 87 Fed. Reg. 54641 (Sept. 7, 2022).

64. McDonald's USA, LLC, Comment to Notice of Proposed Rule on the Standard for Determining Joint-Employer Status (Dec. 21, 2022), https://www.regulations.gov/comment/NLRB-2022-0001-12990.

65. Elisa DeBoer, Comment to Notice of Proposed Rule on the Standard for Determining Joint-Employer Status (Nov. 7, 2022), https://www.regulations.gov/comment/NLRB-2022-0001-3919.

Criticism of the NLRB NPR was not confined to franchise related entities, as the American Hospital Association stated in its comments:

> Critically, the National Labor Relations Board (NLRB) failed to properly investigate the particular economic and practical effects the proposed rule would have on hospitals and health systems. Had it done so, it would have quickly become clear that the proposed rule would adversely impact an already over-burdened hospital field and create a collective bargaining quagmire that will harm hospitals, their patients, their employees, and the communities they serve. . . . At a minimum, the NLRB must . . . exempt hospitals from any final rule. Failure to do so risks compromising the hospital field and its very purpose: patient care.[66]

Perhaps the strongest rebuke to the NLRB's proposed joint employer regulation came from a sister federal agency. On November 29, 2022, the U.S. Small Business Administration (SBA) Office of Advocacy submitted a comment letter to the NLRB asserting that its proposed regulation too broadly expands the joint employer standard, singling out franchise agreements: "[T]his proposal may significantly affect franchisor and franchisee relationships. Franchise agreements often contain many terms and conditions with reserved control over the business operations of a brand, such as provisions regarding management, operations, and human resources."[67] In addition, the SBA noted that "small businesses in retail, restaurants, and hotels commented that this proposed rule may impact their third-party contracts with temporary staffing agencies, vendors, catering, cleaning crews and many other businesses."[68] Moreover, noted the SBA, "[f]ranchisees reported that this proposal may add costs of thousands of dollars a year and may require hiring a dedicated staffer. A restaurant franchisee owner stated that these costs will prohibit small business expansion, as restaurants are currently facing increased food prices and labor shortages."[69]

The above are just a few samples of the negative response to the NLRB NPR. Positive responses largely emanated from unions.[70]

66. Am. Hosp. Ass'n, Comment to Notice of Proposed Rule on the Standard for Determining Joint-Employer Status (Nov. 6, 2022), https://www.regulations.gov/comment/NLRB-2022-0001-2693.

67. U.S. Small Bus. Admin. Office of Advocacy, Comment to Notice of Proposed Rule on the Standard for Determining Joint-Employer Status (Nov. 29, 2022), https://cdn.advocacy.sba.gov/wp-content/uploads/2022/11/29104056/Comment-Letter-NLRB-Joint-Employer-Rule-508c.pdf?utm_medium=email&utm_source=govdelivery.

68. *Id.*

69. *Id.*

70. *See, e.g.*, Serv. Emp. Int'l Union, Comment to Notice of Proposed Rule on the Standard for Determining Joint-Employer Status (Dec. 8, 2022), https://www.regulations.gov/comment/NLRB-2022-0001-11275.

II. The Department of Labor Notice of Proposed Rulemaking: Employee vs. Independent Contractor (Franchisee Deemed an Employee?)

A. *Background*

The Fair Labor Standards Act of 1938 (FLSA) was enacted in the midst of the Great Depression.[71] It mandates that employers pay nonexempt employees at least the federal minimum wage (currently $7.25 per hour); time-and-a-half for overtime (hours worked beyond forty per workweek); imposes maximum hours of work; requires employers to preserve certain records regarding employees; and affords various other rights to employees.[72]

The problem? The FLSA defines the term "employee" in an entirely amorphous fashion: "any individual employed by an employer."[73] And "employer" is defined in the FLSA as including "any person acting directly or indirectly in the interest of an employer in relation to an employee."[74] The last key definition in the FLSA provides that the term "'[e]mploy' includes to suffer or permit to work."[75]

These are extraordinarily broad and fluid definitions. But the U.S. Supreme Court has recognized that the FLSA was "not intended to stamp all persons as employees."[76] In fact, the Court has specifically recognized that "independent contractors" are excluded from FLSA coverage and fall outside the Act's broad understanding of employment.[77] Notably, the FLSA does not define the term "independent contractor" (despite the fact that, in 1947, Congress amended the NLRA's definition of "employee" to exclude "any individual having the status of an independent contractor."[78]) However, the FLSA was never similarly amended by Congress. Trying to synthesize the foregoing, a series of U.S. Supreme Court decisions held that the common law "economic reality" analysis remained the test of employment.[79]

Following these decisions, the Department of Labor issued opinion letters and guidance releases addressing the independent contractor vs. employee issue,[80] but only once by means of a regulation (that came in 1962, when the Department of Labor revised 29 C.F.R. § 788, which addresses employees in small forestry or lumbering operations).[81]

Then, in the waning days of the Trump administration, on January 7, 2021, the Department of Labor published a final rule entitled "Independent

71. Fair Labor Standards Act of 1938, 29 U.S.C. § 201 *et seq.*
72. 29 U.S.C. §§ 206–207, 211.
73. *Id.* § 203(e)(1).
74. *Id.* § 203(d).
75. *Id.* § 203(g).
76. Walling v. Portland Terminal, 330 U.S. 148 (1947).
77. Rutherford Food Corp. v. McComb, 331 U.S. 722 (1947).
78. 29 U.S.C. § 152(3).
79. *See, e.g.*, Goldberg v. Whitaker House Co-op, Inc., 366 U.S. 28, 81 (1961); United States v. Silk, 331 U.S. 704 (1947); Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318 (1992).
80. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218, 62222–62225 (Oct. 13, 2022).
81. *See* 29 C.F.R. § 788.

Contractor Status Under the Fair Labor Standards Act."[82] This new rule set forth regulations to be added to a new part (Part 795) in Title 29 of the Code of Federal Regulations entitled "Employee or Independent Contractor Classification Under the Fair Labor Standards Act."[83] This 2021 "IC Rule" tightened up prior guidance and case law factors to be considered in determining who is to be deemed an employee vs. an independent contractor.[84]

However, soon after President Biden took office, on January 20, 2021, the Department of Labor published a proposal to delay the January 7, 2021, IC Rule's effective date[85] and then published a Notice of Proposed Rulemaking seeking to withdraw the 2021 Rule altogether.[86] On May 5, 2021, the Department indeed announced a final rule withdrawing the 2021 Independent Contractor Rule.[87] This withdrawal rule stated that it would take effect immediately upon publication in the Federal Register on May 6, 2021, but, after litigation challenging the withdrawal of the 2021 Rule, a federal district court in Texas issued a decision vacating the Department of Labor's withdrawal rule.[88] The court held that the Department of Labor failed to provide a meaningful opportunity for comment in promulgating its withdrawal rule; failed to show good cause for making it effective immediately upon publication; and acted in an arbitrary and capricious manner by failing to consider alternatives to rescinding the 2021 Independent Contractor Rule.[89] The Department of Labor appealed to the Fifth Circuit and then advised that court that it was about to promulgate the 2022 independent contractor regulation that we are examining herein, following which the Fifth Circuit stayed the appeal until December 7, 2022 (subject to considering a further stay at that time).[90]

Having lost in court and having been told that it acted in an arbitrary and capricious manner by failing to consider potential alternatives to rescinding the 2021 IC Rule, the Department of Labor, in what the authors view as a clear attempt to circumvent further judicial scrutiny and achieve its desire to rescind the 2021 IC Rule, on October 13, 2022, published the Notice

82. *Id.* §§ 780, 788, 795.

83. Independent Contractor Status Under the Fair Labor Standards Act, 86 Fed. Reg. 1168, 1246–1248 (Jan. 7, 2021).

84. *Id*. at 1171–76; 29 C.F.R. §§ 795.100 – 795.110.

85. Independent Contractor Status Under the Fair Labor Standards Act: Delay of Effective Date, 86 Fed. Reg. 8326 (Feb. 5, 2021).

86. Independent Contractor Status Under the Fair Labor Standards Act: Withdrawal, 86 Fed. Reg. 14027 (Mar. 12, 2021).

87. Independent Contractor Status Under the Fair Labor Standards Act (FLSA): Withdrawal, 86 Fed. Reg. 24303, 24303 (May 6, 2023) (claiming that the 2021 Independent Contractor Rule was inconsistent with the FLSA and would have a confusing and disruptive effect on workers and businesses).

88. Coalition for Workforce Innovation v. Walsh, 2022 WL 1073346 (E.D. Tex. Mar. 14, 2022).

89. *Id*.

90. Stay Order, Coalition for Workforce Innovation v. Walsh, No. 22-40316 (Dec. 12, 2022) (ECF No. 37).

of Proposed Rulemaking under review herein.[91] If this proposed regulation is adopted, it would establish new standards for determining who can be deemed an employee as opposed to an independent contractor under the Fair Labor Standards Act.[92] This new regulation would also explicitly rescind the 2021 IC Rule.[93] The DOL NPR is lengthy and, in the authors' view, a one-sided defense of why the new regulation should replace what the current DOL views as the wrongly crafted 2021 IC Rule.

B. *The Proposed Employee vs. Independent Contractor Regulation*

The proposed new DOL regulation is quite brief—three printed pages.[94] However, the balance of the 137-page DOL NPR[95] sets forth the Department of Labor's views, interpretations, and guidance regarding how its relatively brief new regulation will be interpreted and applied by the DOL and, at its urging, by the courts and administrative bodies. The DOL guidance and interpretations set forth in its NPR pose grave, perhaps even fatal, dangers to the franchise paradigm of doing business, which has so flourished over the past seventy years as to make it an integral component of the American economy.[96] (The fact that the DOL NPR not only contravenes but, instead, never even references over half a century of judicial decisions almost universally declaring franchisees to be independent contractors of their franchisors and not at all employees is remarkable.)

The proposed new DOL regulation—which would significantly modify Part 795 of the Code of Federal Regulations—begins by stating its intent in Section 795.100: memorializing the Department of Labor's interpretations for determining whether workers are employees or independent contractors under the Fair Labor Standards Act and noting that "[t]o the extent that prior administrative rulings, interpretations, practices, or enforcement policies relating to determining who is an employee or independent contractor under the Act are inconsistent or in conflict with the interpretation stated in this part, they are hereby rescinded."[97]

91. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218 (Oct. 13, 2022).

92. *Id.*

93. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218, 62274 (Oct. 13, 2022).

94. *Id.* at 62274–62275.

95. While the downloadable "printed version" of the DOL NPR (10-point or smaller font, .PDF file) at the Federal Register website is fifty-eight pages, the version printed directly from federalregister.gov (which is a slightly larger font size) is approximately 137 pages. *See* https://www.federalregister.gov/documents/2022/10/13/2022-21454/employee-or-independent-contractor-classification-under-the-fair-labor-standards-act.

96. *2022 Franchising Economic Outlook*, Int'l Franchise Ass'n (Feb. 15, 2022), https://www.franchise.org/sites/default/files/2022-02/2022-Franchising-Economic-Outlook.pdf.

97. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218, 62274 (Oct. 13, 2022) (discussing DOL Proposed Regulation § 795.100).

C. *The Economic Realities Test*

Section 795.105 of the DOL's proposed new regulation declares that a "determination of whether workers are employees or independent contractors under the [FLSA] focuses on the economic realities of the workers' relationship with the employer," which "economic realities" test is often applied by courts considering whether a worker is an employee or an independent contractor.[98] Section 795.105 of the proposed Rule then explicitly states: "The Act's definitions are meant to encompass as employees all workers who, as a matter of economic reality, are economically dependent on an employer for work."[99]

Proposed Rule Section 795.110 sets forth the Department of Labor's "economic reality test" consisting of six factors—with the warning that "[c]onsistent with a totality-of-the-circumstances analysis, no one factor or subset of factors is necessarily dispositive, and the weight to give each factor may depend on the facts and circumstances of the particular case. Moreover, these six factors are not exhaustive. . . . [A]dditional factors may be considered."[100] So it is that the DOL is authorizing itself (and the judiciary) to zero in on just one of the six "factors" in determining whether an individual is an employee or independent contractor and further reserving the right to consider yet additional factors virtually at whim.

Section 795.110(b) of the proposed regulation identifies the six "economic reality" factors to be considered by the Department of Labor (and, at its urging, the courts) when construing whether a worker is an employee or an independent contractor.[101]

1. Economic Reality Factor One—Opportunity for Profit or Loss

The first of the six factors identified in Section 795.110(b)(i) of the proposed Rule is the "opportunity for profit or loss depending on managerial skill"[102] and deems the following factors relevant:

> Whether the worker determines or can meaningfully negotiate the charge or pay for the work provided; whether the worker accepts or declines jobs or chooses the order and/or time in which the jobs are performed; whether the worker engages in marketing, advertising, or other efforts to expand their business and secure more work; and whether the worker makes decisions to hire others, purchase materials and equipment, and/or rent space. If a worker has no opportunity for profit or loss, then this factor suggests that the worker is an employee.[103]

This factor may appear to be seemingly anodyne for franchising since, of course, franchisees have a distinct opportunity for profit or loss. But this is not so. Citing a Third Circuit case, the NPR notes that an Uber driver could be considered an employee because Uber determines the fare; which

98. *Id.* (discussing DOL Proposed Regulation § 795.105).
99. *Id.*
100. *Id.* at 62275 (discussing DOL Proposed Regulation § 795.110(b) (7)).
101. *Id.* at 62274–62275 (discussing DOL Proposed Regulation § 795.110(b)).
102. *Id.* (discussing DOL Proposed Regulation § 795.110(b)(1)).
103. *Id.*

driver receives the trip request; whether to refund or cancel a passenger's fare; and a driver's territory.[104] Of course, many franchise systems (especially in janitorial services, home health care, and business staffing) in whole or in part administer systems under which franchisors secure accounts/customers (whether national, regional, or local); establish the prices which the customer/account will pay; allocate those customers/accounts among franchisees; in a number of systems, bill the customer/account, collect the revenue and remit to franchisees their portion of such revenue; and handle customer complaints (at times directing franchisees to issue refunds or credits). Moreover, many franchise platforms have migrated to a resale price maintenance program under which the franchisor can dictate the prices at which franchisees may offer and sell products or services, this in an effort to enable national/regional/local price point advertising.

So while virtually all franchisees possess the opportunity to earn a profit or suffer a loss, seemingly removing them from employee status under Section 795.110(b)(i) of the DOL's proposed Rule,[105] nevertheless the other economic reality factors specified in this section—abilities to negotiate the charge or pay for work provided; accept or decline jobs; or engage in marketing (most franchise systems have long since migrated to national or regional advertising, with franchisees only supplementing same if they desire)—may result in franchisors being deemed the employers of their franchisees (and, as a consequence, their franchisees' employees).

The authors should note that not a word in the DOL NPR references franchising at all, thus seemingly subjecting the franchisor-franchisee relationship to the same employee vs. independent contractor analysis prescribed for individual workers.

2. *Economic Reality Factor Two—Investment by Worker*

The second "economic reality" factor identified in Section 795.110(b)(2) of the proposed Rule addresses investments by the worker and the employer.[106] This factor considers "whether any investments by a worker are capital or entrepreneurial in nature," noting that such investments indicate independent contractor status—but only if they increase the worker's ability to do different types of or more work, reducing costs, or extending market reach.[107] Interestingly, this provision of the proposed Rule states that

> the worker's investments should be considered on a relative basis with the employer's investments in its overall business. The worker's investments need not be equal to the employer's investments, but the worker's investments should support an independent business or serve a business-like function for this factor to indicate independent contractor status.[108]

104. *Id.* at 62237.
105. *Id.*
106. *Id.* at 62274–62275 (discussing DOL Proposed Regulation § 795.110(b)(2)).
107. *Id.*
108. *Id.*

This second "economic reality" factor in the DOL's proposed Rule should not prove inherently challenging to franchise networks because, almost universally, franchisees invest substantial capital in their businesses, which by their very nature are entrepreneurial. However, a danger lies in the prong of this factor calling for a comparison of a franchisee's investment in its business to that of its franchisor's. According to the DOL NPR, "If the worker's investment compares favorably to the employer's investment, then that fact suggests independence on the worker's part. . . . If the worker's investment does not compare favorably . . . then that fact suggests that the worker is economically dependent and an employee of the employer."[109]

This standard could prove most troubling in many franchise networks. While this standard likely will not pose an issue for smaller and start-up franchisors whose capitalization is relatively thin and may compare to the capital investment required of its franchisees, this "economic reality" test may pose a significant issue for major franchisors, which feature extraordinarily strong balance sheets and whose investments in their networks over time cumulatively may total tens or even many hundreds of millions of dollars. Clearly the investment of a single franchisee of one of these very large franchisors will not come close to equaling the latter's cumulative investment in the network.

Moreover, even within any given network, disparate results may pertain. For example, take Pizza Hut, which is a wholly owned subsidiary of YUM! Brands, Inc.[110] (which also owns Taco Bell, KFC, and Habit Burger Grill, which together have 53,424 units both domestically and internationally, the vast majority of which are franchised).[111] Of these, 18,381 are Pizza Hut restaurants.[112] The 2022 YUM! Brands, Inc. annual report reveals that its Pizza Hut division enjoyed an operating profit in 2021 of $387,000,000 and that the franchisor devoted $18,000,000 to capital expenditures during that year.[113] Now it is quite clear that a single unit Pizza Hut franchisee cannot possibly match its franchisor in terms of its investment. But it is very possible that Pizza Hut's largest franchisee, Flynn Restaurant Group—which operates 941 Pizza Hut restaurants and which also owns 441 Applebee's, 282 Taco Bells, 139 Paneras, 369 Arby's, and a 192 Wendy's according to one of its website's subpages[114]—could conceivably match (or come close to matching) those franchisors' capital investments in any given year.

Thus, the striking threat of a dichotomy exists within a single franchise network—single unit franchisees conceivably being deemed employees due to their investments not coming close to those of their franchisor, while larger franchisees perhaps being able to satisfy that equivalence. Recalling

109. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218, 62242 (Oct. 13, 2022).

110. The authors' law firm serves as franchise counsel for YUM! Brands, Inc.

111. YUM! Brands, Inc. Annual Report (From 10-K) (Feb. 22, 2022).

112. *Id*.

113. *Id*.

114. Hut American Group, https://www.hutamerican.com (last visited Feb. 4, 2023).

the DOL Rule's admonition that any one of its "economic reality" factors may be sufficient to determine whether a franchisee is an employee versus an independent contractor and the disparity of venues in which this issue may be determined (courts/administrative agencies/state labor divisions/the Department of Labor itself), this possibility of disparate treatment of any given network's franchisees becomes almost predictable.

3. Economic Reality Factor Three—Permanence of the Work Relationship

The third "economic reality" factor prescribed in Section 795.110(b)(3) of the proposed Rule is the degree of permanence of the work relationship.[115] That section states:

> This factor weighs in favor of the worker being an employee when the work relationship is indefinite in duration or continuous, which is often the case in exclusive working relationships. This factor works in favor of the worker being an independent contractor when the work relationship is definite in duration, non-exclusive, project-based or sporadic based on the worker being in business for themself and marketing their services or labor to multiple entities.[116]

This "degree of permanence" factor will quite naturally prove troublesome when it comes to franchising. The DOL NPR elucidates "that an indefinite or continuous relationship is consistent with an employment relationship," with the DOL adding that "where workers provide services under a contract that is routinely or automatically renewed, courts have determined that this indicates permanence at an indefinite working arrangement associated with employment."[117]

Since virtually every franchise agreement, while not permanent, nevertheless typically features terms of five, ten, or twenty years and is exclusive (as almost all franchise agreements restrict a franchisee's ability to work for others competitively), and because franchise agreements are routinely (and sometimes automatically) renewed, it becomes clear that a determined judge or administrator could cite the "degree of permanence of the work relationship" economic reality factor identified in Section 795.110(b)(3) of the proposed Rule to justify a finding that a franchisee is the employee of its franchisor—especially recalling, once again, that Section 795.110(2) of the proposed Rule, as noted above, grants that judge or administrator authority to give weight to one "economic reality" factor over all of the others.

4. Economic Reality Factor Four—Control

The fourth "economic reality" factor advanced in the proposed DOL Rule is the critical one for franchising: the nature and degree of employer control.

115. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218, 62274–62275 (Oct. 13, 2022) (discussing DOL Proposed Regulation § 795.110(b)(3)).

116. *Id.*

117. *Id.* at 62245.

According to Section 795.110(b)(4) of the proposed DOL Rule, "This factor considers the employer's control, including reserved control, over the performance of the work and economic aspects of the working relationship."[118] The proposed Rule states that facts relevant to the employer's control over the worker include whether the employer sets the worker's schedule, supervises the performance of the work, or explicitly limits the worker's ability to work for others.[119] Moreover, the proposed rule goes on to state:

> Whether the employer controls economic aspects of the working relationship should also be considered, including control over prices or rates for services and the marketing of the services or products provided by the worker. Control implemented by the employer for purposes of complying with . . . safety standards . . . or customer service standards may be indicative of control. More indicia of control by the employer favors employee status; more indicia of control by the worker favors independent contractor status.[120]

This "control" factor is virtually impossible for franchisors to overcome. In fact, every federal and state franchise law defines the term "franchise" as inherently involving a franchisor's control over its franchisees.[121] Indeed, without such control, the franchisor's trademark or service mark may be deemed abandoned.[122] Yet notwithstanding such franchisor "control," virtually every judicial decision over the past half century has deemed franchisees to be independent contractors of their franchisors, and certainly not employees.[123]

But the DOL NPR, seemingly unaware of (or entirely disinterested in) the body of federal and state laws, regulations, and case law governing franchising and intellectual property, advances, in its "control" definition, circumstances germane to almost every franchisor. Look at the above-quoted "control" provision of the DOL NPR and substitute the word "franchisor" for "employer" and "franchisee" for "worker." Readers will quickly discover that franchising's very structure is embraced.

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118. *Id.* (discussing DOL Proposed Regulation § 795.110(b)(4)).

119. *Id.*

120. *Id.*

121. *See, e.g.*, Fed. Trade Comm'n Franchise Rule, 16 C.F.R. § 436; New York Franchise Act, N.Y. Gen. Bus. L. § 681(3).

122. *See, e.g.*, Two Pesos, Inc. v. Taco Cabana, Inc, 505 U.S. 763 (1992); Barcamerica Int'l USA Trust v. Tyfield Importers, Inc., 289 F.3d 589 (9th Cir. 2002) ("[W]here the licensor fails to exercise adequate quality control over the licensee, 'a court may find that the trademark owner has abandoned the trademark, in which case the owner would be estopped from asserting rights to the trademark' (citation omitted)"); Taco Cabana Int'l, Inc. v. Two Pesos, Inc., 932 F.2d 1113 (5th Cir. 1991); Transgo, Inc. v. Ajac Transmission Parts Corp., 768 F.2d 1001 (9th Cir. 1985); Oberlin v. Marlin Am. Corp., 596 F.2d 1322, 1327 (7th Cir. 1979); Haymaker Sports, Inc. v. Turian, 581 F.2d 257 (C.C.P.A. 1978); Ky. Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368 (5th Cir. 1977); Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358 (2d Cir. 1959); Westco Grp., Inc. v. K.B. & Assocs., Inc., 128 F. Supp. 2d (N.D. Ohio 2001); Embedded Moments, Inc. v. Int'l Silver Co., 648 F. Supp. 187 (E.D.N.Y. 1986); Nat'l Lampoon, Inc. v. Am. Broad. Co., 376 F. Supp. 733 (S.D.N.Y. 1974), *aff'd per curiam*, 497 F.2d 1343 (2d Cir. 1974); Matthew J. Mitten, *Protecting the Marks of the Franchise by Proper Use and Quality Control*, *in* The Franchise Trademark Handbook 2, 52 (Louis T. Pirkey ed., 1994).

123. *See supra* note 39 (collecting cases).

A franchisor does possess control (including reserved control) over the performance of its franchisee's business and the economic aspects of the working relationship. The vast majority of franchisors set franchised unit schedules (days and hours of operation). Franchisors supervise the performance of its franchisee's operation, through onsite inspections, training programs, and other means. And, most certainly, virtually all franchise agreements forbid a franchisee working for other competitors. Franchisors reserve the right to supervise or discipline their franchisees. Many franchisors control prices or rates for services that franchisees may charge in order to enable national or regional price-point advertising (without the former "at participating locations only" that engendered much consumer anger when the outlet visited was not a "participating location"). Franchisors prescribe the marketing of their franchisees' services or products. And franchisors, in their franchise agreements or brand standards, mandate customer service standards, safety standards, and franchisee compliance with law.

So it is that the "control" component of the DOL's proposed regulation can almost be viewed as directly targeting franchisors, once again entirely disregarding federal and state statutes and judicial precedent governing franchising (not any of which was cited in the 137 pages of the DOL NPR).

And as bad as the proposed rule is standing on its own, the DOL NPR—which is meant to be followed by the judiciary and administrators in determining who is an employee versus an independent contractor—is even worse regarding the "control" factor, stating that the focus is:

> on whether the employer [franchisor] still retains control over meaningful aspects of the work relationship such that the control indicates that the worker [franchisee] does not stand apart as their own business, not simply whether the employer lacks control over discrete working conditions . . . or whether the employer failed to exercise physical control over the workplace.[124]

As to the "supervision" component of the forthcoming rule's "control" element, the DOL NPR states:

> Like the presence of a pre-defined work schedule, an employer's close supervision of a worker on the job may be evidence of employee status. . . . However, traditional forms of in-person, continuous supervision are not required for a court to determine that this factor weighs in favor of employee status. The form supervision takes can vary by type and method, and this should be part of any consideration of supervision under the control factor.[125]

Indeed, the DOL NPR states outright that "the right of the employer to supervise at its discretion is evidence of control, even if the employer rarely exerts supervision."[126]

On the issue of pricing, the DOL NPR states that "[t]he ability to set a price or rate for the goods or services provided by the worker, or influence

124. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218, 62246 (Oct. 13, 2022).
125. *Id.* at 62249.
126. *Id.*

the price or rate, is relevant when examining the control factor under the economic realities analysis. This fact . . . helps answer the question whether the worker is in business for themself."[127] More bluntly, the DOL NPR states "it is evidence of employee status when an entity other than the worker sets a price or rate for the goods or services offered by the worker, or whether the worker simply accepts a predetermined price or rate without meaningfully being able to negotiate it."[128]

Again, substituting the word "franchisee" for employee and "franchisor" for employer—and recognizing that many franchisors establish retail prices for the goods and services offered by their franchisees in order to enable price-point advertising—the DOL NPR appears to subsume franchisors as "employers" without giving any consideration to franchising's business structures, federal and state franchise laws, the United States Supreme Court's authorization twenty-five years ago for resale price maintenance to be engaged in under a "rule of reason" rather than the former "*per se* violation" standard, and the many business justifications for franchisors engaging in resale price maintenance.[129]

Turning to the "ability to work for others" component of the "control" element of the DOL's proposed rule, the DOL NPR states that it "recognizes that some courts find that less control is exercised by an employer whether a worker can work for others, particularly competitors, and that this is indicative of an independent contractor relationship."[130] However, in franchising, given the confidential training, know-how, detailed operational techniques, technological specifications, and advertising/marketing protocols conveyed to franchisees, virtually every franchise agreement forbids franchisees and their principals from affiliating or associating with, or working for, direct competitors lest such invaluable confidential information and trade secrets be divulged to or utilized by said competitor. Again, the DOL's complete disregard of this foundational element of franchising is striking and poses grave dangers to franchising.

Synthesizing the foregoing, the "control" provisions of Section 795.110(b)(4) may fairly be viewed as a total inversion of the "economic realities" of franchising, capable of turning independent contractor franchisees into employees without any thought or consideration of such realities.

5. Economic Reality Factor Five—Work Integral to Employer's Business

The fifth "economic reality" factor advanced in the proposed DOL Rule also poses a grave danger to franchising: "[t]he extent to which the work

127. *Id*. at 62236.

128. *Id*.

129. *See* State Oil v. Khan, 522 U.S. 3 (1997); *see also* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

130. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218, 62251 (Oct. 13, 2022).

performed is an integral part of the employer's business."[131] Under this Section 795.110(b)(5) of the DOL Rule,

> [t]his factor weighs in favor of the worker being an employee when the work they perform is critical, necessary, or central to the employer's principal business. This factor weighs in favor of the worker being an independent contractor when the work they perform is not critical, necessary, or central to the employer's principal business.[132]

Again, substituting the word "franchisee" for "worker" and replacing the word "employer" with "franchisee" in the above sentences, the reader quickly realizes the danger this provision poses to the franchise method of doing business. Of course, the functions performed by franchisees are an integral part of their franchisor's businesses and are critical, necessary, or central to their franchisors' principal businesses.

This threat to franchising is compounded by this statement in the DOL NPR:

> [I]f the employer could not function without the service performed by the workers, then the service they provide is integral. Such workers are more likely to be economically dependent on the employer because their work depends on the existence of the employer's principal business, rather than having an independent business that would exist with or without the employer.[133]

Once more, substituting the term "franchisor" for "employer" and replacing the word "worker" with "franchisee," the reader quickly ascertains that this alleged "economic reality" factor could result in all franchisees being deemed "workers," not independent contractors, and all franchisors deemed "employers." (The authors use the words "alleged economic reality factor" because, as noted throughout, the DOL NPR does not ever address franchising, its norms and structures, or the economic realities of the franchisor-franchisee relationship.)

6. Economic Reality Factor Six—Skill and Initiative

The sixth "economic reality" factor advanced in Section 795.110(b)(6) of the DOL proposed rule addresses "skill and initiative."[134] Under this factor of the proposed rule, it

> considers whether the worker uses specialized skills to perform the work and whether those skills contribute to business-like initiative. This factor indicates employee status where the worker does not use specialized skills in performing the work or where the worker is dependent on training from the employer to perform the work.[135]

According to the DOL NPR:

> [t]he Department is proposing to reaffirm the longstanding principle that this factor indicates employee status where the worker lacks specialized skills. . . .

131. *Id.* at 62223.
132. *Id.*
133. *Id.* at 62253.
134. *Id.* at 62275 (discussing DOL Proposed Regulation § 795.110(b)(6)).
135. *Id.*

> That the work does not require prior experience, that the worker is dependent on training from the employer to perform the work, or that the work requires no training indicates to us that the worker lacks specialized skills.[136]

Note the above-quoted words "the worker is dependent on training from the employer to perform the work." Virtually every franchisor trains its franchisees on the standards, systems, procedures, protocols, and operational elements of the subject franchise. Very simply put, that is what franchising is all about: replicating a business format through uniform standards that are imparted to franchisees through training and that must be complied with at all times to satisfy the public's demand for uniformity and protect the franchisor's trademark/service mark (which, without such compulsory standards, may be viewed as standing for nothing and thus subject to abandonment).

Once again, the DOL NPR utterly ignores the unique characteristics of franchising and the franchisor-franchisee relationship, perhaps in an effort to have all franchisors deemed to be the employers of their franchisees (and those franchisees' employees) so that unions can increase their membership ranks and engage in collective bargaining with franchisors over the compensation to be paid to those franchisees' employees. Of course, this outcome would leave franchisees utterly bereft—having invested significant monies in developing and opening their franchised units, operating them, and having the opportunity to profit from those units, now those franchisees may legally be deemed to be employees of their franchisors. This outcome would prove anathema to virtually every franchisee whose rights under federal and state franchise laws have been so vigorously protected over the past half century.

7. Economic Reality Factor Seven—Additional Factors

The seventh and final "economic reality" factor identified in Section 795.110(b)(7) of the proposed DOL Rule could prove the most dangerous: "Additional Factors."[137] What this provision states is simple: "Additional factors may be relevant in determining whether the worker is an employee or independent contractor for purposes of the FLSA, if the factors in some way indicate whether the worker is in business for themself, as opposed to being economically dependent on the employer for work."[138]

This standard is entirely amorphous about how it will be applied by courts and administrators when determining whether a franchisee is an independent contractor or, to the contrary, an employee. And once again, the pertinent phrase appears "of whether the workers are economically dependent on the employer for work or in business for themselves." How easy will it be to ascertain that all franchisees are economically dependent on their franchisors for the existence of their businesses? A hypothetical question if ever there was one.

136. *Id.* at 62254.
137. *Id.* at 62275 (discussing DOL Proposed Regulation § 795.110(b)(7)).
138. *Id.*

D. *The Reaction to the DOL NPR*

As of January 26, 2023, the Department of Labor received 55,220 comments addressing its independent contractor Notice of Proposed Rulemaking.[139] On the one hand, most of the comments were negative in tone and came from all walks of life that independent contractors serve (court reporters, nurses, independent owner/operator truckers, musicians, freelancers, and other categories of "gig" workers).[140] On the other hand, there were scores, if not hundreds, of identical comments (potentially as part of labor union lobbying) supporting the DOL's proposed independent contractor rule.[141] All of these comments are available for review on the DOL's website.[142]

III. What Can Franchisors and Franchisees Do?

Given the antipathy toward franchising repeatedly enunciated by "progressive" government officials and labor advocates,[143] franchisors must in the first instance strongly consider judicially challenging the DOL's new independent contractor rule and the NLRB's new joint employer rule if adopted as set forth in the subject NPRs. The very foundations of franchising are clearly targeted and imperiled by these proposed regulations and nothing short of judicial rebuke may reverse their predicted adoption.

As noted throughout this article, both the DOL and the NLRB advance only specious and antiquated grounds as supportive of their proposals and entirely ignore, seemingly intentionally, the vast body of law governing franchising: federal and state franchise laws that define the term "franchise" as subsuming franchisor control over franchisee operations in order to protect the standards of quality and reputations associated by the general public with those franchisors' trademarks and service marks;[144] the Lanham Trademark Act[145] itself; and over a half century of judicial decisions that almost universally have held that franchisors are not the joint employers of their franchisees' employees and that franchisees are independent contractors of their

139. Employee or Independent Contractor Classification Under the Fair Labor Standards Act, Doc. No. WHD-2022-00003, https://www.regulations.gov/document/WHD-2022-0003-0001/comment (last visited Jan. 26, 2023).

140. *See, e.g.*, Julie Layton, Comment to Notice of Proposed Rule on the Employee or Independent Contractor Classification Under the Fair Labor Standards Act (Oct. 13, 2022), https://www.regulations.gov/comment/WHD-2022-0003-0111; Fran Davidson, Comment to Notice of Proposed Rule on the Employee or Independent Contractor Classification Under the Fair Labor Standards Act (Oct. 30, 2022), https://www.regulations.gov/comment/WHD-2022-0003-9878.

141. *See, e.g.*, Robert Drey, Comment to Notice of Proposed Rule on the Employee or Independent Contractor Classification Under the Fair Labor Standards Act (Oct. 31, 2022), https://www.regulations.gov/comment/WHD-2022-0003-11108; Carol Wise, Comment to Notice of Proposed Rule on the Employee or Independent Contractor Classification Under the Fair Labor Standards Act (Oct. 31, 2022), https://www.regulations.gov/comment/WHD-2022-0003-11468.

142. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218 (Oct. 13, 2022).

143. *See generally* Weil, *supra* note 26; Ruckelshaus, *supra* note 27.

144. *See, e.g.*, Fed. Trade Comm'n Franchise Rule, 16 C.F.R. § 436t.

145. 15 U.S.C. § 1051 *et seq.*

franchisors and certainly not employees.[146] This seemingly determined ignorance of franchise law precedent should prove compelling in judicial challenges of the DOL and NLRB's dual thrusts against franchising.

Moreover, a critical question to pose to the courts is whether the DOL and the NLRB themselves have any authority whatsoever to restructure and perhaps eliminate a key component of the United States economy through fiat. As suggested earlier, Congress defined the terms "employer" and "employee" in the NLRA and the FLSA—but never defined the term "joint employer" or "independent contractor." So how is it administrative agencies can usurp what should be Congress's role on such a critical subject? That would be but one question to be advanced when challenging the proposed DOL and NLRB regulations.

On the business side, quite ironically (given the DOL's and the NLRB's purported desire to aid employees), the best moves that both franchisors and franchisees can undertake is to minimize the number of franchisee employees. This can be done (indeed, has already started to be done) through automation. It is widely anticipated that within five years automaton robots will be capable of performing the vast majority of tasks required in a quick serve restaurant (such as preparing and bagging French fries; preparing hamburgers, pizzas and tacos; shakes; and so forth).[147] Already in the quick service restaurant (QSR) setting, the number of employees required has been diminished through compulsory kiosk ordering in lieu of ordering through live counterpersons.[148] As well, to reduce employee headcount, franchisors may cut franchisee hours of operation; offer fewer products/services (sticking to those made by fewer employees in a shorter period of time); and rely more on apps to interface with customers. Moreover, franchisors will increasingly establish "ghost kitchens" (facilities without dining areas or store fronts designed for delivery only transactions), thus eliminating the need for a distinct franchise location and employees thereat.[149]

In the extreme, QSR franchisors may consider reverting to a variation of one of the earliest "fast food" concepts—the Horn & Hardart Automat. As featured in a recent movie,[150] the Automat was an establishment in which patrons could view various menu offerings through a series of locked glass compartments arranged top to bottom and side by side which, in the "old days," could be opened by depositing a certain number of nickels but in today's environment could be opened by a credit card or smartphone swipe. There was no waitstaff in the old Automat, only cleaning crews. But behind

146. *See supra* note 39 (collecting cases).

147. *See, e.g.*, Laura Reiley & Lee Powell, *The Robots Are Here. And They Are Making You Fries*, Wash. Post (Sept. 2022), www.washingtonpost.com/business/2022/09/20/robots-automating-restaurant-industry.

148. *See, e.g.*, Ed Rensi, *McDonald's Says Goodbye Cashiers, Hello Kiosks*, Forbes (July 11, 2018) https://www.forbes.com/sites/edrensi/2018/07/11/mcdonalds-says-goodbye-cashiers-hello-kiosks/?sh=4b5437c36f14.

149. Tony Marks, *I See Ghosts: The Rise of Delivery Only Kitchens*, 24 Franchise Law. 6 (2021).

150. Automat Horn & Hardart Movie (A Slice of Pie Productions 2022).

the scenes of those windowed compartments was an off-premises commissary supplying food and beverage items to outlets and an unseen limited staff restocking each compartment once a customer removed an item therefrom (a function that automation today could replace). Customers loved the old Automat, which closed only due to intracorporate infighting. So it is that the past may be prologue.

In guest lodging, check-in is now available over mobile phones as are reservations, room selection, room entry, amenity requests, and room service. Not only may the front desk become obsolete in a hotel but, as well, bellhops, whose jobs may be supplanted by luggage bearing robots. Hotel restaurants and ballroom meal service can be automated as suggested above and common area housekeeping performed by robots. And management agreements could supplant franchise agreements.

Pressured into diseconomic juxtaposition by the proposed DOL and NLRB regulations, other franchise sectors should follow suit to the greatest extent possible and automate their franchisees' employee tasks.[151] In landscaping, robots can till soil, sow grass, cut grass, and vacuum leaves in the autumn.[152] In home healthcare, robotic lifting machines can help lift patients who are elderly or immobile.[153] And tax preparation services' use of robots and AI to prepare and submit tax returns is already under way.[154]

However, in a far more dire scenario, as a consequence of the DOL and NLRB's proposed regulations, franchisors may find themselves either as direct employers of their franchisees' employees (since, under the DOL proposed regulation, franchisees may be deemed employees of their franchisors and, in turn, their employees will also attain such status) and/or joint employers of their franchisees' employees. Under either scenario, the fundamental franchise relationship will be shattered in an entirely unanticipated fashion, with franchisors now either directly liable or jointly liable for their franchisees' labor law violations (including wage and hour); FICA contributions; Affordable Care Act contributions; workers' compensation premiums; unemployment insurance contributions; the myriad other requirements and mandates imposed upon employers on a federal, state, and local basis; and,

151. *See, e.g.*, John Koetsier, *Robot Fast Food Cook Costs Less Than Half a Human Worker*, Forbes (Sept. 28, 2022), https://www.forbes.com/sites/johnkoetsier/2022/09/28/robot-fast-food-cook-costs-less-than-half-a-human-worker/?sh=61b636183b9e; Mary Meisenzahl, *Chipotle's Chippy Robot Is Starting to Make Tortilla Chips at a California Location—Here Are All The Other Robots Taking Over Fast Food*, MSN.com (Sept. 28, 2022), https://www.msn.com/en-us/money/companies/chipotle-s-chippy-robot-is-starting-to-make-tortilla-chips-at-a-california-location-here-are-all-the-other-robots-taking-over-fast-food/ss-AAWsAjM?ocid=qbes#image=2; Shawn Baldwin, *How Robots Are Helping Address the Fast-Food Labor Shortage*, CNBC.com (Jan. 20, 2023) https://www.cnbc.com/2023/01/20/how-fast-food-robots-are-helping-address-the-labor-shortage.html.

152. Mowing Magic, https://www.mowingmagic.com/robot-mower/best-robotic-lawn-care-services/ (last visited Jan. 26, 2023).

153. *See* John Leland, *Can Robots Save Nursing Homes?*, N.Y. Times (Apr. 21, 2022), https://www.nytimes.com/2022/04/21/realestate/nursing-home-robots.html.

154. Steven Mezzio et al., *Robotic Process Automation for Tax*, J. Acct. (Dec. 1, 2019) https://www.journalofaccountancy.com/issues/2019/dec/robotic-process-automation-for-tax.html.

under the doctrine of *respondeat superior*, liable for all acts, errors, and omissions that transpire at franchised units.

As a consequence, franchisors may find the landscape of franchising so deleteriously destroyed that they simply stop franchising altogether. Not only would this outcome mean that new franchisees would be denied their entrepreneurial desires but, even more dramatically for existing franchisees, their ability to acquire and operate additional franchised units, a most common desire in franchising, will vanish.

At its extreme, the most drastic consequence of the DOL and NLRB's regulations, if adopted as proposed (as they most certainly will be, with minor revisions), is the elimination of existing franchises altogether. Clearly, the DOL and NLRB's regulatory thrusts were not foreseeable—to the contrary, as noted, a half century of decisional law, the Lanham Trademark Act, and the very definitions of the term "franchise" set forth in federal and state franchise laws, rules and regulations (dating back to 1971)[155] would appear to render the DOL and NLRB's proposed regulations not only unforeseeable but also impossible to even imagine.

With this in mind, the "frustration of purpose" legal doctrine may entitle franchisors to terminate all of their franchise agreements on the ground that unforeseeable events subsequent to the formation of those agreements render them impracticable and subject to termination.

As stated in the *Restatement of Contracts (Second)*:

> Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.[156]

The *Restatement* explains that, in order for a party's performance to be discharged by supervening frustration, the frustrated purpose

> must have been a principal purpose of that party in making the contract. It is not enough that he had in mind some specific object without which he would not have made the contract. The object must be so completely the basis of the contract that, as both parties understand, without it the transaction would make little sense.[157]

The doctrine of frustration of purpose excuses a contracting party's performance only where a virtually cataclysmic, wholly unforeseeable event renders the contract valueless to one party[158] and is unavailable if the difficulties that frustrate the purpose of the contract reasonably could have been foreseen.[159] But if unforeseeable frustration will excuse performance of a contract

155. *See, e.g.*, *supra* note 121.
156. Restatement (Second) of Contracts § 261 (1981).
157. *Id.* § 265 cmt.
158. U.S. v. Gen. Douglas MacArthur Senior Vill., Inc., 508 F.2d 377, 381 (2d Cir. 1974) (cleaned up).
159. Warner v. Kaplan, 892 N.Y.S.2d 311, 314–15 (App. Div. 2009).

if the basic purpose of the contract was destroyed by the supervening event, the frustration must be so severe that it is not fairly to be regarded as within the risks that were assumed under the contract and the value of counter-performance to the promisor seeking to be excused must be substantially or totally destroyed.[160]

Under this judicial "frustration of purpose" doctrine, franchisors seemingly may elect to terminate all of their existing franchise agreements on the grounds that the DOL and NLRB regulations—if ultimately adopted and thereafter sanctioned by the judiciary following challenge—so upset and dramatically reconfigure the fundamental economics and structure of franchisor-franchisee relationships and were so unforeseeable as to justify such terminations. Because many franchise agreements entitle franchisors to reacquire the assets of their franchisees following franchise termination, usually at fair market value or book value, franchisors may find the economics of doing so far more favorable than the perverted economics that would prevail should the DOL and the NLRB enact their regulations as proposed. (Of course, any such termination must be accomplished in accordance with state franchise "relationship" laws that impose particular prohibitions and requirements on franchisors in connection with the termination of franchises.)[161]

In such a setting, and given the DOL proposed regulation's determination that a franchisor is the employer of its franchisees (and, therefore, those franchisees' employees) and/or the NLRB's proposed regulation's conclusion that franchisors are the joint employers of their franchisees' employees, the "employer" burdens thrust upon franchisors would compel them to merely hire their former franchisees as managers of the previously franchised units (and serve as the employers as well of those units' employees). In this fashion, may vast numbers of franchisors cease being same and instead join the ranks of non-franchised competitors (such as Chipotle, Shake Shack, Best Buy, and In-and-Out). In the guest lodging sector, management agreements may entirely supplant franchise agreements.

A more depraved outcome triggered by the DOL and NLRB regulatory thrusts can hardly be imagined. Franchisees—the very class which has special protections afforded them by the "franchise relationship" statutes referenced and cited above—would have their enterprises, investments, and their ability to earn profits therefrom evaporated and their futures destroyed.

160. Peoplesoft U.S.A. Inc. v. Softeck, Inc., 227 F. Supp. 2d 1116, 1119 (N.D. Cal. 2002); FPI Dev. Inc. v. Nakashima, 282 Cal. Rptr. 508, 527–29 (Ct. App. 1991).

161. Alaska Stat. Ann. § 45.45.700 *et seq*.; Ark. Code Ann. § 4-72-201 *et seq*.; Cal. Bus. & Prof. Code § 20000 *et seq*.; Conn. Gen. Stat. § 42-133e *et seq*.; Del. Code Ann § 2551 *et seq*.; Haw. Rev. Stat. § 482E-6; Ill. Comp. Stat. §§ 705/18–705/20; Ind. Code § 23-2-2.7-1 *et seq*.; Iowa Code §§ 523H.1 *et seq*., 537A.10; Kan. Stat. Ann. § 16-121 *et seq*.; Mich. Comp. Laws § 445.1527; Minn. Stat. § 80C.14; Miss. Code Ann. § 75-24-51 *et seq*.; Mo. Rev. Stat. §§ 407.400 *et seq*., 407.420; Neb. Rev. Stat. § 87-401 *et seq*.; N.J. Rev. Stat. § 56-10-1 *et seq*.; R.I. Gen. Laws § 6-50-1, *et seq*.; Utah Code Ann. § 152-11-11; Va. Code Ann. § 13.1-564; Wash. Rev. Code §§ 19.100.180, 19.100.190; Wisc. Stat. § 135.01 *et seq*.; D.C. Code § 29-1201 *et seq*.; P.R. Laws Ann. tit. 10, § 278 *et seq*.; V.I. Code Ann. tit. 12A, § 130 *et seq*.

Conclusion

The NLRB NPR and DOL NPR collectively threaten the very foundations and continued existence of franchising, one of the most vibrant elements of the American economy responsible for remarkable wealth generation and employment for over half a century—all in the name of increasing union membership (though, as noted above, the obverse may transpire as a consequence). Both NPRs rely on specious reasoning and precedent. Both NPRs establish an entirely new regulatory scheme (neither the DOL nor the NLRB has ever before codified who is a "joint employer" and who is an "independent contractor"), without so much as a public hearing, any study of franchising, and only a brief comment period afforded. Both NPRs entirely ignore, seemingly intentionally, the vast body of franchise law extant over the past half century—federal and state franchise registration/disclosure and "relationship" laws that actually define franchising as premised on franchisor control over franchisees in order to maintain standards associated with their trademarks and service marks (lest those marks be subject to abandonment); the Lanham Trademark Act (which requires franchisors to establish and enforce standards associated with their trademarks and service marks); and judicial precedents from around the country which almost unanimously hold that franchisors are not the employers of their franchisees or the joint employers of their franchisees' employees. To these authors, such DOL and NLRB regulatory action is an overreach of the administrative state of the highest order and amounts to "this is the law because I say so."

Unless rejected by the judiciary following what surely will be a multitude of challenges, the proposed DOL and NLRB regulations will jeopardize the franchise arena's continued existence and possibly eliminate the vast entrepreneurial and employment opportunities generated by franchising.

The NLRB NPR entirely fails, seemingly intentionally, from addressing the unique characteristics of the franchisor-franchisee relationship. There is not a word on the point, except in the most crucial way: the NLRB NPR actually states: "[T]he Board is emphasizing the relevance of the rule to entities in the following five categories . . . (2) temporary help service suppliers; . . . [and] (4) franchisees. . . ."[162]

To emphasize its targeting of franchising, the NLRB NPR goes on to state: "Franchisors generally exercise some operational control over their franchisees, which potentially renders the relationship subject to application of the Board's joint-employer standard. The NLRB does not have the means to identify precisely how many franchisees operate within the U.S. . . ."[163] This assertion suggests that the Board did not make a serious effort to understand the economic impact of franchising. The International Franchise

162. Notice of Proposed Rulemaking on Joint-Employer Standard, 87 Fed. Reg. 54660 (Sept. 7, 2022).

163. *Id.*

Association details on its website that that in 2022 franchising was forecast to feature more than 792,000 establishments and 8.5 million jobs.

The DOL NPR and the proposed rule itself similarly pose an existential threat to franchising. True it is that a very few franchisees have in the past been considered employees of their franchisors, notably in the janitorial services sector.[164] In contrast, the courts over the past half century have otherwise almost universally deemed franchisees to be independent contractors.[165] Classifying franchisees as employees of their franchisors, as the proposed DOL Rule would seemingly mandate, could destroy the franchise paradigm as we know it.

And why? Neither the DOL NPR nor the proposed Rule itself provides an explanation, since they do not reference franchising at all. It seems like a lost opportunity that the DOL (and the NLRB for that matter) did not seek the input of the Federal Trade Commission, which has regulated franchise sales in the United States since 1979.[166] Or review the provisions of state franchise registration/disclosure and relationship laws, which, since 1971, have striven so valiantly to protect the interests of franchisees but which universally define "franchise" as subsuming a degree of franchisor control over franchisees.[167] Or reference the extensive body of trademark law which requires such franchisor "control" in order to protect the reputations for quality associated with franchisors' trademarks and service marks.[168] Or consult the vast body of case law almost universally holding that franchisees are independent contractors and not employees of their franchisors.[169] Instead, in lieu of Congress finally defining who is an "independent contractor" under the FLSA (having already defined the terms "employer" and "employee" therein) following hearings and deliberations, the DOL is threatening the continued existence and viability of franchising, which is involved in almost $800 billion of economic output, through an administrative process.[170]

164. *See, e.g.*, Hayes v. Enmon Enters., LLC, 2011 WL 2491375 (S.D. Miss. June 22, 2011); Awuah v. Coverall N. Am., Inc., 707 F. Supp. 2d 80 (D. Mass. 2010).

165. *See supra* note 39.

166. 16 C.F.R. § 436.

167. *See, e.g.*, New York Franchise Act, N.Y. Gen. Bus. L. § 681(3).

168. The Lanham Trademark Act not only fosters the notion of brand uniformity but actually compels trademark and/or service mark licensors—and every franchisor is a trademark and/or service mark licensor—to impose standards and controls upon their licensees (and every franchisee is a trademark and/or service mark licensee) to ensure that the mark in question serves its intended purpose: uniformity of goods or services of a certain type and quality, uniformity of appearance and uniformity of operations. Critically, if a franchisor (as licensor) does not impose upon franchisees such standards, that franchisor's trademark (applicable to goods) or service mark (applicable to services) may be deemed abandoned as a matter of law, as it will be viewed as standing for nothing. For detailed discussion of these points, see David J. Kaufmann et al., *A Franchisor Is Not the Employer of Its Franchisees or Their Employees*, 34 Franchise L. J. 439 (2015).

169. *See supra* note 39.

170. *2022 Franchising Economic Outlook*, Int'l Franchise Ass'n (Feb. 15, 2022), https://www.franchise.org/sites/default/files/2022-02/2022-Franchising-Economic-Outlook.pdf.

Since it is likely that the DOL and the NLRB proposed Rules will be enacted precisely as set forth in their NPRs (perhaps with very minor changes), it appears that ultimately it will be up to the courts to recognize franchising's distinctiveness and the utter impropriety of applying the DOL's and NLRB's proposed Rule standards classifying franchisees as their franchisors' employees and further illogically classifying franchisors as the joint employers of their franchisees' employees.

Some Maxims of Franchise Law

*David Gurnick**

I. Introduction

Mr. Gurnick

A maxim is a short statement expressing a general truth or rule or principle. It is a proposition agreed upon by everyone "without proof, argument, or discourse."[1] In law, maxims are traditional legal principles that through repeated application become solidified into concise expressions.[2] In earlier times, ancient maxims were considered "as central pillars of the law," and "teaching of the law was organized round them."[3] Today, many books and articles discuss maxims of jurisprudence, law, and equity.[4] Some maxims have been enacted as legislation.[5] Even when maxims compete or conflict, they provide useful

1. Chrisman v. Linderman, 100 S.W.2d 1090, 1092 (Mo. 1907) (quoting Sir Edward Coke, Institutes of the Laws of England; Or, A Commentary Upon Littleton § 67a (1832)).

2. *Maxim*, Black's Law Dictionary (11th ed. 2019); *see also Maxim*, Oxford Dictionary of Law (9th ed. 2018) (noting equitable maxims are "short pithy statements used to denote the general principles that are supposed to run through equity"); Britt Hanson, *A (Mostly) Succinct History of English Legal Language*, 48 Ariz. Atty. 28, 34 (Aug. 2012) ("When Henry II expanded the jurisdiction of the royal courts, laws needed to be interpreted consistently across the realm—and over time. Thus, judges began to report the reasons for decisions, recording them, and using these same reasons to decide case after case. This was novel. And it led to legal maxims, principles and doctrines.").

3. J. Stanley McQuade, *Ancient Legal Maxims and Modern Human Rights*, 18 Campbell L. Rev. 75, 120 (1996).

4. *See, e.g.*, George Frederick Wharton, Legal Maxims, with Observations and Cases (Baker, Yoorhis & Co., 1878); *see also* Herbert Broom, A Selection of Legal Maxims, Classified and Illustrated (T & J.W. Johnson, 1852); Roger Young & Stephen Spitz, *Suem-Spitz's Ultimate Equitable Maxim: In Equity Good Guys Should Win and Bad Guys Should Lose*, 58 S.C. L. Rev. 175 (2003); Roscoe Pound, *The Maxims of Equity*, 34 Harv. L. Rev. 809 (1921); Jeremiah Smith, *The Use of Maxims in Jurisprudence*, 9 Harv. L. Rev. 13 (1895).

5. *See, e.g.*, Cal. Civ. Code §§ 3509–3548.

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signposts for analysis and focus to assist a court in deciding a case.[6] Put simply, maxims have a long-established, important role in law.[7]

In the franchise and distribution context, courts routinely search for maxims to inform their decisions.[8] For example, in 1985, the New Jersey Supreme Court reversed a trial court's award of compensation to a franchisee whose franchise had been lawfully terminated for good cause due to fraudulent underreporting.[9] After confirming that the applicable relationship statute required no such payment, the court looked for, but found, "nothing in the general body of franchise law to indicate" that the franchisee "should receive value for his franchise as a condition of termination."[10] The court further "uncovered no equitable maxim or other guiding principle that would support the [trial] court's disregard of the terms of the franchise agreements,"[11] and, finding no maxim, the court ruled that the trial court had no basis to award the franchisee any compensation.[12]

It is no longer debatable that franchise and distribution law has become a discernible discipline.[13] So far, however, no assembly of maxims has been identified for relevance in distribution and franchising law. This article suggests some principles that can be considered maxims for distribution and franchise law and seeks to generate thought and further development of maxims for the field.

6. POM Wonderful LLC v. Coca-Cola Co., 573 U.S. 102, 112 (2014) (noting "a threshold dispute has arisen as to which of two competing maxims establishes the proper framework for decision").

7. An 1878 text discusses approximately 1,256 maxims. *See generally* Wharton, *supra* note 4.

8. *See, e.g.*, Jay Bharat Devs., Inc. v. Minidis, 84 Cal. Rptr. 267, 273 (Ct. App. 2008) (in a franchise termination case, the court indicating that "venerable doctrine of unclean hands arises from the maxim that one who comes to court seeking equity must come with clean hands"); Charania v. Ramada Inns, 383 S.E.2d 603, 604 (Ga. Ct. App. 1989) (where party claimed no agreement existed, while claiming advantage of an executed agreement he signed, operative maxim was that to be enforceable a contract must be signed by the party sought to be bound).

9. Dunkin' Donuts of Am., Inc. v. Middletown Donut Corp., 495 A.2d 66, 74 (N.J. 1985).

10. *Id.* at 74.

11. *Id.*

12. Maxims may be largely agreed, but they are not immutable. In 1985, the New Jersey Supreme Court could not find a maxim indicating a terminated franchisee was entitled to compensation. Since then, several states enacted laws that *require* compensation in favor of terminated franchisees. For example, California now requires a franchisor to offer to repurchase the franchisee's resalable current inventory that meets the franchisor's standards at the lower of fair wholesale market value or price paid by the franchisee. Cal. Bus. & Prof. Code § 20035. Some other states have a similar requirement. *See, e.g.*, Wash. Rev. Code §§ 19.100.180(2)(i), (j) (requiring a franchisor to compensate a nonrenewed franchisee for inventory, supplies, equipment and furnishings and to purchase inventory and supplies from a terminated franchisee).

13. The Federal Trade Commission Franchise Rule, state disclosure laws, state relationship laws, and federal and state special industry laws all focus specifically on franchise sales and relationships. The American Bar Association has a body devoted to the study and discussion of franchise law, the ABA Forum on Franchising. This body publishes a journal devoted to the field of franchise law, the *Franchise Law Journal.* The ABA has published a textbook for courses on franchise law. The State Bar of California recognizes franchise and distribution law as a field of specialization for lawyers.

II. Some Maxims of Distribution and Franchising Law

A. *To Be Enforceable, a Contract Must Be Signed by the Party Sought to Be Bound.*

Franchises are contractual relationships.[14] Usually they are based on a written contract. The first maxim addresses the situation where not all parties have signed a franchise agreement.

For example, in *Charania v Ramada Inns, Inc.*, a hotel franchisor obtained damages for its breach of contract claim against a franchisee under a written franchise agreement and personal guaranty.[15] Although the franchisee admitted signing the agreement and guaranty, it argued that the franchisor's failure to sign meant there was no legal agreement.[16] The court rejected the franchisee's argument, noting the franchisee signed and claimed the advantage of the agreement.[17] "The operative maxim," said the court, "is that to be enforceable a contract must be signed by the party sought to be bound," and because enforcement against the franchisor was not at issue, the party sought to be bound was the franchisee, which had signed the agreement.[18]

The maxim stands for the proposition that to enforce a written agreement against a party, that party must have signed the agreement.[19] The maxim also stands for the proposition that an agreement may be enforced against a party who signed, even if the party seeking enforcement did not itself sign the agreement.[20]

It is important to note, however, that the inverse of this maxim is not always true. The absence of a signature does not necessarily relieve that party from performance. For example, in *Carlock v. Pillsbury*, individual plaintiffs formed corporations to operate franchised retail ice cream stores.[21] The corporations were not parties to written franchise agreements.[22] Defendants argued this circumstance barred claims by those corporations for

14. *See, e.g.*, Robert W. Emerson & Lawrence J. Trautman, *Lessons About Franchise Risk From YUM! Brands and Schlotsky's*, 24 Lewis & Clark L. Rev. 997, 1003 (2020) ("A franchise is a contractual relationship where one party, the franchisor, provides business tips and tricks to another party, the franchisee. In exchange, the franchisee provides the franchisor with a royalty fee."); Deborah S. Coldwell, Judith R. Blakewayaal, Clifford B. Husted & Paul Goldean, *Franchise Law*, 53 SMU L. Rev. 1055, 1056 (2000) ("A franchise is a contractual relationship consisting of three elements: (1) a significant association between the franchisee's business and the franchisor's trademarks; (2) payment of a franchise fee; and (3) the franchisor's right to exercise significant power over, or provide significant assistance to, the franchisee in the operation of its business."); Barry Winyett Tyerman, Note, *A Tempest in a Chicken Bucket: Some Reflections on Franchise Regulation in California*, 17 UCLA L. Rev. 1101, 1102 (1970) (A "franchise is a contractual relationship in which each party agrees to undertake certain obligations embodied in the franchise agreement in return for concurrent advantages.").

15. Charania v. Ramada Inns, 383 S.E.2d 603, 604 (Ga. Ct. App. 1989).

16. *Id.*

17. *Id.* (noting the franchisee operated under the agreement for more than six months).

18. *Id.*

19. *See id.*

20. *See id.*

21. *See* Carlock v. Pillsbury, 719 F. Supp. 791, 800 (D. Minn. 1989) (summarizing parties).

22. *Id.* at 854.

fraudulent inducement or breach of contract.[23] Defendants noted that the standard franchise agreement granted rights only to persons who signed the agreement.[24] Plaintiffs claimed defendants consistently dealt with the corporations as franchisees, selling them ice cream, accepting payments, and treating them as parties to written franchise agreements.[25] Plaintiffs claimed this course of dealing established implied contracts with the same terms as the defendants' standard form of franchise agreement.[26]

The court agreed. The court noted that in certain circumstances "a contract may be implied from the conduct of the parties."[27] Whether an implied contract exists is determined by objective manifestations of the parties.[28] Whether a contract is to be implied, and the existence of its terms, are questions for the trier of fact, which defeated the defendants' motion for summary judgment.[29]

B. *"The Cornerstone of a Franchise System Must Be the Trademark or Trade Name of a Product."*[30]

Courts often refer to a franchisor's trademark as the "cornerstone" of a franchise system.[31] Indeed, every test to determine whether a business relationship constitutes a franchise requires a license to use the franchisor's trademarks.[32] The product or service that is franchised, the advertising of the

23. *Id.* at 853.
24. *Id.* at 854.
25. *Id.*
26. *Id.* at 853.
27. *Id.* at 854.
28. *Id.*
29. *Id.*
30. Susser v. Carvel Corp., 206 F. Supp. 636, 640 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964).
31. *See, e.g.*, Krebs Chrysler-Plymouth, Inc. v. Valley Motors, 141 F.3d 490, 497 (3d Cir. 1998); Mumford v. GNC Franchising LLC, 437 F. Supp. 2d 344, 350 (W.D. Pa. 2006); Instructional Sys., Inc. v. Comput. Curriculum Corp., 614 A.2d 124, 139 (N.J. 1992); Lasday v. Allegheny Cty., 453 A.2d 949, 951 (Pa. 1982); Atl. Richfield Co. v. Razumic, 390 A.2d 736, 740 (Pa. 1978); *see also* W. Michael Garner, *Trademarks in Franchising: The Basics*, 14 Wake Forest J. Bus. & Intell. Prop. L. 599, 600 (2014) ("It has been said that a trademark is the cornerstone of a franchise system.").
32. *See* 16 C.F.R. § 436.1(a)(1); Cal. Corp. Code § 31005(A)(2); Conn. Gen. Stat. § 42-133e(b)(2); 815 Ill. Comp. Stat. § 705/3(1); Ind. Code § 23-2-2.5-1(1)(a); Iowa Code § 523h.1(3)(a)(1)(c); Md. Code Reg. § 14-201(e)(2); Mich. Comp. Laws § 445.1502(2)(b); N.Y. Gen. Bus. Law § 681(3)(b); N.D. Code § 51-19-02(5)(a)(2); Okla. Stat. tit. 71, § 802(5)(b); Or. Rev. Stat. § 650.005(4)(b); R.I. Gen. Laws § 19-28.1-3(g)(1)(C); Va. Code § 13.1-559; Wash. Rev. Code § 19.100.010(6)(A)(ii); Wis. Stat. § 553.03(4)(a)(2); Cal. Comm'r of Fin. Prot. & Innovation (formerly Comm'r of Corporations), Comm'r Release 3-F, When Does an Agreement Constitute a "Franchise" (June 22, 1994); Carlos v. Philips Bus. Sys., Inc., 556 F. Supp. 769, 776 (E.D.N.Y. 1983) (substantial association with franchisor's trademark was satisfied where distributor was encouraged to associate the business with manufacturer's trademark, made extensive use of the trademark, business phone was answered by using the trademark, and the business station prominently featured the franchisor's name), *aff'd*, 742 F.2d 1432 (2d Cir. 1983); Kim v. Servosnax, Inc., 13 Cal. Rptr. 2d 422, 425–29 (Ct. App. 1992) (licensee's business operating office building cafeteria was "substantially associated" with licensor's trademark though licensee was prohibited from using the name in relation to customers, but had used the name in obtaining an agreement with the property owner to place a cafeteria in the building).

"brand," and the license that binds the franchisee and franchisor together all have at their heart the franchisor's trademarks or other identifying names or symbols.

This second maxim recognizes that a fundamental, essential element of the franchise relationship is the operation by the franchisee in association with the franchisor's brand. The Federal Trade Commission (FTC), in adopting its Trade Regulation Rule on Franchising, noted that, typically in franchising, "a company (the franchisor) owns a trademark which it licenses others to use upon condition that the user (the franchisee) conform its business operations to the franchisor's standards, insofar as it is associated with the trademark."[33] As stated by the Commissioner who administers the California Franchise Investment Law, "the objective of the Law is to deal with a multiplicity of business arrangements presented to the public as a unit or marketing concept operated pursuant to a uniform marketing plan and under a common symbol."[34]

C. *Franchising Involves Unequal Bargaining Power of Franchisors and Franchisees and Therefore Carries Within Itself the Seeds of Abuse*

Decades ago, courts acknowledged the conventional wisdom that franchisors, the parties who owned the trademark and intellectual property and granted the franchise rights, were the better-informed, more sophisticated, often larger, stronger parties in franchisor-franchisee relationships.[35] This wisdom held that, as a result, franchisors often took unfair advantage of their franchisees.[36] To address this imbalance, Congress first enacted the Automobile Dealers' Day in Court Act, prescribing good faith in automobile

33. Fed. Trade Comm'n, Statement of Basis and Purpose for Trade Regulation Rule on Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59614, 59623 (Dec. 21, 1978).

34. Cal. Comm'r of Fin. Prot. & Innovation (formerly Comm'r of Corporations), Comm'r Release 3-F, When Does an Agreement Constitute a "Franchise" (June 22, 1994).

35. *See, e.g.*, Ungar v. Dunkin' Donuts of Am., Inc., 531 F.2d 1211, 1222–23 (3d Cir. 1976) ("The franchise system in this country today is not free from problems. Most, if not all, of these arise from the disparity in power and sophistication between franchisor and franchisee."); Dep't of Labor & Indus. v. Lyons Enters., Inc., 374 P.3d 1097, 1102 (Wash. 2016) (stating, the "franchisor normally occupies an overwhelmingly stronger bargaining position and drafts the franchise agreement so as to maximize its power to control the franchisee") (internal quotations and citations omitted).

36. *Lyons Enters., Inc.*, 374 P.3d at 1102; *see also, e.g.*, Paul Steinberg & Gerald Lescatre, *Beguiling Heresy: Regulating the Franchise Relationship*, 109 Dick. L. Rev. 105, 107 (2004) (explaining that the relationship between franchisor and franchisee is characterized by inequality. Franchisees typically are small businesspersons, while franchisors typically are large corporations, and the agreements tend to reflect this gross bargaining disparity because they usually are form contracts the franchisor prepared and offered to franchisees on a take it or leave it basis. The franchise agreement usually also lets the franchisor terminate or refuse to renew for virtually any reason.).

manufacturer-dealer relationships,[37] and the Petroleum Marketing Practices Act,[38] which regulates petroleum franchisor-franchisee relationships. Addressing this imbalance was also among the reasons for the issuance by the FTC of regulations regarding franchising and business opportunities.[39] And many states cited to this perceived imbalance to support laws regulating presale franchise registration and disclosures, laws regulating termination, nonrenewal and other aspects of franchise relationships,[40] and other laws regulating franchisor relationships.[41]

In the case law context, two California opinions further developed the third maxim that unequal bargaining power carries with it the "seeds of abuse." In *E. S. Bills v. Tzucanow*, a gas station franchisee, which also leased the building from the franchisor gasoline supplier, complained that gasoline prices were too high and began to buy from another source in breach of the franchise agreement.[42] After excluding evidence that the franchisor charged the public lower retail prices at its franchisor-owned stations than it charged the franchisee at wholesale, the trial court ruled in favor of the franchisor to evict the franchisee based on the above breaches.[43] The California Supreme Court reversed, holding that excessive pricing could refute the supplier's claim of good cause for termination.[44] In a concurrence, Justice Mosk noted that the imbalance of power between the franchisor and franchisee and the franchise agreement's nature as an adhesion contract were seeds of abuse in the franchise relationship.[45]

Relatedly, in *Postal Instant Press, Inc. v. Sealy*, a California appellate court considered whether a franchisee's failure to timely pay past royalties entitled the franchisor to both terminate the franchise agreement and obtain

37. In 1939, the FTC found that General Motors, Chrysler, Ford, and other car makers imposed unfair conditions on dealers. They forced dealers to sign agreements that did not clearly define the parties' rights and obligations. They conducted unfair inspections of dealer facilities. They forced dealers to buy more cars than could be sold. They forced dealers to invest in facilities without a long-term agreement and without assuring dealers would be provided enough cars to sell. *See* 1939 Fed. Trade Comm'n Ann. Rep. 22, 25–26. In response to these concerns, in 1956, Congress enacted the Automobile Dealers' Day in Court Act. 15 U.S.C. §§ 1221–1225.

38. 15 U.S.C. §§ 2801–2841.

39. 16 C.F.R. §§ 436.1–436.11. The FTC's Statement of Basis and Purpose for Franchise Rule notes, for example, that "a serious informational imbalance exists between prospective franchisees and their franchisors," "many prospective franchisees possess a low level of business sophistication," and "misrepresentations and failure to disclose material facts are widespread in franchising." 43 Fed. Reg. 59625, 59627 (Dec. 21, 1978).

40. *See, e.g.*, Freedman Truck Ctr., Inc. v. Gen. Motors Corp., 784 F. Supp. 167, 171 (D.N.J. 1992) (noting that New Jersey Franchise Practices Act "reflects the legislative concern over longstanding abuses in the franchise relationship," and that the legislature "recognized the franchisor's superior bargaining position in the franchise relationship").

41. *See, e.g.*, Ungar v. Dunkin' Donuts of Am., Inc., 531 F.2d 1211, 1222–23 (3d Cir. 1976) ("Abuses such as arbitrary franchise terminations and fraudulent promotional schemes have been the object of legislative concern.").

42. E. S. Bills v. Tzucanow, 700 P.2d 1280, 1283 (Cal. 1985).

43. *Id.* at 1283–84.

44. *Id.* at 1285–87.

45. *Id.* at 1288 (Mosk, J., concurring).

damages for future lost royalties.[46] Reversing the trial court, the appellate court held that the franchisor's decision to terminate the franchise agreement, not the franchisee's breach of the agreement, was the proximate cause of the lost future royalties.[47] Absent this necessary causal connection, the lost future royalties awarded by the trial court were deemed by the appellate court to be excessive, oppressive, and disproportionate to the loss.[48]

In the decision, the appellate court observed that "franchise agreements are commercial contracts" but they "exhibit many of the attributes of consumer contracts."[49] The court described "a prevailing, although not universal, inequality of economic resources between the contracting parties," stating that franchisees "typically, but not always, are small businessmen or businesswomen" or people "seeking to make the transition from being wage earners and for whom the franchise is their very first business" and that franchisors "typically, but not always, are large corporations."[50] Franchise agreements, the court continued, "tend to reflect this gross bargaining disparity" because they usually are "form contracts the franchisor prepared and offered to franchisees on a take-or-leave-it basis."[51] Owing to what the court saw as great bargaining disparity and adhesion contracts, it concluded: "Franchising involves the unequal bargaining power of franchisors and franchisees and therefore carries within itself the seeds of abuse. Before the relationship is established, abuse is threatened by the franchisor's use of contracts of adhesion presented on a take-it-or-leave-it basis."[52]

Many commentators and participants in franchising challenge this maxim. One commentator argues that prejudging the parties' bargaining power in this way is wrong because "[b]argaining power is never a simple issue and can change instantly and radically upon an infinite array of inputs."[53] Another commentator criticizes the import of this maxim on multiple grounds.[54] First, "classification of franchise agreements as adhesion contracts . . . disregards the fact that would-be franchisees are not limited to purchasing a

46. Postal Instant Press, Inc. v. Sealy, 51 Cal. Rptr. 2d 365, 368–75 (Ct. App. 1996).

47. *Id.* at 369–70.

48. *Id.* at 371.

49. *Id.* at 374–75.

50. *Id.* at 373.

51. *Id.*

52. *Id.* at 374 (quoting Ungar v. Dunkin' Donuts of Am., Inc., 531 F.2d 1211, 1222–23 (3d Cir. 1976)); *see* Nagrampa v. Mailcoups, Inc., 469 F.3d 1257, 1282 (9th Cir. 2006) (quoting *Postal Instant Press Inc.*, 51 Cal. Rptr. at 373). Numerous commentators have repeated this phrase in descriptions of franchising. *See, e.g.*, Filemon Carrillo & Jazlyn Cabula, *Claiming Rescission: The Battle for Equity*, 42 Franchise L.J. 47 (2022) (quoting *Postal Instant Press Inc.* and noting that unsuspecting franchisees who do business "with the wrong franchisor can find themselves losing their life savings, struggling with severe debt, and dealing with costly litigation"); Robert W. Emerson, *Franchising and the Parol Evidence Rule*, 50 Am. Bus. L.J. 659, 713 (2013) (stating that "likened to an adhesion contract, with the power disparity very much weighted toward the franchisor, the franchise agreement 'carries within itself the seeds of abuse'").

53. Daniel D. Barnhizer, *Context as Power: Defining the Field of Battle for Advantage in Contractual Interactions*, 45 Wake Forest L. Rev. 607, 625 (2010).

54. Mary deLeo, Note, *Emasculating Goliath: Did* Postal Instant Press v. Sealy *Strike an Unfair Blow at the Franchising Industry?*, 25 W. St. U. L. Rev. 117, 154 (1997).

franchise in order to start a business in their desired area. The option to enter into the market as an independent entrepreneur is always available."[55] Second, the commentator notes that "[the] prospective franchisees are not forced to deal with only a few franchisors whose contract terms are identical; the phenomenal growth in franchising has created competition among franchisors to attract the best from among qualified franchisees."[56]

Another commentator questions the continued applicability of this maxim. Today, franchisees "are more savvy than their counterparts forty years ago, most notably because of the presale information available to them and the widespread emergence of the multiunit franchisee."[57] In fact, the presale information available in modern disclosure documents is "the very information a number of states and the FTC have determined will allow the franchisee to make an informed buying decision."[58]

D. *Franchise Laws Are Liberally Construed to Quell the Harm They Seek to Protect Against*

Some franchise protection statutes include the rule of liberal construction as a statutory mandate.[59] Even without this instruction, courts deem most franchise-related statutes as remedial or protective and therefore interpret them liberally to effectuate their objective to reduce or stop the mischief they are directed to eliminate.[60]

55. *Id.*

56. *Id.*

57. William Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, 28 Franchise. L.J 23, 28 (2008).

58. *Id.*

59. *See, e.g.*, N.Y. Gen. Bus. Law § 695(2) ("This article shall be liberally construed to effect the purposes thereof."); Wis. Stat. § 135.025(1) ("This chapter shall be liberally construed and applied to promote its underlying remedial purposes and policies."); A.J. Temple Marble & Tile v. Union Carbide Marble Care, 618 N.Y.S.2d 155, 161 (N.Y. App. Div. 1994), *aff'd*, 625 N.Y.S.2d 904 (N.Y. App. Div. 1995), *aff'd as modified*, 663 N.E.2d 890 (N.Y. 1996) (New York Franchise Sales Act "is remedial in nature, and therefore, to be liberally construed.").

60. *See, e.g.*, Khorenian v. Union Oil Co., 761 F.2d 533, 535 (9th Cir. 1985) (Petroleum Marketing Practices Act must be construed liberally to achieve legislative goal of protecting franchisees); Va. Imps., Ltd. v. Kirin Brewery of Am., LLC, 589 S.E.2d 470, 478 (Va. Ct. App. 2003) (Virginia's Beer Franchise Act and Wine Franchise Act are to be liberally construed and applied to promote their underlying purposes and policies); Dr. Pepper Bottling Co. v. Frantz, 842 S.W.2d 37, 41 (Ark. 1992) (noting and applying rule of liberal construction to Arkansas Franchise Practices Act); Bush v. Nat'l Sch. Studios, Inc., 407 N.W.2d 883, 887 n.2 (Wis. 1987) (quoting Wisconsin Fair Dealership Law provision, Wis. Stat. § 135.025, which states as a statutory rule of construction that the "chapter shall be liberally construed and applied to promote its underlying remedial purposes and policies"); Muha v. United Oil Co., 433 A.2d 1009, 1013 (Conn. 1980) (court noting no disagreement with plaintiffs that Connecticut Franchise Act's purpose was to correct abuses in franchise relationships, particularly in the petroleum industry, its provisions are remedial "and should be liberally construed in favor of the class sought to be benefited."); Gentis v. Safeguard Bus. Sys., Inc., 71 Cal. Rptr. 2d 122, 124 (Ct. App. 1998) (remedial or protective statutes like the California Franchise Investment Law "are liberally construed to effect their object and quell the mischief at which they are directed;" accordingly, regarding the definition of a franchise, "this means each element should be construed liberally to broaden the group of investors protected by the law"); Enservco, Inc. v. Ind. Sec. Div., 623 N.E.2d 416, 424–25 (Ind. 1993) (noting that Indiana's franchise fraud statute directs in Section 23-2-2.5-47 that it be liberally construed to prohibit and prevent fraud and assure disclosure of

But liberal construction has its limits. In *Muha v. United Oil Co.*, the lessees of a service station argued that the owner of (and distributor of gasoline to) the station constituted a franchisor under the then-applicable Connecticut statute.[61] Although the legislature had recently amended the statute to expressly qualify this type of business relationship as a franchise, the version applicable to the relevant time period did not, and the Connecticut Supreme Court refused to apply the rule of liberal construction to stretch it so.[62] The court said it was "true that the original franchise act was remedial in nature," and the legislature could have adopted a broader statutory definition of franchisors, but it did not do so; and "courts are not empowered in such a situation to alter the meaning of clear language employed by the legislature."[63] The court concluded that when "the language used by the legislature is plain and unambiguous, there is no room for construction by the courts and the statute will be applied as its words direct."[64]

E. *Ambiguity in a Written Agreement Is Interpreted Against the Drafter*

The fifth maxim relates to contract interpretation, which is appropriate for an industry, like franchising, that relies on written agreements. A contract is ambiguous if reasonably susceptible to more than one meaning.[65] Circumstances can make terms of an agreement ambiguous.[66] The agreement may

sufficient and reliable information for investors to exercise independent judgment in franchise transactions).

61. *Muha*, 433 A.2d at 1012.

62. *Id.* at 1013.

63. *Id.*

64. *Id.* at 1013–14; *see also* Autohaus Brugger, Inc. v. Saab Motors, Inc., 567 F.2d 901, 911 (9th Cir. 1978) ("[G]ood faith" in the federal Automobile Dealers Day in Court Act, 15 U.S.C. § 1222, has a "limited and restricted meaning and is not to be construed liberally."); Kusel Equip. Co. v. Eclipse Packaging Equip., Ltd., 647 F. Supp. 80, 81 (E.D. Wis. 1986) (once a business relationship is found to be a dealership, the law is liberally construed to effectuate its purpose of protecting dealers, but, the definition of dealership is not to be construed expansively); Empire Volkswagen, Inc. v. World-Wide Volkswagen Corp., 627 F. Supp. 1202, 1209–10 (S.D.N.Y. 1986) ("[G]ood faith" in Automobile Dealers' Day in Court Act "has a specific, narrow meaning, and is not to be construed liberally.").

65. *See, e.g.*, Knipe Land Co. v. Robertson, 259 P.3d 595, 601 (Idaho 2011) (contract term is ambiguous when there are two different reasonable interpretations, or its language is nonsensical); Cal. Teachers Ass'n v. Governing Bd. of Hilmar Unified Sch. Dist., 115 Cal. Rptr. 2d 323, 328 (Ct. App. 2002) (contract is ambiguous if "reasonably susceptible to more than one interpretation"); Pioneer Peet, Inc. v. Wuality Grassing & Servs., Inc., 653 N.W.2d 469, 473 (Minn. Ct. App. 2002) (stating that writing is ambiguous if, judged by its language alone and without resort to extrinsic evidence, it is reasonably susceptible of more than one meaning).

66. *See, e.g.*, Nat'l Union Fire Ins. Co. of Pittsburgh v. CBI Indus., Inc., 907 S.W.2d 517, 520 n.4 (Tex. 1995) ("If a contract called for goods to be delivered to "the green house on Pecan Street," and there were in fact two green houses on the street, it would be latently ambiguous."); *see also*, Joshua M. Silverstein, *Contract Interpretation and the Parol Evidence Rule: Toward Conceptual Clarification*, 24 Chap. L. Rev. 89, 108 (2020) (noting classic example in the case of Raffles v. Wichelhaus, 159 Eng. Rep. 375 (1864), wherein a contract said that certain cotton would arrive on the ship "Peerless." But two ships had that name, "creating an ambiguity that only became apparent when the language of the agreement was applied to the subject matter of the contract—the cotton on the ship 'Peerless.'").

contain wording that on its face can have multiple meanings.[67] Or an agreement with ostensible facial clarity insofar as the judge is concerned, may be susceptible to other meaning understood by the parties.[68] Countless circumstances, many unanticipated, can generate ambiguity.[69]

When parties advance inconsistent interpretations of a contract, courts often adopt the construction that is unfavorable to the drafter.[70] In Latin, this maxim is *verba chartarum fortuis accipiuntur contra proferentem*, but often shortened to *contra proferentem*.[71] It is a rule of construction "based on elementary notions of fairness—that the drafting party was responsible for including the particular language in the contract and presumably had the greater opportunity to clarify the language in its favor, if that was the parties' intent, or at least to protect its own interests from a lack of clarity."[72] As explained by Blackstone, "the principle of self-preservation will make men sufficiently careful not to prejudice their own interest by the too extensive meaning of their words,"[73] and by this principle "all manner of deceit in any grant is avoided; for men would always affect ambiguous and intricate expressions, provided they were afterwards at liberty to put their own construction upon them."[74]

But the principle of construing ambiguities against the drafter is not absolute. For courts to invoke it, they first must find the contract ambiguous. For

67. *See, e.g.*, T.G.I. Friday's, Inc. v. Int'l Rest. Grp., Inc., 569 F.2d 895, 898–99 (5th Cir. 1978) (restriction against licensee of T.G.I. Friday's using "names of the days of the week" in any other business was ambiguous as to whether it prohibited use of all seven days, or just certain other days, and construing against drafter did not restrict use of "Saturday" in another business); Donald W. Lyle v. Heidner & Co., 278 P.2d 650, 653 (Wash. 1954) (order for lumber designating delivery in late November/early December set indefinite time and was ambiguous as to time for delivery; it was understood in the industry to mean delivery anytime from December 1 to 15 and understood to allow, if necessary, up to thirty days for arrival of a vessel to ship the product if a vessel was not in the port); *see also* Silverstein, *supra* note 66, at 98 (discussing ambiguity in agreements with illustration based on the *Lyle* case).

68. *See, e.g.*, Pac. Gas & Elec. Co. v. G.W. Thomas Drayage Co., 442 P.2d 641, 644 (Cal. 1968) ("[T]est of admissibility of extrinsic evidence to explain the meaning of a written instrument is not whether it appears to the court to be plain and unambiguous on its face, but whether the offered evidence is relevant to prove a meaning to which the language of the instrument is reasonably susceptible.").

69. *See, e.g.*, Charter Oil Co. v. Am. Emp'rs' Ins. Co., 69 F.3d 1160, 1167 (D.C. Cir. 1995) ("Latent ambiguity can arise where language, clear on its face, fails to resolve an uncertainty when juxtaposed with circumstances in the world that the language is supposed to govern.").

70. Caterpillar Tractor Co. v. Collins Mach. Co., 286 F.2d 446, 450–51 (9th Cir. 1960) ("[W]hen two inconsistent interpretations of a contract are advanced the construction which is unfavorable to the drafter shall be adopted."); Clise Inv. Co. v. Stone, 13 P.2d 9, 10–11 (Wash. 1932) (same); *see also* St. Charles Foods, Inc. v. Am.'s Favorite Chicken Co., 198 F.3d 815, 821 (11th Cir. 1999) (applying the rule that ambiguity be construed against the drafter); Fiat Distribs., Inc. v. Hidbrader, 381 N.E.2d 1069, 1071 (Ind. Ct. App. 1978) (noting the word "current" in the contract and as applicable to the situation, was ambiguous and its meaning was not made clear in the contract; therefore, it was proper for the trial court to consider parol evidence and to construe the meaning against the drafter of the contract).

71. David Horton, *Flipping the Script:* Contra Proferentem *and Standard Form Contracts*, 80 U. Colo. L. Rev. 431, 438–39 (2009).

72. Impac Mortg. Holdings, Inc. v. Timm, 255 A.3d 89, 97 (Md. 2021).

73. Herbert Broom, A Selection of Legal Maxims 379 (3d ed. 1852).

74. *Id.*

example, in *NaturaLawn of America, Inc. v. West Group, LLC*, a franchisee sued for violating the franchise agreement's post-termination restrictive covenant, arguing that the covenant should not be enforced because the franchise agreement, which expired by its terms, had not been terminated by either party.[75] The franchisee claimed this at least created a question of ambiguity, which the court should construe against the franchisor.[76] In rejecting the argument, the court stated:

> "[E]xpiration" of an agreement is a more specific type of "termination." The fact that both words appear in other provisions of the Franchise Agreements does not undercut this conclusion. Indeed, the Franchise Agreements provide that the non-compete clause would apply after termination "for any reason." Clearly, "expiration" is one reason for the "termination" of an agreement. There is no substantial reason identified by defendants why a court would bend over backwards to distort the plain meaning of these everyday terms in order to find an ambiguity in the Franchise Agreements so that the agreements might be "interpreted" against [the franchisor] as the drafter of the agreements.[77]

Courts, therefore, first apply other rules of construction, like contract terms must be interpreted according to their plain meaning, and only turn to *contra proferentem* where uncertainty remains.[78] As the California Supreme Court explained, the *contra proferentem* principle "applies only as a tie breaker, when other canons fail to dispel uncertainty."[79]

F. *There Is No Private Cause of Action Under the FTC Franchise Rule*

In 1978, the FTC adopted the regulation entitled *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*.[80] This rule, generally referred to as the "FTC Franchise Rule" or "Franchise Rule," seeks to regulate the process by which franchises are sold, most notably by requiring franchisors to provide various pieces of information in a certain format.

In the seminal case to address whether the Franchise Rule contains a private right of action, the D.C. Circuit analyzed the history of the Federal Trade Commission Act (FTCA) and various considerations that affect the

75. NaturaLawn of Am., Inc. v. West Grp., LLC, 484 F. Supp. 2d 392, 401 (D. Md. 2007).

76. *Id.*

77. *Id.*

78. Cal. Civ. Code § 1654 ("In cases of uncertainty not removed by the preceding rules, the language of a contract should be interpreted most strongly against the party who caused the uncertainty to exist."); AWIN Real Estate, LLC v. Whitehead Homes, Inc., 472 P.3d 165, 170 (Mont. 2020) (noting Mont. Code § 28-3-206 provides: "In cases of uncertainty not removed by" other specified parts of the code, "the language of a contract is interpreted most strongly against the party who caused the uncertainty to exist"); Badie v. Bank of Am., 79 Cal. Rptr. 2d 273, 287 (Ct. App. 1998) (explaining that if uncertainty is not removed by other rules of interpretation, a contract must be interpreted most strongly against the party who prepared it).

79. Pac. Gas & Elec. Co. v. Super. Ct., 19 Cal. Rptr. 2d 295, 309 (Ct. App. 1993), *abrogated by* Advanced Micro Devices, Inc. v. Intel Corp., 885 P.2d 994 (Cal. 1994).

80. 16 C.F.R. §§ 436.1–436.11; *see* Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59614, 59621 (Dec. 21, 1978).

analysis whether a statute creates a private right of action.[81] The court concluded that the FTCA

> nowhere purports to confer upon private individuals, either consumers or business competitors, a right of action to enjoin the practices prohibited by the Act or to obtain damages following the commission of such acts. On careful examination of the Act and its legislative history, both when passed in 1914 and amended in 1938, we find strong indication that Congress did not contemplate or intend such a private right of action.[82]

Rather, the FTC is the authority with enforcement authority concerning the FTCA.[83]

Although now well-settled, these early rulings on the absence of a private right of action under the Franchise Rule met resistance. The Franchise Rule, with its mandated pre-offer disclosures, is "analogous to the Securities Exchange Commission Rules on disclosure which have been held to be enforceable by private right of action."[84] In the securities context, private rights of action were implied in areas not expressly provided in the statutes. For example, in *Ernst & Ernst v. Hotchfelder*, the U.S. Supreme Court noted that although Securities and Exchange Commission Rule 10(b) "does not, by its terms, create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established."[85] In *J. I. Case Co. v. Borak*, the Court again permitted a private right of action to enforce a Securities Exchange Act regulation, noting that private enforcement "provides a necessary supplement to Commission action."[86]

In fact, the FTC, in its Statement of Basis and Purpose for the Franchise Rule, included language that supported interpreting the final rule to include a private right of action:

> The Commission believes that the courts should and will hold that any person injured by a violation of the Rule has a right of action against the violator under the Federal Trade Commission Act, as amended, 15 U.S.C. §§ 41–58 (1976), and this Rule. The existence of such a right is necessary to protect the members of the class of whose benefit the statute was enacted and the rule is being promulgated, is consistent with the legislative intent of the Congress in enacting the Federal Trade Commission Act, as amended, and is necessary to the enforcement

81. Holloway v. Bristol-Myers Corp., 485 F.2d 986, 987 (D.C. Cir. 1973) ("[P]rivate actions to vindicate rights asserted under the Federal Trade Commission Act may not be maintained.").

82. *Id.* at 988–89; *see also* Drake v. Sometime Spouse, LLC, 784 F. App'x 602, 604 (10th Cir. 2019) (no private right of action under FTC Act); Lingo v. City of Albany Dep't of Cmty. & Econ. Dev., 195 F. App'x 891, 894 (11th Cir. 2006) (same).

83. *See*, *e.g.*, Roberts v. Cameron-Brown Co., 556 F.2d 356, 361 n.6 (5th Cir. 1977) (noting "regulation is in the hands of the administrative agency, and not the private citizen").

84. Freedman v. Meldy's, Inc., 587 F. Supp. 658, 660 (E.D. Pa. 1984).

85. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (citing multiple prior precedents).

86. J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

scheme established by the Congress in that Act and to the Commission's own enforcement efforts.[87]

But in another early case, *Days Inn of America Franchising, Inc. v. Windham*, the U.S. District Court for the Northern District of Georgia rejected the franchisee's argument that the FTC's Statement of Purpose supports a private right of action.[88] The district court emphasized that Congress, not the FTC, decides whether to create a private right of action and "no express or implied evidence exists demonstrating that Congress adheres to the position advanced by the FTC. Indeed, the legislative history . . . reveals Congressional disdain for the FTC's rulemaking procedures."[89] The *Windham* court cited *Freedman v. Meldy's, Inc.*, which noted "Congress' intent has not been shown to have changed in any way as a result of the FTC's 1979 franchise disclosure rules."[90] The district court also noted that "whether or not a private right of action exists for any act of Congress is a matter traditionally left to the judiciary."[91]

As a result of the above cases and others, it is now generally accepted that no private right of action exists under the Franchise Rule.[92]

87. *See* Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59614. 59723 (Dec. 21, 1978).

88. Days Inn of Am. Franchising, Inc. v. Windham, 699 F. Supp 1581 (N.D. Ga. 1988).

89. *Id.* at 1582–83 (noting that other courts also followed *Freedman* in declining to permit a private right of action).

90. Freedman v. Meldy's, Inc., 587 F. Supp. 658, 662 (E.D. Pa. 1984).

91. *Id.* at 660.

92. *See, e.g.*, Morrison v. Back Yard Burgers, Inc., 91 F.3d 1184, 1187 (8th Cir. 1996) (no private cause of action existing despite knowing violation of Franchise Rule); Banek Inc. v. Yogurt Ventures U.S.A. Inc., 6 F.3d 357, 359 (6th Cir. 1993) (noting lower court dismissed Franchise Rule claim because there is no private right of action under the rule); Alfred Dunhill Ltd. v. Interstate Cigar Co., 499 F.2d 232, 237 (2d Cir. 1974) ("[T]he provisions of the Federal Trade Commission Act may be enforced only by the Federal Trade Commission. Nowhere does the Act bestow upon either competitors or consumers standing to enforce its provisions."); Senior Ride Connection v. ITN Am., 225 F. Supp. 3d 528 , 531 n.1 (D.S.C. 2016) (noting "no federal private right of action to enforce the Franchise Rule"); A Love of Food 1, LLC v. Maoz Vegetarian USA, Inc., 70 F. Supp. 3d 376, 382 (D.D.C. 2014) ("The FTC can bring suit to enjoin a franchisor's failure to furnish the required information in violation of the Franchise Rule, but no private right of action is available . . . ."); Vino 100, LLC v. Smoke on the Water, LLC, 864 F. Supp. 2d 269, 281 (E.D. Pa. 2012) (Franchise Rule "defines conduct that the FTC considers a violation of § 5 of the Federal Trade Commission Act"; but private parties "are not permitted to enforce § 5 of the Federal Trade Commission Act. Only the FTC may do so."); St. Martin v. KFC Corp., 935 F. Supp. 898, 907 (W.D. Ky. 1996) (Congress intended to make the administrative program for enforcing the FTCA an exclusive one and did not intend to permit a private cause of action under the FTCA and regulations.); Brill v. Catfish Shaks of Am. Inc., 727 F. Supp. 1035, 1041 (E.D. La. 1989) (intent and actual harm are not required to establish violation of the Franchise Rule but there is no private right of action for the violation); Layton v. AAMCO Transmissions, Inc., 717 F. Supp. 368, 371 (D. Md. 1989) (Franchise Rule violation does not give rise to a private cause of action.); *Windham*, 699 F. Supp. at 1582 (Congress's intent of no private right of action had not changed following FTC's statement in favor of private right of action and distinguishing "sole federal court decision supporting" private right of action, *Guernsey v. Rich Plan of Midwest*, 408 F. Supp. 582 (N.D. Ind. 1976), on ground that in *Guernsey* the FTC had taken enforcement action, but had not done so here); Olivieri v. McDonald's Corp., 678 F. Supp. 996, 1000 n.2 (E.D.N.Y. 1988) (noting several courts concluded there is no private right of action under the Franchise Rule); Akers v. Bonifasi, 629 F. Supp. 1212,

However, the absence of a private right of action for violating the FTC Rule, does not necessarily mean no repercussions exist for violating the rule. Many state laws prohibit unfair or deceptive practices.[93] These are often called "Little FTC Acts."[94] In a few states, violation of the Franchise Rule may be grounds for a claim under a Little FTC Act.[95] And some courts even hold that a Franchise Rule violation is a per se Little FTC Act violation.[96]

In *Legacy Academy, Inc. v. Mamilove, LLC*, the Georgia Court of Appeals ruled that a claim under the state's Little FTC Act could be based on violation of the Franchise Rule.[97] Georgia's Little FTC Act states: "When the law requires a person to perform an act for the benefit of another or to refrain from doing an act which may injure another, although no cause of action is given in express terms, the injured party may recover for the breach of such legal duty if he suffers damage thereby."[98] A jury found in favor of a franchisee that there had been a Franchise Rule violation.[99] On appeal, the court ruled that although there is no private cause of action under the Franchise

1221–22 (M.D. Tenn. 1985) (private litigants cannot invoke federal court jurisdiction for violating Franchise Rule, as exclusive remedial power is vested by Congress in the FTC); Legacy Acad., Inc. v. Mamilove, LLC, 761 S.E.2d 880, 892 (Ga. App. 2014), *aff'd in part and rev'd in part on other grounds*, 771 S.E.2d 868 (Ga. 2015) ("[P]lain language of 15 U.S.C. § 45 clearly shows that the statute does not provide a private cause of action.").

93. *See* Stephanie L. Kroeze, *The FTC Won't Let Me Be: The Need for a Private Right of Action Under Section 5 of The FTC Act*, 50 Val. U.L. Rev. 227, 241 (2015) ("Since the 1970's, most every state, in one form or another, has enacted its own Little FTC Acts governing consumer protection law.").

94. *See, e.g.*, Tucker v. Sierra Builders, 180 S.W.3d 109, 114–15 (Tenn. Ct. App. 2005) (describing broad scope of Tennessee's Little FTC Act, noting such acts are so designated due to similarity to provisions of the FTCA prohibiting unfair or deceptive trade practices, and explaining the Tennessee Act, "like the little FTC acts of many other states, explicitly provides that it is to be interpreted and construed in accordance with interpretations" of the FTCA by the federal courts).

95. *See, e.g.*, Bethany L. Appleby, Robert S. Burstein & John M. Doroghazi, *Cause of Action Alchemy: Little FTC Act Claims Based on Alleged Disclosure Violations*, 36 Franchise L. J. 429 (2017).

96. Nieman v. Dryclean USA Franchise Co., 178 F.3d 1126, 1128–29 (11th Cir. 1999) (under Florida Deceptive and Unfair Trade Practices Act, a franchisee could sue a Florida franchisor for violating the FTC Franchise Rule); Aurigemma v. Arco Petroleum Prods. Co., 734 F. Supp. 1025, 1029 (D. Conn. 1990) (noting that courts construing the Connecticut Unfair Trade Practices Act are to be guided by FTC and judicial interpretations given to the FTCA and allowing claim under that act to proceed where plaintiff's allegations arose from the defendant franchisor's alleged noncompliance with the disclosure requirements of Franchise Rule); Rodopoulos v. Sam Piki Enters., Inc., 570 So. 2d 661, 665 (Ala. 1990) (FTC regulations were admissible in fraud case regarding defendants' duty to disclose and approving trial court's instruction to the jury that in "the course of this trial, there has been reference to regulations promulgated by the Federal Trade Commission. I charge you that you may consider those regulations in determining what duty, if any, the defendants owed the plaintiffs to disclose [their] earnings relative to the operation of [their] business."); Morgan v. Air Brook Limousine, Inc., 510 A.2d 1197, 1206 (N.J. Super. Ct. 1986) (a franchisor's failure to comply with the Franchise Rule is an act or practice in violation of the New Jersey Consumer Fraud Act).

97. Legacy Acad., Inc. v. Mamilove, LLC, 761 S.E.2d 880, 892 (Ga. Ct. App. 2014), *aff'd in part and rev'd in part*, 771 S.E.2d 868 (Ga. 2015).

98. Ga. Code § 51-1-6.

99. *Legacy Acad., Inc.*, 761 S.E.2d at 882.

Rule, the franchisee could pursue a claim under the state's Little FTC Act based on Franchise Rule violations.[100]

Similarly, a Texas state court addressed whether a franchisee could maintain a cause of action against a franchisor under the Texas Deceptive Trade Practices—Consumer Protection Act due to the failure to make required pre-sale disclosures under the Franchise Rule.[101] The Texas Deceptive Trade Practices-Consumer Protection Act states that it applies to violations of the FTCA or its regulations.[102] A jury ruled in favor of the franchisee, and the Texas Court of Appeals upheld the jury verdict, stating:

> [A]ppellants complain that the failure to disclose upon which appellee relies for one of its DTPA claims is based solely on failure to give written disclosures required by the Federal Trade Commission, and that, since there is no private federal remedy, the failure to disclose cannot give rise to a DTPA claim either. Appellee brought this action on the ground that failure to make such written disclosures was a deceptive act under §17.46(b) [of the DTPA]. Appellee clearly did not bring an action under federal law. Appellants' violation of federal law was merely used as a basis for finding an independent violation of the DTPA. The DTPA itself provides in §17.49(b) that: "The provisions of this subchapter do apply to any act or practice prohibited . . . by a rule or regulation of the Federal Trade Commission."[103]

Thus, while the maxim is correct that there is no private cause of action for violating the Franchise Rule, there may be a cause of action under a state's Little FTC Act for violation of the Franchise Rule.

G. *More Than Just a Franchise Law Violation Is Necessary for a Franchisee to Rescind*

In the 1970s, states began enacting laws regulating offers and sales of franchises and ongoing franchise relationships.[104] The laws were a response to the problem of misrepresentations made by franchisors in selling franchises

100. *Id.* at 892–93.

101. Tex. Cookie Co. v. Hendricks & Peralta, Inc., 747 S.W.2d 873 (Tex. App. 1988).

102. Tex. Bus. & Com. Code § 17.41–17.63.

103. *Tex. Cookie*, 747 S.W.2d at 877; *see* Fla. Auto Auction of Orlando, Inc. v. U.S., 74 F.3d 498, 502 n.2 (4th Cir. 1996) (rejecting an argument that a duty imposed by federal regulations cannot give rise to a state common law claim); TC Tech. Mgmt. Co. v. Geeks on Call Am., Inc., 2004 WL 5154906, at *5 (E.D. Va. 2004) (holding that a franchisee could use the FTC Rule in establishing a fraud by omission claim against a franchisor who concealed information relating to earnings claims); Rodopoulos v. Sam Piki Enters., Inc., 570 So. 2d 661, 666 (Ala. 1990) (holding that federal franchise disclosure rule created a duty to disclose applicable to common law claims).

104. *See, e.g.*, William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, 28 Franchise L.J. 23, 27–28 (2008) (discussing California Franchise Investment Law, that took effect January 1, 1971; Delaware Franchise Security Law, that took effect July 8, 1970, prohibited termination or nonrenewal of franchised distributors without good cause or in bad faith; New Jersey Franchise Practices Act passed in 1971, which prohibited arbitrary and capricious cancellation of franchises while preserving right of franchisors to safeguard their interests through clear nondiscriminatory standards; and Washington state passage of Franchise Investment Protection Act in 1971, taking effect in 1972).

and other oppressive tactics used by franchisors against franchisees.[105] These statutes can appear to establish strict liability for violations. One court stated that a state's franchise statute "appears to impose absolute legal liability, akin to strict liability, on franchisors that make an "untrue statement of a material fact."[106]

However, courts have generally held that these franchise laws are not strict liability statutes.[107] Even in the *Long John Silver's* decision, quoted above, the court ultimately held that "a franchisee must establish reasonable reliance to merit an award of damages" under Minnesota's franchise law.[108] The North Dakota Supreme Court similarly concluded that "violation of franchise law does not place a franchisee in a position where he is entitled to automatic rescission."[109] In *Two Men & a Truck/International v. Two Men & a Truck/Kalamazoo*,[110] the U.S. District Court for the Western District of Michigan examined an earlier Michigan appellate state court ruling, which held that a franchisor's violation of the franchise law gave the franchisee an unqualified right to rescission (essentially finding the statute to be one of strict liability).[111] The court found the prior ruling "to be an anomaly and contrary to precedent set by the Michigan Supreme Court" and chose to follow the earlier decision's dissenting opinion.[112] The earlier decision's dissent, and thus the rule of decision in *Two Men & a Truck*, endorsed an unclean hands defense to a claim of rescission for violation of the state's franchise law.[113]

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105. *See, e.g.*, Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether to Hire Counsel*, 51 San Diego L. Rev. 709, 713 (2014) (explaining that state legislation and federal rulemaking sought to police franchisor representations and franchisor-franchisee relationships due to reputation of franchisors as dishonest businesspersons looking to swindle investors).

106. Long John Silver's Inc. v. Nickleson, 923 F. Supp. 2d 1004, 1016 (W.D. Ky. 2013); *see also* Brill v. Catfish Shaks of Am., Inc., 717 F. Supp. 1035, 1042 (E.D. La. 1989) (noting Franchise Rule makes it "an unfair or deceptive act or practice for a franchisor to fail to provide a franchisee with" the franchise disclosure document information, and that "intent and actual harm are not required to establish a violation"); Martino v. Cottman Transmissions Sys., Inc., 554 N.W.2d 17, 21 (Mich. Ct. App. 1996) (upon a franchisor's violation of the Michigan Franchise Investment Law, a franchisee has an unqualified right to rescission, whether or not the franchisee has unclean hands); Enservco, Inc. v. Ind. Sec. Div., 623 N.E.2d 416, 423 (Ind. 1993) ("[C]ulpability is not an element of a violation" under Indiana's franchise law, and the absence of language "bearing on mental state" indicated the legislature intended the statute to "operate as strict liability provisions.").

107. *See, e.g.*, Dunn v. Nat'l Beverage Corp., 729 N.W.2d 637, 654 (Minn. Ct. App. 2007) ("[T]he franchise statute is not a 'strict liability' statute."). *But see* EV Scarsdale Corp. v. Engel & Voelkers N.E. LLC, 13 N.Y.S. 3d 805, 813 n.6 (App. Div. 2015) (stating that Section 683 of New York's franchise law "is a strict liability statute," and on that basis denying a defendant franchisor's motion to dismiss, but in further comments allowing for the possibility that there may have been no damages).

108. *Long John Silver's Inc.*, 923 F. Supp. 2d at 1016.

109. Peck of Chehalis, Inc. v. C.K. of W. Am., 304 N.W.2d 91, 98 (N.D. 1981).

110. Two Men & a Truck/Int'l v. Two Men & a Truck/Kalamazoo, 955 F. Supp. 784 (W.D. Mich. 1997).

111. *Martino*, 554 N.W.2d at 21.

112. *Two Men & a Truck/Int'l*, 955 F. Supp. at 785 ("[T]his Court finds the dissent in *Martino* to reflect the way the Michigan Supreme Court would apply the remedy of rescission to violations of the [Michigan Franchise Investment Law].").

113. *Id.* at 785–86 (quoting *Martino*, 554 N.W.2d at 24 (Taylor, J., dissenting)).

The case of *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.* presents another example of the absence of strict liability under a state's franchise law.[114] There, a federal district court found the defendant franchisor sold a franchise to a franchisee "without having registered its offering prospectus in the state of Maryland, and, thus, it violated Maryland's registration requirement."[115] But, despite the violation, the franchisee presented no evidence to connect defendant's failure to register its offering prospectus in Maryland to the franchisee's business losses. To the contrary, the record indicated that the failure to register was generally harmless.[116] The court rejected several claims for relief by the franchisee, despite these and other violations.[117] The court concluded that "a franchisee must demonstrate that a franchisor's failure to register caused the harm that the franchisee sustained in order to be entitled to money damages for registration violations."[118]

H. *A Franchise Relationship Alone Does Not Create a Fiduciary Duty*

Fiduciary duty can be an elusive concept in law.[119] Some scholars consider fiduciary relationships to be a subset of contract relationships.[120] Under this notion, fiduciary and non-fiduciary contracts are at opposite ends of a continuum.[121] Others view fiduciary relationships as existing wherever a vulnerable party is called on to trust another[122] or where "one party gives another discretion and control over a critical resource."[123] Hence, a fiduciary relationship can be created by an agreement or can be implied in law.[124] A

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114. A Love of Food I, LLC v. Maoz Vegetarian USA, Inc., 70 F. Supp. 3d 376 (D.D.C. 2014).

115. *Id.* at 396.

116. *Id.* at 397.

117. *Id.* at 395.

118. *Id.* at 397; *see also* Cluck-U Chicken, Inc. v. Cluck-U Corp., 358 F. Supp. 3d 1295, 1315 (M.D. Fla. 2017) (ruling that technical violations of the Franchise Rule were not *per se* violations of Florida Deceptive and Unfair Trade Practices Act and a triable issue existed whether misrepresentations and omissions in the sale of a franchise were material and were relied on by Plaintiffs).

119. Kelli Alces, *The Fiduciary Gap*, 40 Iowa J. Corp. L. 351, 355 (2015) (noting fiduciary duty has at times seemed to be one of the most elusive concepts in Anglo-American law).

120. *Id.* at 356.

121. *Id.*

122. *Id.* at 360

123. *Id.* at 358; *see also* Rajala v. Allied Corp., 919 F.2d 610, 614 (10th Cir. 1990), *cert. denied*, 500 U.S. 905 (1991) (explaining three kinds of fiduciary relationships: (1) those specifically created by contract such as principal-agent, attorney-client, and trustor-trustee; (2) those created by formal legal proceedings such as guardian/conservator and ward, and executor and administrator of an estate; and (3) those implied in law due to the facts of the transactions and relationship of the parties).

124. *See, e.g.*, Pizza Mgmt., Inc. v. Pizza Hut, Inc. 737 F. Supp. 1154, 1182 (D. Kan. 1990) (Generally, "there are two types of fiduciary relationships: (1) those specifically created by contract such as principal and agent and (2) those implied in law due to the factual situation surrounding the transactions and relationship of the parties to each other and to the transactions. The latter category depends on the facts in each case."); Gen. Bus. Machs. V. Nat'l Semiconductor Datachecker/DTS, 664 F. Supp. 1422, 1425 (D. Utah 1987) (fiduciary or confidential relationship "may be created by contract or by circumstances where equity will imply a higher duty in a relationship because the trusting party has been induced to relax the care and vigilance he would ordinarily exercise.").

comment to the *Restatement (Second) of Torts* states that a fiduciary relation "exists between two persons when one of them is under a duty to act for or give advice for the benefit of another upon matters within the scope of the relation."[125] Fiduciary relationships can exist though the parties do not designate their relationship as such.[126]

Traditional fiduciary relationships include those among trustees and beneficiaries, agents and principals, lawyers and clients, directors and officers and their corporation, and partners in a partnership.[127] The debate over whether the franchisor assumes any fiduciary duties on behalf of its franchisees has been discussed by scholars and litigated with some frequency.[128] Almost uniformly, courts rule that the franchise relationship does not itself establish a fiduciary relationship.[129]

125. Restatement (Second) of Torts § 874 cmt. A. (1979); *see, e.g.*, Mahaska Bottling Co. v. PepsiCo Inc., 271 F. Supp. 3d 1054, 1081 (S.D. Iowa 2017) (quoting section 874).

126. Alces, *supra* note 119, at 358 ("If explicitly calling the relationship fiduciary were required, it would be easy to take advantage of relatively unsophisticated parties and avoid fiduciary obligation entirely. Indeed, we must compare relationships that have not been called fiduciary explicitly to those that typically are fiduciary to decide whether uncertain relationships are fiduciary.").

127. *See generally* Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 Am. U. L. Rev. 75 (2004).

128. *See, e.g.*, D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399, 1478 (2002) (noting "courts consistently hold that franchisors have no fiduciary duty"; and though "the issue is persistent," commenting that "courts have reached the correct conclusion"); Marc A. Wites, *The Franchisor as Predator: Encroachment and the Implied Covenant of Good Faith*, 7 U. Fla. J.L. & Pub. Pol'y 305, 325–27 (1996) (discussing the 1979 *Arnott* decision and noting "despite the compelling reasoning in *Arnott*, subsequent decisions refused to find an inherent fiduciary duty in franchise relationships" and "most courts refuse to find a fiduciary duty in the franchise relationship"); Anne L. Austin, *When Does A Franchisor Become a Fiduciary?:* Crim. Truck & Tractor Co. v. Navistar International Transportation Corporation, 43 Case W. Rsrv. L. Rev. 1151, 1161–62 (1993) (noting majority of jurisdictions reject automatic imposition of per se fiduciary duty in a franchise relationship); Harold Brown, *Franchising—A Fiduciary Relationship*, 49 Tex. L. Rev. 650 (1971) (arguing for fiduciary duty of franchisors in favor of franchisees).

129. *See, e.g.*, Broussard v Meineke Disc. Muffler Shops, 155 F.3d 331, 348 (4th Cir. 1998) (explaining fiduciary obligations are out of place in relationship of two business entities pursuing their own interests and is unnecessary in view of protection provided by federal regulations); Williams v. Dresser Indus., 120 F.3d 1163, 1170 n. 41 (11th Cir. 1997) ("[E]xcept in cases of franchise terminations or when a duty is created by the express terms of a contract," courts do not impose general fiduciary obligations upon franchisors); Original Great Am. Chocolate Chip Cookie Co., Inc. v. River Valley Cookies, Ltd., 970 F.2d 273, 280 (7th Cir. 1992) (holding parties to a contract are not fiduciaries, even if contract is a franchise); McGuirk Oil Co. v. Amoco Oil Co., 889 F.2d 734, 737–38 (6th Cir. 1989) (finding no evidence of a confidential relationship); O'Neal v. Burger Chef Sys., Inc., 860 F.2d 1341, 1350 (6th Cir. 1988) (explaining franchise agreements do not give rise to fiduciary relationships); Premier Wine & Spirits v. E. & J. Gallo Winery, 846 F.2d 537, 540–41 (9th Cir. 1988) (bare franchisor-franchisee relationship not enough to establish fiduciary relationship); Bright v. Land O'Lakes, Inc., 844 F.2d 436, 440 (7th Cir. 1988) ("[W]e are unconvinced that the contractual relationship between a distributor, Bright, and a processor, Land O'Lakes or Norris, rises to the level of a fiduciary relationship."); Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285, 1292 (9th Cir. 1987) ("[R]elation between a franchisor and a franchisee is not that of a fiduciary to a beneficiary."); Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480, 485 (5th Cir. 1984) (noting that, except in franchise termination cases, courts have not imposed fiduciary obligations on franchisors); Murphy v. White Hen Pantry Co., 691 F.2d 350, 355–56 (7th Cir. 1982) (declining to find fiduciary duty); Collins v. Int'l Dairy Queen, 54 F. Supp. 2d 1351, 1352 (M.D. Ga. 1999) (The "vast majority of

Though the absence of a fiduciary duty arising from the franchise relationship itself may be stated as a maxim, this does not mean fiduciary obligations are entirely absent from franchise relationships. The existence of a franchisor-franchisee, dealer-distributor, or manufacturer-distributor relationship has been held "not to preclude a finding of a fiduciary relationship" in particular situations.[130] For example, the concept of a fiduciary duty has been mentioned in the context of terminations.[131] Many courts indicate openness to finding a fiduciary obligation when justified by particular factual circumstances.[132]

One frequently cited case, *Arnott v. America Oil Co.*, did suggest that a fiduciary duty is inherent in franchising.[133] In that matter, a gas station franchisor, characterized as a "major oil company," terminated a franchisee by terminating his lease and evicting him from the service station that he operated.[134] The franchisee originally operated a station in Minneapolis, Minnesota, but the oil company persuaded him to lease and operate a station in Sioux Falls, South Dakota.[135] The oil company repeatedly violated policies promising its franchisee would be free to offer competitive brands of motor oil; to obtain tires, batteries, and accessories from any supplier; to set his

courts who have considered the issue have ruled that a franchisor-franchisee relationship, standing alone, does not create a fiduciary relationship."); AAMCO Transmissions, Inc. v. Harris, 759 F. Supp. 1141, 1147 (E.D. Pa. 1991) (franchise relationship is not fiduciary in nature); Layton v. AAMCO Transmissions, Inc., 717 F. Supp. 368, 371 (D. Md. 1989) (franchisor-franchisee relationship is not fiduciary); Saey v. Xerox Corp., 31 F. Supp. 2d 692, 699 (E.D. Mo. 1998) (noting New York and Missouri courts reject proposition that franchisor-franchisee relationship automatically gives rise to a fiduciary duty); Oil Express Nat'l, Inc. v. Burgstone, 958 F. Supp. 366 (N.D. Ill. 1997) (fiduciary relationship could exist outside traditional attorney-client, principal-agent, trustee-beneficiary, or partnership relationships, but party must prove it is highly dependent on advice of another to establish such duty); St. Martin v. KFC Corp., 935 F. Supp. 898, 908 (W.D. Ky. 1996) (holding no rigid formula or classification establishes what conditions create fiduciary relationships, each individual situation is considered, and decisions do not say a franchise agreement cannot impart a fiduciary relationship but standing alone it does not create a fiduciary duty); Wayman v. Amoco Oil Co., 923 F. Supp. 1322, 1362 (D. Kan. 1996) (explaining fiduciary duties do not arise just from franchise relationship in which one party has more discretion than the other and that something above and beyond ordinary franchise relationship must be shown).

130. Collins v. Int'l Dairy Queen, 54 F. Supp. 2d 1351, 1352 (M.D. Ga. 1999); *see also* Gen. Bus. Machs. v. Nat'l Semiconductor Datachecker/DTS, 664 F. Supp. 1422, 1425 (D. Utah 1987) ("Several courts and authorities have recognized that within appropriate circumstances a franchise relationship may give rise to fiduciary duties" and citing decisions).

131. *See* Newark Motor Inn Corp. v. Holiday Inns, Inc., 472 F. Supp. 1143, 1152 (D.N.J. 1979) (noting that cases finding a quasi-fiduciary relationship involved franchise termination).

132. *See, e.g.*, Mahaska Bottling Co. v. PepsiCo Inc., 271 F. Supp. 3d 1054, 1081 (D. Iowa 2017) (discussing fiduciary relationships); *Saey*, 31 F. Supp. 2d at 699 (rejecting proposition that no fiduciary relationship may ever exist between a franchisor and franchisee and stating that an examination of the facts is necessary); Carter Equip. Co. v. John Deere Ind. Equip. Co., 681 F.2d 386, 390–91 (5th Cir. 1982) (holding district court did not err in submitting to jury the question whether fiduciary duty existed in particular franchise relationship and explaining rules and circumstances surrounding how to determine if a fiduciary relationship exists); Picture Lake Campground v. Holiday Inns, Inc., 497 F. Supp. 858, 869 (E.D. Va. 1980) (explaining franchise relationship is a business relationship, not a fiduciary relationship).

133. Arnott v. Am. Oil Co., 609 F.2d 873 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980).

134. *Id.* at 876.

135. *Id.* at 877.

own prices; and would be free from coercion or pressure from the company.[136] The company then pressured the franchisee to remove competitive brands and buy from specified suppliers.[137] The oil company's representatives made misrepresentations and exerted other pressures on the franchisee, including during a severe nationwide gas shortage, which hurt the franchisee's profitability.[138] Eventually, the franchisor cancelled the franchisee's lease for the station location.[139] A jury found that the franchisor made fraudulent representations, breached a fiduciary duty by terminating the franchisee's lease without good cause, and committed other wrongs.[140]

On appeal, the franchisor argued that the evidence did not support the existence of a fiduciary relationship.[141] The Eighth Circuit, which called the existence of a fiduciary relationship a "close question," found the relationship between an oil company and its dealer was a franchise, and found that a fiduciary duty was inherent in that relationship.[142] Looking to other cases, the court indicated the franchisee, by virtue of the franchisor's dominant position and the legal structure of the agreements whose terms the franchisee could not vary, was compelled to rely on the franchisor's good faith.[143] The court also noted legislation restricting franchisors from terminating a franchise without good cause, as an indicator of the fiduciary nature of the franchise relationship.[144] The Eighth Circuit concluded that the district court did not err in instructing the jury that a fiduciary relationship existed between the parties and ample evidence supported the jury verdict that the franchisor breached that duty.[145]

Though the *Arnott* court stated a fiduciary duty is inherent in franchise relationships, subsequent decisions declined to follow or narrowed the scope of the decision. [146] The Eighth Circuit later stated *Arnott* decided only that "*arbitrary termination* of Arnott's service station lease constituted a breach of Amoco's implied duty of 'good faith and fair dealing.'"[147] The court added that, because the duty of good faith and fair dealing is inherent in every business relationship, labeling the duty as "fiduciary" was unnecessary.[148] The Eighth Circuit stated, therefore, that *Arnott* does not stand for the

136. *Id.* at 877–78.
137. *Id.* at 878.
138. *Id.* at 879.
139. *Id.*
140. *Id.* at 876.
141. *Id.* at 881.
142. *Id.*
143. *Id.* at 881–84.
144. *Id.* at 883.
145. *Id.* at 884.
146. *See, e.g.*, Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480, 485 (5th Cir. 1984) (distinguishing *Arnott* as having "applied no more than basic contract principles to hold that the defendant breached a duty of good faith and fair dealing"); Cap. Ford Truck Sales, Inc. v. Ford Motor Co., 819 F. Supp. 1555, 1579 n. 31 (N.D. Ga. 1992) ("*Arnott* takes a distinctly minority position and numerous courts have refused to follow the case.").
147. Bain v. Champlin Petroleum Co., 692 F.2d 43, 48 (8th Cir. 1982).
148. *Id.*

proposition that the grant of a franchise in all instances imposes on the franchisor all the duties and responsibilities which traditionally pertain to a true fiduciary."[149] *Arnott* is thus one more of the cases indicating that a franchise relationship does not by itself establish a fiduciary obligation, but a fiduciary relationship may be found to exist when justified by the facts.[150]

I. *Franchise Laws Are Construed Liberally, but Exemptions Are Construed Narrowly*

State franchise registration and disclosure laws are structured to establish a general rule that prohibits the offer or sale of a franchise in the state, unless the offer and sale are registered, or exempt from registration.[151] A typical provision in a state's franchise registration law states that "it shall be unlawful for any person to offer or sell any franchise in this state unless the offer of the franchise has been registered under this part or exempted . . . ."[152] In practice, the statutes create a general rule requiring a franchise to be registered, and an exception for franchises that are exempt from registration, or excluded by definition from the scope of the law.

Courts routinely hold that the franchise laws, as remedial statutes, are to be construed liberally. As stated by one court: "As a general matter, remedial or protective statutes such as the Franchise Investment law are liberally construed to effect their object and quell the mischief at which they are

149. *Bain*, 692 F.2d at 48; *see also* Cambee's Furniture, Inc. v. Doughboy Recreational, Inc., 825 F.2d 167, 171 (8th Cir. 1987) ("We have construed the holding in *Arnott* . . . as resting on the implied covenant of good faith and fair dealing, and have held that a franchise or other ordinary business relationship does not alone create fiduciary duties."); Pinnacle Pizza Co. v. Little Caesar Enters., 560 F. Supp. 2d 786, 801 (D.S.D. 2008) (same).

150. In *Roberts v. C.R. England, Inc.*, 318 F.R.D. 457, 510 (D. Utah 2017), the U.S. District Court for the District of Utah, on a motion for class certification, cited *Arnott* for the proposition that "a franchisee relationship may give rise to a fiduciary duty." The court added that the question of fiduciary duty would require addressing if the relationship between independent contractors and defendants, driven by inducement to invest in becoming long haul delivery drivers, leasing vehicles, and entering into independent contractor agreements, together with disparity in access to information, created a fiduciary relationship. *Id.*

151. *See, e.g.*, Cal. Corp. Code § 31110 (unlawful to offer or sell any franchise in the state unless the franchise has been registered or is exempt); 815 Ill. Comp. Stat. § 705/5(1) (same); Ind. Code § 23.3.3.5.5 (a person wanting to offer for sale a franchise in Indiana and who is not exempt must register the franchise with the Indiana Securities Commissioner); Md. Code Bus. § 14-214; Minn. Stat. § 80C.02; N.Y. Gen. Bus. Law § 683.1; Va. Code Ann. §13.1-560; Wash. Rev. Stat. § 19.100.020(1); *see also* Tyerman, *supra* note 14, at 1124 ("The proposed Franchise Investment Law makes it unlawful for any franchisor to offer or sell any franchise in this state unless the offer has been registered or exempted."). State franchise registration and disclosure laws are modeled on securities laws, which have the same general structure. *See, e.g.*, Keating v. Superior Court, 645 P.2d 1192, 1202–03 (Cal. 1982), *rev'd in part, appeal dismissed in part sub nom.*, Southland Corp. v. Keating, 465 U.S. 1 (1984) ("California's policy of protecting judicial remedies for this state's franchise investors was patterned after, and is consistent with, federal policy in the analogous area of securities."); *see also* Neal H. Brockmeyer, *Regulation of Securities Offerings in California: Is It Time for a Change After a Century of Merit Regulation?*, 54 Loy. L.A. L. Rev. 1, 60–61 (2020) (noting 1933 Securities Act prohibited offer or sale of securities unless a registration statement is filed with the SEC and is in effect or the offer or sale is exempt).

152. Cal. Corp. Code § 31110. Similar or equivalent formulations appear in 815 Ill. Comp. Stat. § 705/5(1); Ind. Code § 23.3.3.5.5; Md. Code Bus. § 14-214; Minn. Stat. § 80C.02; N.Y. Gen. Bus. Law § 683.1; Va. Code Ann. § 13.1-560; Wash. Rev. Stat. § 19.100.020(1).

directed."[153] This principle in franchise laws follows from the same principle applied in the securities laws[154] and more broadly to rules on construing remedial legislation generally.[155] This principle of liberal construction means that, when defining and applying terminology of the law, the elements are likewise "construed liberally to broaden the group of investors protected by the law and to carry out the legislative intent."[156]

However, this maxim of liberal construction does not mean that every business relationship falls within the coverage of a franchise law. As stated by the Arkansas Supreme Court, "[T]he business relationship created by this contract was not a franchise within the meaning of that term in [the Arkansas Franchise Act]. We give a liberal construction to the act to effectuate its remedial purposes. However, we must still apply its provisions according to their plain meaning."[157] The court noted that the legislature intended the state's franchise law to apply where a person grants another a license to "sell or distribute goods or services within an exclusive or nonexclusive territory."[158] But the case before the court concerned insurance: the defendant "maintained no inventory, had no authority to set prices, and could not enter into a binding contract,"[159] and had authority "no further than to solicit and procure applications for insurance."[160]

In contrast to the liberal interpretation of franchise laws, exemptions and exclusions from the coverage of the law are construed narrowly.[161] This prin-

153. Kim v. Servosnax, Inc., 13 Cal. Rptr. 2d 422, 427 (Ct. App. 1992); *see* Thompson v. Amoco Oil Co., 903 F.2d 1118, 1119 (7th Cir. 1990) (explaining Petroleum Marketing Practices Act is Congress's attempt to decrease bargaining power disparity between franchisors and franchisees, and, as remedial legislation, must be given a liberal construction consistent with its purpose to protect franchisees).

154. *See, e.g.*, Gordon v. Drews, 595 S.E.2d 864, 868 (S.C. Ct. App. 2004) ("[S]ecurities laws are remedial in nature and, therefore, should be liberally construed to protect investors."); Blau v. Redmond, 240 S.E.2d 273, 276 (Ga. Ct. App. 1977) ("Georgia Securities Act is remedial in nature, intended for the protection of investors, and is to be broadly and liberally construed to effectuate its aim.").

155. *See, e.g.*, State *ex rel.* Hodge v. Town of Turtle Lake, 508 N.W.2d 603, 606 (Wis. 1993) (holding that state open meeting law should be construed liberally to achieve its purpose of providing public full information regarding government affairs, while exemption should be construed strictly).

156. *Kim*, 13 Cal. Rptr. 2d at 427.

157. Stockton v. Sentry Ins., 989 S.W.2d 914, 917 (Ark. 1999).

158. *Id.*

159. *Id.*

160. *Id.*; *see* Super Value Stores, Inc. v. D-Mart Food Stores, Inc., 431 N.W. 2d 721, 726 (Wis. Ct. App. 1988) (Wisconsin Fair Dealership Law should be liberally construed to promote its underlying purposes and policies, but agreement expressly permitted alleged conduct and defendant therefore did not violate plain language of statute defendant was alleged to have violated; a different conclusion would not be liberal construction but would mean rewriting the statute).

161. *See, e.g.*, Morris v. Int'l Yogurt Co., 729 P.2d 33, 35–36 (Wash. 1986) (exemptions normally construed narrowly and require strict compliance); City of Hesperia v. Lake Arrowhead Cmty. Servs. Dist., 250 Cal. Rptr. 3d 82, 94 (Ct. App. 2019) (statutory exemptions must be narrowly construed); Bd. of Medical Quality Assurance v. Andrews, 260 Cal. Rptr. 113, 119 (Ct. App. 1989) ("[S]tatutes conferring exemptions from regulatory schemes are narrowly construed."); *see also* Dollar Sys., Inc. v. Avcar Leasing Sys., Inc., 673 F. Supp. 1493, 1501–02 (C.D. Cal. 1987) (franchisor not qualifying for exemption under two states' franchise laws due to failing, prior to

ciple, too, follows from the same principle applied in the securities laws[162] and other laws.[163]

III. Conclusion

Maxims provide useful guideposts in understanding the law, summarizing historical wisdom, and communicating well-established rules and principles of law to clients, courts, and the community. The law is filled with maxims of law and jurisprudence. As the field of franchise law has developed, it is now possible to recognize and state some acquired wisdom as maxims. As the field continues to develop, additional elements are likely to be recognized and established as useful maxims.

selling the franchise, to file required exemption notices), *aff'd in part*, *remanded in part*, 890 F.2d 165 (9th Cir. 1989).

162. *See*, *e.g.*, U.S. v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir. 1967) (Section 5 of the Securities Act being for protection of the public, the terms of an exemption must be strictly construed against the one claiming it); Gordon v. Drews, 595 S.E.2d 864, 868 (S.C. Ct. App. 2004) ("We are mindful that we must narrowly construe exemptions under the Act because the securities laws are remedial in nature and, therefore, should be liberally construed to protect investors."); Blau v. Redmond, 240 S.E.2d 273, 276 (Ga. Ct. App. 1977) (noting that while securities law is to be broadly and liberally construed to effectuate its aim, "its exceptions must be narrowly viewed").

163. *See*, *e.g.*, State *ex rel.* Hodge v. Town of Turtle Lake, 508 N.W.2d 603, 606 (Wis. 1993) (noting that state open meeting law should be construed liberally to achieve its purpose of providing public full information regarding government affairs, while exemption should be construed strictly); Cmty. Lutheran Sch. v. Iowa Dep't of Job Serv., 326 N.W.2d 286, 289 (Iowa 1982) (tax exemption statutes being strictly construed with doubts resolved in favor of taxation and against exemption); Town of La Pointe v. Madeline Island Ferry Line, 508 N.W.2d 440, 442 (Wis. App. 1993) (same).

The New European Block Exemption Regulation on Vertical Agreements: Renewal of the Safe Harbor for Vertical Agreements Such as Franchise Agreements and a New Era on What Is (and Is Not) Permitted on Digital Commerce Within the European Union

*Martine de Koning & Jelle Blom**

I. Introduction

Ms. de Koning

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Due to the vertical nature of franchise agreements from an antitrust perspective, franchise attorneys that represent clients seeking to expand or operate in the European Union (EU) must understand the scope of the EU's cartel prohibition as it is applied to vertical agreements.[1] On May 10, 2022, the revised EU Block Exemption Regulation on Vertical Agreements[2] (VBER 2022) and accompanying Guidelines on Vertical Restraints (Guidelines 2022) were published, and they became effective on June 1, 2022.[3] The VBER 2022 replaces the

1. Consolidated Version of the Treaty on the Functioning of the European Union art. 101, 2008 O.J. (C 115) [Hereinafter TFEU].

2. European Commission Press Release IP/22/2844, Antitrust: Commission Adopts New Vertical Block Exemption Regulation and Vertical Guidelines (May 10, 2022) [hereinafter Press Release]; *see also* Commission Regulation (EU) No. 2022/720 of 10 May 2022 on the Application of Article 101(3) of the Treaty on the Functioning of the European Union to Categories of Vertical Agreements and Concerted Practices, 2022 O.J. (L 134) [hereinafter VBER 2022].

3. Commission Guidelines on Vertical Restrictions, 2022 O.J. (C 248/01) [hereinafter Guidelines 2022].

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former EU Block Exemption Regulation on Vertical Agreements (VBER 2010)[4] and accompanying Guidelines (Guidelines 2010).[5]

This article explains key changes that were made in the VBER 2022 compared to the VBER 2010. To allow for a deeper dive into the nuances, changes, and clarifications stemming from this new piece of European legislation and its impact on the international franchising practice in Europe, this article first provides some background to EU competition law and its system of block exemption regulations. It then addresses the VBER 2022 and Guidelines 2022 themselves. This article will explain that, while clarifications were added on a number of topics, the most striking new rules relate to digital commerce, such as online sales, exchange of information in the context of dual distribution, Internet platforms, and retail parity (most favored customer) obligations, in particular when used across platforms.[6]

II. The Objective of Competition Law and the Function of the Block Exemption Regulations

The objective of competition law is to ensure effective and fair competition. It is, among other things,[7] key that companies independently set their market behavior and that trade in the EU internal market (e.g., trade between EU member states)[8] is not hindered. EU competition law contains several prohibitions addressing conduct that impedes effective and fair competition, such as the cartel ban and the ban on abuse of a dominant position.[9] In brief, the cartel ban prohibits all collaboration between undertakings[10] that has as its object or effect to appreciably prevent, restrict, or distort competition on the relevant market.

The cartel ban is set out in Article 101(1) of the Treaty on the Functioning of the European Union (TFEU).[11] This ban not only aims to protect

4. Commission Regulation (EU), No. 330/2010 of April 20, 2010, on the Application of Article 101(3) of the TFEU to Categories of Vertical Agreements and Concerted Practices, 2010 O.J. (L 102) [hereinafter VBER 2010].

5. Commission Guidelines on Vertical Restraints, 2010 O.J. (C 130/01) [hereinafter Guidelines 2010].

6. The authors have previously published a similar version of this article in the Dutch academic journal *Computerrecht* (2022/220, nr. 6, pp. 420–28). In light of the importance of this topic to the franchise bar generally and the limited ability of North American lawyers to access or understand articles originally published in Dutch, the authors have adapted, and expanded upon, the *Computerrecht* article for the *Franchise Law Journal*.

7. Such other things are, for example: a dominant market position may not be abused and mergers above certain thresholds should be notified to the European Commission.

8. EU competition law is only applicable if trade between member states of the EU is appreciably hindered or impeded. For domestic situations, national competition laws of the relevant EU member states(s) should be applied.

9. *See* TFEU, art. 101.

10. Competition law is only applicable to economic activity, not to public/government policy or services. An "undertaking" normally includes its subsidiaries (e.g., the group of entities under common control are viewed as one undertaking. Intercompany agreements thus often fall outside competition law).

11. TFEU, art. 101.

consumers from such detrimental arrangements, but also pursues the wider objective of achieving an integrated internal market within the European Union, to enhance effective competition and cross-border sales in the EU.[12] Horizontal collusion, such as on resale prices, market sharing, and quotas are good examples of restrictions that by their object distort competition.[13] Certain arrangements in vertical agreements, such as distribution, franchise, and agency agreements for products or services can also impede competition by their object or effect.[14] Undertakings may therefore not use vertical agreements to restrict competition or to reestablish private barriers between member states where state barriers have been successfully abolished.[15]

Article 101(3) of the TFEU provides for an individual exemption. It states that the cartel ban does not apply to collaborations that contribute to improving the production or distribution of goods or to promoting technical or economic progress, and that are proportional to achieve this goal while allowing consumers a fair share of the resulting benefit.[16] This is an individual exemption from the cartel ban, and it only applies if four cumulative criteria have been met.[17]

For ease of application of the cartel ban of Article 101, and to assist with the self-assessment that companies must carry out before implementing restrictions that may harm competition, group exemptions (so called block exemptions) have been developed.[18] These block exemptions apply in various fields, both for horizontal and vertical agreements. They serve to create a "safe harbor" for agreements meeting specific conditions, usually a market threshold as well as other conditions. These other conditions usually entail meeting a description of a somewhat more "benign" competitive restraint, often with a time limit on its duration and/or a restriction on its scope, as well as the absence of other "very harmful" restrictions, which are referred to as "hardcore."[19] Regulations have direct effect in the European Union and are binding on courts and competition authorities.[20] This is different from Directives, which member states must implement into national law and only have direct horizontal effect if certain conditions are met, such as if

12. Guidelines 2022, art. 1.2(5).

13. EU Guidelines on the Applicability of Article 101 of the TFEU to Horizontal Co-Operation Agreements, 2011 O.J. (C 11) 1.

14. Guidelines 2022, arts. 1.2–2.2.

15. *Id.*, art. 1.2(5).

16. TFEU, art. 101(3).

17. *Id.*

18. EU Regulation 19/65/EEC empowers the Commission to apply Article 101(3) of the TFEU by regulation to certain categories of agreements and corresponding concerted practices that fall within Article 101(1)'s scope. *See also* VBER 2022, recital 1.

19. *See, e.g.*, Press Release, *supra* n. 2.

20. Extensive case law supports this point. *See, e.g.*, Case C-26/62, NV Algemene Transport- en Expeditie Onderneming van Gend en Loos v. Netherlands Inland Revenue Administration, 1963 E.C.R. 1; *The direct effect of European Union Law*, Eur-Lex, https://eur-lex.europa.eu/EN/legal-content/summary/the-direct-effect-of-european-union-law.html (last visited Feb. 12, 2022), *Primacy of EU Law*, Eur-Lex, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=LEGISSUM:primacy_of_eu_law (last visited Feb. 12, 2023).

the Directive, for example, has not been timely or correctly implemented and the obligation is suitable for such effect, or guidelines by the European Commission (Commission) that provide for interpretation.[21] EU competition law applies if there is appreciable effect on trade between member states.[22] EU law must be applied effectively and uniformly in the EU, including by national competition authorities and courts. Member State competition laws apply to domestic situations, but these generally should be in line with EU law.[23] In the Netherlands, for example, the VBER applies through a clause in the Dutch Competition Act that declares the block exemptions applicable.[24] Therefore, the block exemptions play a key role in the application of competition law in the EU, even in cases within member states.

To successfully rely on the VBER 2022, the market share of both the supplier and the buyer in the relevant market cannot exceed thirty percent.[25] Not exceeding this threshold is a condition for application of the safe harbor provided by the VBER.[26] Moreover, the agreement at issue cannot contain any hardcore restrictions within the meaning of Article 4 of VBER 2022 or excluded restrictions within the meaning of Article 5 of VBER 2022.[27] If the agreement contains a hardcore restriction, then the entire agreement cannot benefit from the safe harbor.[28] It remains possible to test the agreement individually against Article 101(3) of the TFEU to see if the hardcore restriction can be excused, but that outcome is not likely. Restrictions excluded from exemption in the VBER 2022 do not harm reliance on the VBER as to the other provisions of the agreement (as long as the excluded provisions are severable from the rest of the agreement).[29]

This article only explains the VBER 2022 and does not discuss any other exemptions, such as the De Minimis Notice of the Commission that applies to agreements of minor importance, which do not appreciably restrict competition.[30]

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21. Case C-106/89, Marleasing SA v. La Comercial Internacional de Alimentacion SA, 1990 E.C.R. 395; Case C-240/98, Océano Grupo Editorial SA v. Roció Murciano Quintero, 2000 E.C.R. 346.
22. C-5/69, Franz Völk v. S.P.R.L. Ets J. Vervaecke, 1969 E.C.R. 35.
23. Council Regulation No 1/2003 of 16 December 2002 on the Implementation of the Rules on Competition Laid Down in Articles 81 and 82 of the Treaty, 2003 O.J. (L 1), for example, contains details on the precise complex relationship between national and EU competition laws.
24. Dutch Competition Act, art. 12.
25. For a definition of the relevant market, see Commission Notice on the Definition of the Relevant Market for the Purposes of Community Competition Law, 1997 O.J. (C 372), 5–13, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:31997Y1209%2801%29.
26. VBER 2022, art. 3.
27. *Id.*, arts. 4, 5.
28. *Id.*, art. 4.
29. *Id.*, art. 5.
30. Commission Notice on Agreements of Minor Importance Which Do Not Appreciably Restrict Competition Under Article 101(1) of the Treaty on the Functioning of the European Union, 2014 O.J. (C 291).

A. *History of the Block Exemption Regulation on Vertical Agreements*

In 2022, the VBER 2010 and Guidelines 2010 were twelve years old and outdated, especially regarding digital commerce and the platform economy. Therefore, they needed replacement. It is worth mentioning that the United Kingdom in 2022 has introduced post-Brexit a largely similar group exemption regulation of its own.[31]

Before the expiration of the VBER 2010, the European Union Commission (Commission) evaluated the VBER 2010 over a number of years. It launched a market consultation to collect and analyze feedback on the VBER 2010 and Guidelines 2010 and on earlier drafts of the renewal documents.[32]

Overall, the experiences with the VBER 2010 were good, and generally the feedback was that it should be renewed or replaced with something similar after updating and improving certain aspects.[33] This response prompted the Commission to draft a new block exemption regulation. One of its main purposes was to adapt the "safe harbor" in order to eliminate "false positives"[34] from the effect of the new rules, and to reduce "false negatives."[35] According to the Commission in its press release and explanatory note that accompanied the new VBER 2022, the false positives include mainly dual distribution arrangements and retail parity obligations, where the rules can be stricter to avoid anti-competitive situations.[36] The false negatives includes restrictions regarding active and online sales and dual pricing, where negative impact on competition is less likely and the rules could be more relaxed.[37] These specific examples are addressed in more detail below. In addition, the Commission considered it important to provide stakeholders with simpler, clearer, and more up-to-date rules and guidance for the purpose of self-assessment regarding Article 101 of the TFEU.[38]

Since 2010, there have been many developments (in the market) for which the VBER 2010 did not (or did not adequately) provide. For example, the role of e-commerce in the distribution of goods and services has become much more prominent in the last decade. Online marketplaces—such as price

31. The Competition Act 1998 (Vertical Agreements Block Exemption) Order 2022, SI 2022/516 (Eng.); VABEO Guidance (Eng.), https://www.gov.uk/government/publications/vabeo-guidance.

32. EU Competition Rules on Vertical Agreements–Evaluation, European Commission, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/1936-EU-competition-rules-on-vertical-agreements-evaluation_nl (last visited Feb. 12, 2023).

33. Press Release, *supra* note 2; *see also* Explanatory Note on the New VBER and Vertical Guidelines, European Commission (May 10, 2022), https://competition-policy.ec.europa.eu/system/files/2022-05/explanatory_note_VBER_and_Guidelines_2022.pdf [hereinafter Explanatory Note].

34. "False positives," which are discussed in the Explanatory Note, *supra* note 33, are arrangements that benefit wrongly from the safe harbor. *Id.* at 1.

35. "False negatives," which are discussed in the Explanatory Note, *supra* note 33, are arrangements that should benefit from the safe harbor, but wrongly do not do so. *Id.* at 1–2.

36. *See generally* Press Release, *supra* note 2; Explanatory Note, *supra* note 33.

37. Explanatory Note, *supra* note 33, at 2–4.

38. *Id.*

comparison sites, search engines, and online marketplaces[39]—have become essential elements of trade. According to the Commission, in mid-2022 one million companies in the EU were offering goods and services via online marketplaces.[40] More than fifty percent of the small and medium-sized businesses that sell via online marketplaces do this on an international level.[41] Not quite unexpectedly, most changes therefore concern online sales and online marketplaces. Rules concerning resale price maintenance, selective and exclusive distribution, and restricting passive sales have mostly remained the same.[42] The VBER 2022 has added nuances, some clarifications, and a few minor additional exceptions to the former rules, which regarded (almost) all Internet sales as passive sales that can basically not be prohibited (except to non-authorized sellers in a selective distribution system, for example).[43]

As usual, the Commission first prepared a draft version of the VBER 2022 and Guidelines 2022.[44] These drafts were followed by a public consultation round, in which stakeholders could give input.[45] This input was not altogether positive, which resulted in quite a few changes.[46] After this first round of consultation, a separate consultation round was organized that focused only on the exchange of information in the context of dual distribution, which is addressed at Article 2(5) of VBER 2022.[47] On May 10, 2022, the Commission published the revised and final versions, which, as stated above, became effective on June 1, 2022. Under Article 10 of VBER 2022, a transitional period of twelve months applies to agreements that were already in force on May 31, 2022, and do not meet the VBER 2022, but do meet the VBER 2010. These agreements should be brought in compliance with the new rules by May 31, 2023.[48]

39. Such platforms are described in many different terms, like third-party platforms or open marketplaces. In this article we will use the term "online marketplaces."

40. *Online Platforms*, European Commission, https://digital-strategy.ec.europa.eu/en/policies/online-platforms (last visited Feb. 12, 2023).

41. *Id.*

42. The popular use in the United States of "minimum advertised pricing" (MAP) is now mentioned expressly as a form of resale price maintenance. In an exclusive distribution system, a maximum of five distributors can be designated. *See* Explanatory Note, *supra* note 33, at 4–6.

43. *Id.*

44. *Annex to the Communication from the Commission*, *Approval of the Content of a Draft for a Commission Regulation on the Application of Article 101(3) of the Treaty on the Functioning of the European Union to Categories of Vertical Agreements and Concerted Practices*, COM (2021) 5026 final (Sept. 7, 2021); *Annex to the Communication from the Commission*, *Approval of the Content of a Draft for a Communication From the Commission*, *Commission Notice*, *Guideline on Vertical Restraints*, COM (2021) 5038 final (Sept. 7, 2021).

45. EU Competition Rules on Vertical Agreements–Evaluation, European Commission, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/1936-EU-competition-rules-on-vertical-agreements-evaluation_nl (last visited Feb. 12, 2022).

46. Explanatory Note, *supra* note 33.

47. *Additional Public Consultation on Proposed Guidance Relating to Information Exchange in the Context of Dual Distribution*, *Intended to Be Added to the Vertical Guidelines*, European Commission, https://competition-policy.ec.europa.eu/public-consultations/2021-vber_en (last visited Feb. 12, 2023).

48. VBER 2022, art. 10.

As briefly explained earlier, while the VBER 2022 has direct effect in EU Member States, competition authorities from EU Member States are in principle not bound by the Guidelines 2022 and other communications from the Commission. Commission guidelines, notices, and other communications are soft law instruments that in principle do not have a legally binding effect on national competition authorities and courts.[49] However, experience has shown that the Commission guidelines nevertheless have practical effects and "authority," whereas national authorities and courts do indeed seek guidance from the Commission's guidelines. Also, often national authorities publish their own guidance, usually largely in-line with the Commission's guidance. For example, shortly after the new rules and explanation were published, the Dutch Authority for Consumers and Markets (ACM) renewed its guidelines "Agreements between Suppliers and Buyers" in line with Guidelines 2022 and published them on July 7, 2022, for application in national cases.[50]

B. *Main Changes in VBER 2022*

This section discusses the main changes regarding restrictions on online sales, the exchange of information in the context of dual distribution, online marketplaces (also known as online platforms, online intermediation or online brokering services), and retail parity obligations (most favored nation clauses). It also provides some considerations regarding the new rules. This article does not attempt to cover all changes compared to the VBER 2010 and the Guidelines 2010.

1. Restrictions on Internet Sales

About five years ago, the Commission concluded that the ways manufacturers sold their products directly to end users were rapidly changing. For example, the E-Commerce Sector Inquiry performed by the Commission at the time revealed that a large number of manufacturers chose to operate through their own web shops.[51] This approach led to manufacturers increasingly engaged in competition with their own (wholesale and retail) buyers. Selective distribution appeared to have increased. Moreover, manufacturers were imposing more restrictions on buyers to step up control over distribution. Examples of these restrictions included price restrictions and restricting the use of search engines, price comparison sites, and online marketplaces. This trend appears to have grown steadily in the past few years.[52]

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49. Art. 249 TFEU en CJEU of 13 December 2012, C-226/11 (Expedia).

50. *See Regulation Renewal*, Dutch Auth. for Consumers and Markets (July 7, 2022), https://www.acm.nl/system/files/documents/leidraad-afspraken-tussen-leveranciers-en-afnemers_0.pdf.

51. *Report from the Commission to the Council and the European Parliament, Final Report on the E-commerce Sector Inquiry*, COM (2017) 229 final (Oct. 15, 2017), https://competition-policy.ec.europa.eu/system/files/2021-10/2017_ecommerce_SI_final_report_en.pdf [hereinafter E-Commerce Final Report].

52. *Id.*

At the end of 2017, just after the publication of the E-Commerce Sector Inquiry, all this seemed to come together perfectly in the *Coty* judgment.[53] There, the European Court of Justice (ECJ) considered not only that using a selective distribution system for luxury goods falls outside Article 101(1) of the TFEU if the Metro criteria[54] are met, but also ruled that it is allowed to prohibit the authorized distributors from using unauthorized online marketplaces (as far as this stipulation serves to ensure a "luxury image" for the goods) and that such a prohibition is not a hardcore restriction within the meaning of Articles 4(b) and 4(c) of VBER 2010.

An interesting question is how *Coty* relates to price comparison sites. At the time, several authors compared restricting the use of price comparison sites by buyers with a contractual restriction on sales via online marketplaces and referred to the Commission's E-Commerce Sector Inquiry, in which online marketplaces and price comparison sites had been commented on without a clear distinction as regards their function.[55]

The Commission has answered the call for setting clear rules in the field of online sales and online advertising. In the Guidelines 2010, the Commission still described the Internet as "a powerful tool to reach a greater number and variety of customers."[56] A ban on the use of the Internet was regarded as a hardcore restriction of passive sales.[57] In the *Pierre Fabre* judgment, the ECJ clarified that an absolute direct or indirect ban on Internet sales is not allowed under the VBER 2010.[58] Incidentally, it did not follow from this judgment that an absolute ban could never be justified objectively, even though this would only be justified in exceptional situations and would require an individual test against Article 101(3) of the TFEU.[59]

The use of Internet is addressed in more detail in the VBER 2022. For example, Article 4(e) of the VBER 2022 expressly provides that suppliers may set certain demands on Internet sales, as long as the demands do not prevent buyers from effectively using the Internet to sell goods or offer services.[60] Besides, restrictions may be imposed on online advertising, as far as these do not have the object of preventing the use of an entire advertising channel by the buyer.[61]

The question that comes up naturally here is how far suppliers can go in restricting the use of the Internet. The Commission clarified that online sales restrictions are generally allowed if the buyer remains free to (1) operate its own online store, and (2) advertise online.[62] A distinction must be

53. Case C-230/16, Coty Germany GmbH v. Parfümerie Akzente GmbH, 2017 E.C.R. 91.
54. Case C-26/76, Metro v. Commission, 1977 E.C.R. 167.
55. *See generally* E-Commerce Final Report, *supra* note 51.
56. Guidelines 2010, no. 52.
57. *Id.*, nos. 52–56.
58. Guidelines 2010, no. 52; Case C-439/09, Pierre Fabre v. Autorité de la Concurrence, 2011 E.C.R. 649.
59. Case C-322/01, Metro v. Comm'n, 2003 E.C.R. 664.
60. VBER 2022, art. 4(e).
61. Guidelines 2022, no. 210.
62. *Id.*, no. 208.

made between the buyer's own sales channel—the online store—and online advertising channels such as price comparison sites and search engines.

As far as their own sales channel, the Commission gives several examples of requirements a supplier can impose on its buyer, irrespective of the distribution system the supplier uses. It is possible to set conditions intended to ensure the quality or appearance of the buyer's online store, to set the way in which the goods are displayed, or to require that the buyer operates one or more brick and mortar shops or showrooms. Quality standards were already permitted in selective distribution in the Guidelines 2010. But the VBER 2022 states that the online criteria and offline criteria no longer have to be equivalent.[63] The point of time the supplier has to share these quality standards with the buyer is not specified. In the authors' opinion, it is obvious that this sharing will be on the later of either the entry into a new commercial relationship (so that the buyer knows what to expect) or at the time the supplier wants to start using these standards. This conclusion is definitely the case if the supplier sets the demand that the buyer can only "go live" with its online store after the supplier has approved the online store.[64] It is not allowed to impose a restriction with the purpose of considerably reducing the total volumes of the online sales, for instance, so that the volumes correspond to the demand from customers in certain territories or the demand from certain customer groups.[65]

The use of language options in online stores is a relevant change for distribution systems in which a territory is exclusively allocated to a buyer. In the Guidelines 2010, the option of choosing between languages in an online store was still considered to be part of the passive sale.[66] The VBER 2022 reversed this assumption.[67] For example, they provide that if there is exclusive distribution and the buyer uses languages in its online store that are not spoken in the buyer's exclusive territory, this situation generally indicates active selling and can therefore be restricted. However, this assumption is not made if an English language option is offered.[68] Other forms of active sale are targeted advertising and promotions. This will be the case with online advertising if it is possible for the advertiser to target potential customers by their geographic location. By contrast, it will not be the case if advertising can also be seen by potential customers located in territories exclusively allocated to other distributors, and it is not possible to mask such advertising.

As for the other sales channels, the Commission states expressly that suppliers are allowed to impose a direct or indirect ban on the use of online marketplaces. This statement is in line with the *Coty* judgment.[69] In addition,

63. Guidelines 2010, no. 56; Guidelines 2022, no. 235.
64. District Court Midden Nederland 03 Dec. 2014, ECLI:NL:RBMNE:2014:6156.
65. Guidelines 2022, no. 204(d).
66. *Id.*, no. 52.
67. VBER 2022, art. 1(1).
68. Guidelines 2022, no. 213.
69. *Id.*, no. 208.

restrictions may be imposed on online advertising, so long as they do not have the object of preventing the use of an *entire* advertising channel by the buyer.[70] Although this rule does not concern a manufacturer's own sales channel, such a ban may have as its object to prevent certain customers from being able to find the online store of the buyer. According to the Commission, a vertical agreement that restricts one of these channels and de facto prohibits the buyer from using the Internet to sell the contract goods or services has, at the very least, the object of restricting passive sales to end users wishing to purchase online.[71] This outcome also means that not all price comparison sites and search engines can be prohibited. A seller is allowed to prohibit some specific sites like these, as long as the buyer retains a realistic option of using other advertising channels. It is also possible to impose quality standards. The Commission, however, states expressly that prohibiting the use of the most widely used advertising services in the particular online advertising channel may amount to a hardcore restriction, if it is probable that the remaining services in that advertising channel cannot reach the potential customers of the buyer.[72]

What is new is that the Commission clarified in the Guidelines 2022 that "dual pricing" may be permitted under the VBER 2022.[73] This means that suppliers can apply a wholesale price that is (often) higher for products that are sold online by their buyers than the price used for products that are sold offline. In the VBER 2010, such dual pricing was still treated as a hardcore restriction.[74] The reason behind the prior rule was that in 2010 the Commission considered it necessary to protect the online sales of goods and to create a level playing field for online and offline sales.[75] In 2022, this prohibition is no longer necessary.[76] Of course, it will differ per product type and sector, but it can be assumed that the costs of operating a brick-and-mortar shop will often be significantly higher than the costs of running a web shop. Online providers can "free ride" on the "pre-sales services" of retailers with a brick-and-mortar shop. This situation creates an imbalance in the relationship between sellers engaging mainly in offline sales and parties that are mainly selling online. This is why the Commission no longer designates such a restriction as "hardcore." According to the Commission, dual pricing may incentivize or reward an appropriate level of investments in online or offline sales channels. However, this result assumes that such a difference in pricing does not have the object of restricting sales to particular territories or customers, or to prevent that the Internet can be used as a sales channel, or to limit the quantity of products made available to the buyer for sale online. The Commission states that the difference in pricing must be reasonably

70. *Id.*, no. 206(g).
71. *Id.*, no. 203.
72. *Id.*, no. 206.
73. *Id.*, no. 209.
74. Guidelines 2010, no. 52(d).
75. *Id.*, no. 52(d).
76. Guidelines 2022, no. 209.

related to differences in the investments and costs incurred by the buyer to make sales in each channel.[77] For example, a supplier cannot keep the prices of products sold online so high as to be sold at a loss or have the object of restricting sales to particular territories or customers. The Commission has left it to the market parties to assess which price difference is proportionate. There is no pre-pricing justification required; rather, suppliers will have to be able to justify a price difference in retrospect.[78]

Much of the retail sector has welcomed this change with cheers.[79] After all, this change will entail better protection of offline sales channels and can make it worthwhile to keep investing in brick-and-mortar shops. That paradigm befits current market developments, in which the physical retail sector was hard hit in the Covid-19 pandemic, whereas e-commerce has flourished, or has at least remained upright during that period.

2. Dual Distribution

In the run-up to the final version of the VBER 2022, the concept of dual distribution stirred up discussion among suppliers, distributors, and retailers.[80] Dual distribution refers to the scenario where a supplier not only sells goods or services directly to its independent buyers, but also competes with these parties. The most common variant is a supplier that sells to distributors, franchisees, and/or agents, and also sells directly to end buyers through its own stores and/or an online store.

The debate focused mainly on the exchange of information.[81] Under the VBER 2010, dual distribution was exempt if the supplier was active at the upstream level as a manufacturer, importer, or wholesaler and at a downstream level as an importer, wholesaler, or retailer of goods, while the buyer sold the contract goods at the downstream level and was not a competing undertaking at the upstream level where it bought the contract goods.[82] The VBER 2010 assumed that the retailer is not active at wholesale level, that any potential impact on the competitive relationship between the manufacturer and retailer at the retail level is of lesser importance than the potential impact of the vertical supply agreement on competition in general at the manufacturing or retail level.[83] In other words, the fact that the supplier itself also operates at retail level does not basically change the vertical

77. *Id.*

78. *Id.*

79. This follows also from the submissions in the consultation. *See* EU Competition Rules on Vertical Agreements–Evaluation, European Commission, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/1936-EU-competition-rules-on-vertical-agreements-evaluation_nl (last visited Feb. 12, 2023).

80. *Additional Public Consultation on Proposed Guidance Relating to Information Exchange in the Context of Dual Distribution, Intended to Be Added to the Vertical Guidelines*, European Commission, https://competition-policy.ec.europa.eu/public-consultations/2021-vber_en (last visited Feb. 12, 2023).

81. *Id.*

82. Guidelines 2010, no. 28.

83. *Id.*

nature of the supply relationship between these two parties.[84] Thus, the ban on exchanging information was limited to sharing plans about future prices, margin, quantities of products, and where or to whom the competitor will be selling, which might lead to resale price maintenance and/or market partitioning.[85]

Sharing competition-sensitive information is potentially problematic between (potential) competitors, as it may eliminate competition.[86] Concerted market practices may take away the incentive to be cheaper, better, and more innovative. The Commission considered the sharing of information in the context of dual distribution to be a false positive and intended to restrain the sharing of information further.[87] For that reason, Article 2(4), points a and b, of the *draft version* of the VBER 2022 provided that dual distribution would only be exempted if the market share of the supplier and the buyer would not be higher than ten percent.[88] If the market share exceeded ten percent but was below the thirty percent market share, the exchange of information could still fall under the exemption, but should be reviewed under the rules in place for horizontal exchange of information.

This proposed change caused an unfavorable reaction from the marketplace.[89] Following a new consultation round, it was eventually decided not to include the thresholds mentioned above.[90] However, the Commission did clarify in which dual distribution situations the sharing of information is probably fine and in which situations it is not. In the recitals to the VBER 2022, the Commission specifies that the exchange of information is only permitted "where the information exchange is *both* directly related to the implementation of the vertical agreement *and* necessary to improve the production or distribution of the contract goods or services."[91] However, Article 2(5) of the VBER 2022 reads as follows:

> The exceptions set out in paragraph 4, points (a) and (b) shall not apply to the exchange of information between the supplier and the buyer that is either not directly related to the implementation of the vertical agreement or is not necessary to improve the production or distribution of the contract goods or services, or which fulfils neither of those two conditions.[92]

The wording of this particular article is a bit complex and disconnected from the explanation that the Commission offered regarding its intent.

84. VBER 2010, art. 2(4).
85. Resale price maintenance is a hardcore restriction. *See* VBER 2010, art. 4(a).
86. EU Guidelines on the Applicability of Article 101 of the TFEU to Horizontal Co-Operation Agreements, 2011 O.J. (C 11) 1.
87. VBER 2010, art. 4(a); Guidelines 2010, no. 28.
88. VBER 2022 (draft), art. 2(4).
89. *Additional Public Consultation on Proposed Guidance Relating to Information exchange in the Context of Dual Distribution, Intended t o Be Added to the Vertical Guidelines*, European Commission, https://competition-policy.ec.europa.eu/public-consultations/2021-vber_en (last visited Feb. 12, 2023).
90. Guidelines 2022, nos. 88–103.
91. VBER 2022, recital 13 (emphasis added).
92. *Id.*, art. 2(5).

The recitals of the VBER 2022[93] indicate these two cumulative conditions: "where the information exchange is both directly related to the implementation of the vertical agreement and necessary to improve the production or distribution of the contract goods or services."[94] In the Guidelines 2022, the Commission mentions "to fulfil the two conditions," and repeats the text of the article.[95]

The new rules for dual distribution will lead to an increase in having to conduct self-assessments. The contracting parties will have to decide for themselves whether the exchange of information is permitted according to the starting points and criteria in the Guidelines 2022. The Guidelines 2022 contain both a list of examples that are deemed to be covered by the safe harbor and a list of examples that are generally not covered by it.[96] For instance, the exchange of information on technical or logistical information and information about marketing and promotional campaigns falls under the exemption.[97] Similarly, information relating to customer purchases, customer preferences, and customer feedback also satisfies the exemption, provided that such information is not used to restrict the territory into which or the customers to whom the buyer may sell.[98] The same goes for information on marketing and promotional campaigns and information on performance achieved.[99] There, the Commission gives the example of aggregated information communicated by the supplier to the buyer relating to the marketing and sales activities of other buyers, provided that this does not enable the buyer to identify the activities of particular competing buyers.[100] Exchanges of information that are generally not permitted concerns, for example, the sharing of future downstream sales prices, or information relating to identified end users (unless this sharing is necessary to implement or monitor compliance with a selective distribution agreement or an exclusive distribution agreement).[101] The same goes for information relating to goods sold by a buyer under its own brand name exchanged between the buyer and a manufacturer of competing branded goods, unless the manufacturer is also the producer of those own-brand goods.[102]

The self-assessment remains a tall order that will not always result in the desired certainty. Parties often will need to seek the help of a lawyer and/or take precautions to ensure staying on the side of caution, with the goal of limiting the risk that exchanging information will be treated as burdensome to competition. The Commission gives the following examples of

93. *Id.*, recital 13.
94. *Id.*, recital 12.
95. Guidelines 2022, nos. 96, 101, 102.
96. *Id.*, nos. 99, 100.
97. *Id.*, no. 99.
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.*, no. 100.
102. *Id.*

measures that parties can take: exchanging information in aggregated form or installing firewalls to ensure that information communicated by the buyer is accessible only to the personnel responsible for the supplier's upstream activities.[103] Of course, it is doubtful whether these approaches are desirable and feasible, and the use of such precautions cannot bring information exchanges within the safe harbor that would otherwise fall outside the scope of that exemption.[104]

Not without logic, the Commission clarifies that it may depend on the distribution model whether exchanged information is covered by the safe harbor.[105] The Commission refers not only to exclusive distribution and selective distribution, but also to franchising for which it may be necessary "for the franchisor and franchisee to exchange information relating to the application of a uniform business model across the franchise network."[106]

3. Agency

In recent years, suppliers have increasingly used agency in various sectors, especially in e-commerce, when they implement an omnichannel strategy: an integrated approach of online and offline sales. Where there is agency within the meaning of competition law, the selling or purchasing function of the agent is deemed to form part of the principal's activities.[107] As a result of this qualification, the entire agreement eludes the effect of Article 101 of the TFEU.[108] In that case, there is *genuine* or *true* agency. The presence of a genuine agency relationship means that the principal can impose all sorts of sales restrictions that would otherwise qualify as hardcore restrictions. Examples are the setting of resale prices to be used by the agent (with a ban on using its own commissions to lower the prices), or a general ban on using the Internet as a sales channel.[109]

Agency within the meaning of competition law must be distinguished from the civil-law variant in the EU Commercial Agency Directive[110] as implemented, for example, in the Netherlands Civil Code. Under the civil-law variant, the agent may bring leads and/or conclude agreements in the name of and for the risk and account of the principal, but may never conclude agreements on behalf of the principal in its own name. Agency within the meaning of competition law may also involve a commission agent (e.g., so-called "undisclosed agency"). There, the agent has the mandate to act on

103. *Id.*, no. 103.
104. *Id.*
105. *Id.*, no. 98.
106. *Id.* The assessment of franchise agreements are addressed at numbers 85–87, 165–69, 174, 197(b), of the Guidelines 2022. The conclusions about franchising are largely consistent with earlier guidance based on ECJ 28 Jan. 1986, 161/84, Pronuptia Case can be found at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A61984CJ0161.
107. ECJ CEPSA II, 11 Sept. 2008, C-279/06.
108. Guidelines 2022, nos. 29–46.
109. *Id.*, no. 41.
110. Council Directive 86/653/EEC of 18 Dec. 1986 on the Coordination of the Laws of the Member States Relating to Self-Employed Commercial Agents, 1986 O.J. (L 382).

behalf of and for the risk and account of the principal, but the agent concludes agreements in his own name with customers.[111]

Genuine agency under competition law is subject to the following rules. The framework set out in the Guidelines 2022 for the purpose of determining whether an agency agreement exists is updated and elaborated on from the Guidelines 2010. However, the decisive factor remains the same and is whether the agent bears any or only insignificant financial or commercial risk.[112] If the agent bears no significant financial or commercial risk in connection with the contracts that the agent concludes or negotiates on behalf of the principal, the relationship between an agent and the principal can be designated as a relationship in which the agent no longer acts as an independent economic undertaking. This is a codification of the *CEPSA I* and *II* judgments, and this concept was already included in the 2010 Guidelines.[113]

The Guidelines 2022 contain a few important changes compared to the Guidelines 2010. For example, the Guidelines 2010 provided that it is not material for the assessment "whether the agent acts for one or several principals."[114] The Guidelines 2022 state expressly that this qualification is less likely if the agent acts on behalf of "a large number of principals."[115] For that reason, agreements between undertakings operating in the online platform economy generally do not meet the conditions to be designated as a genuine agency agreement.[116] In addition, undertakings active in the online platform economy typically make significant market-specific investments, indicating that those undertakings bear significant financial or commercial risks associated with the transactions that they intermediate.

An important nuance occurs when the agent may temporarily, for a very brief period of time (e.g., by way of a "flash title"), acquire the property in the contract goods while selling them on behalf of the principal. That circumstance does not preclude the existence of a genuine agency agreement that falls outside the scope of cartel ban.[117] In addition, the Guidelines 2022 provide an extensive framework a principal may use to cover the relevant risks and costs in order to ensure that the agent does not bear any significant risks.[118]

As already included in the VBER 2010, the agent cannot own the products sold, or bear any risk for stock, showrooms, or credit risk.[119] The VBER 2022 clarifies the requirement that dual agency is not permitted.[120] Dual

111. Guidelines 2022, 3.2, no. 29

112. *Id.*, nos. 29–46.

113. Guidelines 2010, nos. 12–21; Case C-217/05, Confederación Espanola de Empresarios de Estaciones de Servicio v. CEPSA, 2006 E.C.R. 784; Case C-279/06, CEPSA Estaciones de Servicio SA/LV Tobar e Hijos SL, 2008 E.C.R. 485.

114. Guidelines 2010, no. 13.

115. *Id.*, no. 30.

116. Guidelines 2022, no. 46.

117. *Id.*, no. 33(a).

118. Guidelines 2010, nos. 32–36.

119. *Id.*, no. 33(a), (c), (d), (g).

120. *Id.*, nos. 3(c), 33(h).

agency is a scenario in which the agent, besides acting as an agent for the principal, is also active in the same product market for his own account and risk.[121] In the context of e-commerce and omnichannel,[122] dual agency is much more common than in the past, which had prompted certain market actors to request a more detailed elaboration. During the revision of the VBER 2010, the Commission already published a working paper on dual agency.[123] This working paper clarifies that the coexisting of those forms of collaboration is possible in theory, provided that two kinds of activities can be delineated.[124]The working paper deals with the scenario in which a supplier is already collaborating with a distributor, who is also appointed as an agent to sell another product or products that present distinct characteristics, such as higher quality, novel features, or additional functions, so-called "differentiated products."[125] These characteristics should make it possible to distinguish objectively between activities covered by the agency agreement and activities covered by the distribution agreement. This distinction is relevant because all risks associated with sales under the agency agreement must be borne by the principal.[126] The risk of dual agency is precisely that it is often hard to make this distinction, especially if the agent/distributor performs these activities on the same product market. The competition-law risk that occurs, which is also known as the "spill-over effect," is that the agent, when he has to take certain decisions as a distributor, will possibly be influenced by the information that was provided or the obligations that were imposed in the scope of the agency agreement.[127] This risk will be especially present where the situation concerns information or instructions about the pricing of the products.

The relevant parts of the aforementioned working paper were largely copied in the Guidelines 2022.[128] The conclusion also was repeated that generally—the less interchangeable the products sold under the agency agreement and the products sold independently by the agent, the less likely it is that the objections mentioned above will arise.[129] Naturally, this determination will depend on the facts and circumstances of the case and will have to be assessed case by case. The authors suspect that, given these clarifications, it will not be easy for suppliers using dual agency to apply this rather artificial divide and to collect sufficient evidence that their agency relationship is still "genuine."

121. *Id.*, nos. 3(c), 33(h), 36–40.

122. Omnichannel means sales to consumers in a connected marketplace (e.g., via online and offline sales or a combination thereof).

123. *See also* European Commission, *Distributors That Also Act as Agents for Certain Products for the Same Supplier*, *available at* https://ec.europa.eu/competition/consultations/2018_vber/working_paper_on_dual_role_agents.pdf.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. Guidelines 2022, nos. 36, 38.

129. *Id.*, no. 38.

4. Online Intermediation Services

When a vertical agreement has been concluded by an undertaking that is active in the online platform economy, the question is whether this agreement relates to the provision of online intermediation services. As mentioned above, vertical agreements entered into by undertakings active in the online platform economy generally do not meet the requirements of a genuine agency agreement falling outside the scope of the cartel ban.[130]

The question is thus whether these services are *online intermediation services*. This definition is new in the VBER 2022. The definition was derived from Regulation (EU) 2019/1150 of the European Parliament and of the Council of the European Union and adapted in such a way that the definition also refers to undertakings and comprises both online intermediation services that facilitate direct transactions between undertakings and direct transactions between undertakings and final consumers.[131] Examples of online intermediation services are e-commerce marketplaces, app stores, price comparison sites, and social media services.[132]

To be designated as a provider of online intermediation services, an undertaking has to facilitate *direct* transactions between two other parties.[133] It makes no difference to this qualification if the undertaking collects payments for transactions that it intermediates. Besides, the offering of additional services, such as advertising services or insurances, does not prevent an undertaking from being designated as a provider of online intermediation services, and this vertical agreement still can rely on the safe harbor.[134]

An undertaking that provides online intermediary services will be designated as a *supplier*. An undertaking that offers goods or services via online intermediary services will be designated as a *buyer* in respect of those online intermediary services. These designations affect how the VBER 2022 is applied to the contractual relationships between platforms and their contractual counterparts.

Article 2(6) of the VBER 2022 provides that the safe harbor does *not* apply if the provider of online intermediary services fulfills a "hybrid function."[135] This circumstance occurs when the provider is also a competing undertaking in the relevant market for the sale of the intermediated goods or services.[136] The logic behind this concept is that these providers serve a large number of resellers, may enjoy network effects (amount of transactions, users, value of transactions may be relevant), make sizeable investments and bears risks (potentially much higher than the price of the goods

130. *Id.*, no. 46.

131. Regulation (EU) 2019/1150 of the European Parliament and of the Council of June 20, 2019, on promoting fairness and transparency for business users of online intermediation services, 2019 O.J. (L 186).

132. Guidelines 2022, no. 64.

133. *Id.*, no. 65.

134. *Id.*, no. 66.

135. VBER 2022, art. 2(6).

136. Guidelines 2022, no. 104.

sold on these platforms), have economic bargaining power and may have the option of favoring their own sales over third parties that use their platform services.[137] In such cases, the agreement requires individual testing against Article 101 of the TFEU.[138]

5. Retail Parity Obligations

The rules for "retail parity obligations" (sometimes called "most favored nation/customer clauses") were also scrutinized. These are clauses in which (in most cases) a provider of online intermediary services (i.e., the platform) requires a seller of goods or services not to offer those goods or services to another party on more favorable conditions via certain other channels. These conditions may concern prices, inventory, or availability.[139] Several variations are imaginable. For example, the Guidelines 2022 make a distinction between wide, narrow, or across-platform retail parity obligations.[140] In short, wide retail parity obligations require the seller to offer the product or service at no other sales channel on more favorable conditions.[141] This, for example, may concern both the seller's own sales channels ("narrow") and the sale via competing providers of online intermediary services ("across platform"). The scope of narrow retail parity obligations is limited to the direct sales channels of the seller.[142] Across-platform retail parity obligations do not allow buyers of online intermediation services to offer goods or services to end users on more favorable conditions via competing online intermediation services.[143]

The use of such clauses has greatly increased over the past years because they allow platforms to protect their business model.[144] This clause is a way to prevent companies from "free riding" on the services of the platform or that a sale is eventually concluded directly with the supplier or via a competing platform.[145] The platform also remains more competitive because it can offer customers the lowest price. There are therefore pro- and anti-competitive effects.[146] The Guidelines 2022 elucidate that across-platform retail parity obligations are more likely than other types of parity obligations to produce anti-competitive effects.[147] Such clauses may soften competition and facilitate collusion between providers of online intermediation services. Moreover, they may foreclose entry by new providers of online intermediation

137. *Id.*; *see, e.g.*, nos. 46, 208, ECJ 10 Nov. 2021, Google Shopping T 612/17.
138. If not block exempted, an assessment of the agreement/clause that appreciably restricts competition against the criteria of TFEU article 101(3) is necessary to determine whether it is prohibited or permitted.
139. Guidelines 2022, no. 356.
140. *Id.*, nos. 253–55, 356–78.
141. *Id.*, no. 358.
142. *Id.*, nos. 369–71.
143. *Id.*, nos. 358, 360–68.
144. *Id.*, no. 372.
145. *Id.*
146. *Id.*, nos. 253–55, 356–78.
147. *Id.*, nos. 360–68.

services.[148] Therefore, the VBER 2022 excludes from the block exemption all "across-platform retail parity obligations," as far as they concern sales to end users (retail).[149] If a provider of online intermediation services makes the offering of a more favorable commission rate to competing platforms subject to the condition that the seller also propose those favorable rates to the provider, it is not exempted under the VBER 2022, but the remainder of the agreement may still benefit from the VBER 2022 provided that the parity clause is severable from the agreement.

Conclusion

The run-up to the new VBER 2022 was a long and elaborate process in which feedback from stakeholders was collected and analyzed and a consultation round was held. After an additional consultation round regarding the exchange of information in the scope of dual distribution, the framework of the 2010 VBER has mainly remained intact. However, the VBER 2022 and Guidelines 2022 add important nuances, clarifications, and additional exceptions. These were necessary, in particular, as a result of developments in the field of e-commerce, the rise of the platform economy, and a few important judgments rendered by the ECJ in recent years.

Regarding franchising, the situation seems to have stayed largely the same. Provided they are necessary to protect the know-how and the common identity and uniformity of the franchise system, several standard clauses in franchise agreements, such as purchasing obligations and non-competes during the term of the franchise agreement, are regarded as falling outside the cartel prohibition.[150] Other restrictions, such as post termination non-compete clauses, fall within the safe harbor of the VBER if they meet the applicable conditions regarding market share thresholds. Other categories are hardcore and prohibited in most circumstances, such as, for example, resale price maintenance (including MAP clauses), restrictions on using the Internet to sell to end users, restricting cross-sales between authorized distributors/resellers in a selective distribution system, and restricting passive sales, for example, outside an exclusively allocated territory. For any franchise (distribution or agency) network that is active in the EU and European Economic Area and engages in any form of online sales or advertising, or concludes agreements with or sells via Internet platforms (online intermediation services), or plans to engage in such activities, the 2022 VBER and Guidelines are a *must-read.*

An important change concerns Internet restrictions. For example, the VBER 2022 now provides expressly that suppliers may set certain demands on Internet sales, as long as this does not prevent buyers from "effectively using the Internet" to sell goods or offer services. It is not known whether

148. *Id.*
149. VBER 2022, art. 5(1)(d).
150. *See supra* note 106.

this change was intended to add a nuance to the *Pierre Fabre* judgment in which it was held that a direct or indirect absolute ban on resale via the Internet is not allowed under the VBER 2022. It is important that restrictions may be imposed on online advertising, as far as these do not have the object of preventing the use of an entire advertising channel. According to the Commission, a vertical agreement that restricts one of these channels and de facto prohibits the buyer from using the Internet has the object of restricting passive sales to end users wishing to purchase online. In addition, the *Coty* judgment was codified in the Guidelines 2022, by including the provision that it is exempted to impose a direct or indirect ban on the use of online marketplaces. Another relevant aspect is that the definitions of passive and active sales in the online context have been clarified. The main point here is the targeting by the website or online offer, making the language and wording of the website very relevant. If there is exclusive distribution, the buyer may be contractually restricted from using languages that are not spoken in the exclusive territory allocated to him. Other forms of active sale are targeted advertising and promotions. Dual pricing—a supplier charging products or services to retailers at offline and online price differences—is exempted, provided that this can be justified from a costs perspective.

The new rules seem to be particularly stricter for dual distribution and dual agency. Nevertheless, after an extra market consultation had been organized, a compromise seems to have been found specifically on dual distribution, which does give market parties some clarification about the exchange of information in this context without squeezing suppliers into a too tight straitjacket. It was widely welcomed that franchise relationships were mentioned as a situation where the exchange of information may be "*necessary to improve the production or distribution*" and thus benefit from the safe harbor as it would relate to the application of a uniform business model across the franchise network. Of course, it will depend on the franchise system, the type of data, and precisely what data is permissible to share between a franchisor and a franchisee. The lists of data mentioned in the Guidelines 2000 that are usually permitted to be shared will be helpful in practice, and not future pricing, for example, for which it will be difficult to find a justification. It is also important to realize there is rarely to never a justification to facilitate or allow franchisees (who often are or can easily become competitors) to share competition sensitive data such as on pricing, quota, or commercial strategy.

The clarifications regarding dual agency, however, seem to give little additional room, although this seems to have been intentional. In the authors' opinion, little extra room has been created to apply actual agency in scenarios where the agent also sells products for its own account and risk in the same product market. However, it is possible that dual genuine agency may be applied in certain sectors, where differentiated products play a significant role.

The most drastic changes relate to undertakings operating in the online platform economy. A platform that provides online intermediation services while it is a competing undertaking in the relevant market falls outside the scope of the safe harbor. Besides, vertical agreements that are entered into by such undertakings will generally not meet the conditions to be categorized as agency agreements under competition law. Across-platform retail parity obligations have already been evaluated by various authorities and courts within the EU, with different outcomes.[151] Although they may still remain too strict for some market parties, the VBER 2022 and Guidelines 2022 do probably offer a welcome clarification in this respect excluding from the safe harbor only across platform retail parity obligations (e.g., restrictions offering more favorable conditions on competing platforms).

Changing regulatory environment is not new for platforms and other digital service providers, and these sets of regulations will not be the last. The Digital Services Act (effective in 2024)[152] and the Digital Markets Act (effective in 2023)[153] will impose more restraints on platforms and digital service providers.[154] The Commission also launched several investigations into the conduct of some large platforms.[155]

Will all of this be relevant to franchise networks? Not only do many franchise networks prescribe if and how the Internet can be used by their franchisees, but also some franchise networks operate a website or platform that facilitates transactions between franchises and customers. It is possible that a franchisor thus operates as an Internet platform in the eyes of the European law. It will be interesting to monitor the development of these new regulations and of current matters in the time to come.

151. *See, e.g.*, BGL (Holdings) Ltd. v. Competitions & Mkt. Auth., [2022] CAT 36 (UK).

152. Regulation (EU) 2022/2065 of the European Parliament and of the Council of 19 Oct. 2022 on a Single Market for Digital Services and Amending Directive 2000/31/EC (Digital Services Act), 2022 O.J. (L 277).

153. Regulation (EU) 2022/1925 of the European Parliament and of the Council of 14 Sept. 2022 on Contestable and Fair Markets in the Digital Sector and Amending Directives (EU) 2019/1937 and (EU) 2020/1828 (Digital Markets Act), 2022 O.J. (L 265).

154. European Commission Press Release IP/20/2347, Europe Fit for the Digital Age: Commission Proposes New Rules for Digital Platforms (Dec. 15, 2020).

155. *See, e.g.*, European Commission Press Release IP/21/2061, Antitrust: Commission Sends Statement of Objections to Apple on App Store Rules for Music Streaming Providers (Apr. 30, 2021); European Commission Press Release IP/22/394, Protecting Consumers from Misleading Reviews: 55% of Screened Websites Violate EU Law (Jan. 22, 2022).

Protecting Goodwill in New Zealand: Franchise Agreement Clauses Affecting Real Estate and Restraining Competition

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New Zealand, which is located in the southwestern Pacific Ocean, has a highly developed free-market economy. Its population was 5,127,400 as at September 2022[1], it is the fiftieth-largest national economy in the world when measured by nominal gross domestic product, and it has one of the most globalized economies in the world, depending heavily on international trade.[2] For these reasons, New Zealand represents a compelling potential market for foreign franchisors looking to expand internationally.

Despite the country's close alignment with Australia, there currently is no franchise-specific law in New Zealand that regulates offers and sales of franchises. There is also no law in New Zealand that regulates the relationship between franchisors and franchisees, unlike Australia.[3] As a general outline, New Zealand operates on a common law legal system with a constitutional framework inherited from the English legal system.[4]

As foreign franchisors set their sights on the country for expansion, either with direct franchisee relationships or through a master franchise arrangement, they should consider how they will protect their brand's goodwill once it has been established in the local economy.

In retail franchising, in local economies, consumers associate certain brands with types of real estate, sites, or locations. When a franchise

1. StatsNZ, https://www.stats.govt.nz/topics/population (last visited Jan. 23, 2023).
2. StatsNZ, https://www.stats.govt.nz/topics/gross-domestic-product (last visited Jan. 23, 2023).
3. For an overview of Australian franchise laws, see *Franchising Laws Including the Code*, Australian Competition & Consumer Comm'n, https://www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/about-franchising/franchising-laws-including-the-code (last visited Jan. 23, 2023).
4. *Legal History*, Teara, https://teara.govt.nz/en/law/page-1(last visited Jan. 23, 2023).

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agreement expires or is terminated, franchisors must decide whether to maintain their brand's presence in the local economy in which the franchisee operated.

To give the franchisor the most optionality upon expiration or termination of a franchise agreement, two clauses should be used in franchise agreements in New Zealand: (1) clauses affecting the real estate that are used to operate the franchised business; and (2) clauses restraining franchisees from engaging in competition with the brand during and after the term of the franchise agreement.

This article will discuss these clauses, how they should be used, and how they have been interpreted by courts in New Zealand under applicable local law. As in any situation where a client is taking actions outside of the home jurisdiction, it is imperative that when a franchisor seeks to expand to New Zealand, foreign lawyers should use a lawyer in New Zealand to help prepare their client's franchise agreements with terms that will have the highest likelihood of being enforced in New Zealand.

I. Real Estate Arrangements Available to Franchised Businesses Operating in New Zealand

Like most of the world, real estate can be owned, leased, sub-leased, or licensed. In New Zealand, it is most common for franchised businesses to be operated under a lease, with the lease being held either in the name of the franchisor or franchisee. All leases in New Zealand must comply with the Property Law Act 2007 (Property Law Act). In brief, the purpose of the Property Law Act is to restate, reform, and codify (in part) certain aspects of the law relating to real and personal property.[5]

In larger and more well-known franchise systems that have well-capitalized and seasoned franchisee operators, it is the author's experience that landlords in New Zealand are often willing to sign leases directly with franchisees. However, for most franchise systems, it is more common for landlords to require a guaranty from the franchisor, or to insist upon signing the lease directly with the franchisor, who in turn can sublease or license the premises to its franchisee.

II. Control of Premises Leased in New Zealand

Location can be one of the most determinative factors in the success or failure of a franchised business. Franchisors often devote substantial time, energy, and resources into identifying new development markets and in testing the viability of specific properties and locations that may be suggested by the franchisee during site selection. Upon expiration or termination of the

5. Property Law Act 2007, s 3. All citations are to the laws of New Zealand unless otherwise indicated.

franchise agreement, it is common for the parties to have competing interests when it comes to the real estate from which the franchised business is operated. Specifically, the landlord simply wants a paying tenant to continue. The franchisor may want control of the space, either to refranchise the location or to prevent the franchisee from attempting to compete against it. The franchisee, depending on their financial condition, may wish to control the space and rebrand, or it may wish to walk away from the location and avoid as much liability as possible.

It is therefore essential for the franchise agreement to cover obligations regarding the site on which the franchised business will operate. Putting aside what a landlord in New Zealand may require, some franchisors may want to take the lease and control the physical site while other franchisors do not want anything to do with the leasing of premises. Those franchisors would allow the franchisee to take a lease of premises from a landlord directly. In either arrangement, franchisors who are considering expansion in New Zealand should include their real estate strategy in their expansion planning.

A. *Sublease*

If the franchisor wishes to control the location of its franchised operations in the best and most effective way, it should take the head or primary lease from a landlord and have a direct relationship with that landlord.

When the franchisor is ready to appoint the franchisee to a specific location and in premises at that location, then it can either grant a sublease or a license to occupy the premises. In New Zealand, subleases are commonly granted by a lessor/sublessor for a term of one day less than the term of the lease,[6] and the franchisee will be invited to pay the rent directly to the landlord. If a sublease is entered into by the parties, the landlord normally would have to provide its written consent, but the franchisor would be primarily obligated to perform and abide by the covenants in the head lease.

The following is a sample of a lease provision that can be used by a franchisor with a landlord in New Zealand:

> *Subletting/occupation licence*
> (a) *The franchisor shall be entitled without consent of the landlord to grant to any franchisee of the franchise network either a licence to occupy or a sublease to occupy all of the premises.*
> (b) *Where the franchisor triggers either of its abovementioned rights, it shall prior to commencement of the licence/sublease:*
>   (i) *enter into and procure that its occupation licence holder/sublessee enters into an occupation rights document/sublease which document requires the occupation rights holder/sublessee to honour all of the obligations of the tenant under the lease; and*
>   (ii) *provide the contact details of the occupation licence holder/sublessee to the landlord.*

6. Property Law Act 2007, s 215.

(c) *The franchisor shall ensure that the landlord's reasonable costs associated with the franchisor exercising its rights are paid either directly or by the occupation licence holder/sublessee.*

B. *Leasing of Premises by the Franchisee*

If the franchisor does not wish to take the head lease in order to decrease its rental liability position, then it would arrange for the franchisee to take the lease from the landlord. In the author's experience, only when a brand is well known and has a track record will landlords usually agree to this arrangement, as most would prefer to have a franchised brand being the franchisor as the principal obligator under a lease.

If the franchisee is to take the lease of the premises directly, then the franchise agreement should include special clauses to cover the scenario of the franchisee being in breach of the franchise agreement. If the franchise agreement does not contain clauses that allow the franchisor to take over the lease or to have step-in rights, then the franchisor would lose the premises and the franchised location, and, as a result, its goodwill in the local market would be lost. It also may face a more arduous task of enforcing a covenant not to compete.

If the franchisee takes the head lease, the franchisor should insist on the inclusion of special terms in the lease to provide the franchisor with options upon a termination of the franchise agreement. In practice, these provisions may appear as follows:

Termination of franchise agreement: Notwithstanding anything to the contrary contained in this lease, the landlord, the tenant, and the franchisor agree that if the franchise agreement ("franchise agreement") between the tenant as franchisee and the franchisor (together with its successors and assigns) is terminated for any reason then the franchisor or its nominee shall have the right ("option") to take an assignment of this lease and the following provisions shall apply:

(a) *The franchisor may advise the landlord of its intention to exercise the option and as soon as practicably possible following receipt of that correspondence, the landlord shall provide to the franchisor a full statement ("landlord's statement") setting out all funds and outstanding obligations owing by the tenant to the landlord. The franchisor shall then have thirty days after receiving the landlord's statement to exercise the option by written notice ("option notice") to the landlord and tenant.*

(b) *No assignment of this lease contemplated by the option notice shall take effect until the landlord has received payment of all rent and outgoings arrears (if any) and a deed of assignment of lease which deed of assignment of lease shall:*

 (i) *where the assignee/nominee is a company other than the franchisor, then as security for that assignee's/nominee's obligations under the lease, provide for either the personal guarantees of its directors or a bank guarantee for a sum equal to three months' rent*[7] *plus goods and services tax at the then current rental; and*

 (ii) *be executed by the franchisor (as assignee) and the tenant (as assignor) or as otherwise executed pursuant to these provisions.*

7. In the author's experience, three months of rent is the market expectation for a security deposit by landlords in New Zealand.

> (c) *As soon as practicable after receiving the deed of assignment of lease executed pursuant to special condition 1.1(b)(ii) above, the landlord shall execute the same and provide a copy to each of the franchisor and the tenant without delay.*
>
> (d) *For the avoidance of doubt, the franchisor shall not be obligated to procure personal guarantees in favour of the landlord as security for its obligations under the lease where it exercises the option.*

These types of clauses will give the franchisor a right to step in and operate the franchisee's business from the premises or appoint a new franchisee for the location upon expiration or termination of the franchise agreement. The franchisor should also review the entirety of the lease to confirm that its right to take over the lease under the franchise agreement is consistent with the provisions of the lease. When the franchisor "steps in" to the franchisee's lease and gains control of the premises, it may also want to take possession of the fixtures, fittings, and equipment left behind by the franchisee, subject to those assets being mortgaged or charged in favor of a lender. These issues should also be covered in the franchise agreement and lease, as well.

C. *Notice and Cure Clauses*

Clauses governing notice of a lease default and an opportunity for the franchisor to cure are critical if the lease is between the franchisee and the landlord and the franchisor desires to protect its brand in the location.

A notice clause provides the franchisor with the right to receive copies of all written communications from the landlord at the same time notices are sent to the tenant. In this way, the franchisor can monitor the tenant's compliance with its lease. Usually the notice provision will provide the franchisor with the opportunity to cure alleged defaults, but the cure right should be an option and not an obligation. If such cure is made by the franchisor, the lease should also state that the franchisor curing the default is not a general assumption of the lease obligations unless the franchisor expressly agrees to do so in writing. Franchisors will not step in to cure only technical defaults as they are obviously more concerned where there is a likelihood of the tenant's default resulting in a termination of the lease. The right to receive notice of default allows the franchisor to prevent the landlord from terminating the lease. By curing a default giving rise to termination, the franchisor may avoid eviction and the prospect of a replacement tenant capitalizing on the goodwill tied to the location.

D. *Post-Termination Obligations in the Franchise Agreement*

Many franchise agreements contain post-termination obligations that require the franchisee to assign the lease of the premises to the franchisor upon request. These clauses can be enforced in New Zealand if there is a lease that is capable of being assigned. If there is no lease, either because it has been terminated by the landlord or the franchisee is holding over after its expiration, then these clauses would be of no assistance to the franchisor.

In the uncommon circumstance in which the franchisee or its affiliate owns the underlying real estate, post-termination obligations can become complicated. In *Foodstuffs North Island Limited v. Ravla Trading Limited*,[8] a case decided in favor of a franchisor, the High Court at Gisborne enforced a provision in a franchise agreement that permitted the franchisor to purchase the franchisee's business and take over premises owned by the franchisee's family trust.[9]

Ravla Trading Limited (RTL) was a Four Square grocery franchisee in Gisborne, New Zealand.[10] The parties entered into a franchise agreement in 2008 in which Mr. Ravla was an approved operator and both Mr. Ravla and his wife were guarantors.[11] The parties entered into a further agreement in 2017 pursuant to which Mr. Ravla was again the approved operator.[12] The 2017 agreement included clauses prohibiting RTL from damaging the goodwill of Foodstuffs or being involved in a business that competed with Foodstuffs or the franchised business.[13] It also included a clause requiring RTL to obtain the prior written approval of Foodstuffs to sell the franchised business and a right of first refusal for Foodstuffs to purchase the business.[14]

When the 2008 agreement was signed, RTL held a lease of the premises.[15] Without the knowledge of Foodstuffs, in 2016, RTL purchased the building in which the leased premises was located.[16] In July 2019, RTL transferred ownership of the building into the Ravla Family Trust (Trust).[17]

In June 2019, RTL wrote to Foodstuffs, advising that Mr. Ravla was ill, and Mrs. Ravla was appointed to operate the business.[18] However, she wanted to operate an independent grocery store and accordingly RTL suggested a termination date of August 1, 2019.[19] Foodstuffs advised that it did not want to terminate the agreement and as RTL had no right to terminate it unilaterally, it had to sell the business to an approved purchaser.[20] Alternatively, it was interested in taking the head lease and operating the store.[21]

When Foodstuffs refused to consent to the proposal there was a period of silence from RTL during which time it was later discovered that the ownership of the premises had been transferred to the Trust.[22]

The case came before the High Court at Gisborne as an interim injunction application to restrain RTL and the Trust from taking any steps to transfer to any party the franchised business or any interest or right of

8. Foodstuffs N. Island Ltd. v. Ravla Trading Ltd., [2019] NZHC 2357.
9. *Id.* at [20].
10. *Id.* at [4].
11. *Id.* at [8].
12. *Id.* at [11].
13. *Id.* at [14].
14. *Id.* at [18].
15. *Id.* at [24].
16. *Id.* at [25].
17. *Id.* at [29].
18. *Id.* at [26].
19. *Id.*
20. *Id.* at [19] (b).
21. *Id.* at [27](d).
22. *Id.* at [29].

possession in respect of the premises.[23] As the opinion in the case explained, the criteria for granting an injunction in New Zealand is that a party would experience irreparable damage or injury without the injunction, and that there is a serious issue of law or fact that could warrant a potential court case and the granting of a permanent injunction.[24] Justice Ellis granted the injunction and was of the view that RTL's intention to transfer its business to a new entity was an anticipated breach of the agreement in that it was without the consent of Foodstuffs and without first offering it to Foodstuffs. Justice Ellis also said that the transfer of the premises by RTL to the Trust was for the purpose of avoiding its obligations under the franchise agreement and the Trust itself was a sham insofar as the transfer of the premises was concerned.[25]

As to the balance of convenience, Justice Ellis was of the view that there was little undue prejudice that might be suffered by RTL, whereas, by contrast, Foodstuffs would suffer damage to the goodwill of its brand and its goodwill at the premises if the provisions contained in the franchise agreement were not enforced.[26]

Although a reasonably uncommon set of facts, this case should be considered when drafting franchise agreements if there is any possibility that franchisees or their affiliates could own the real estate in which the franchised business will be operated. Specifically, this case counsels that franchisors who value the location of a particular site should own it or attempt to own it as that would give them ultimate control of the site. If that is not possible, then franchisors could take the headlease and offer a sublease to franchisees or allow franchisees to take the lease so long as franchisors have step-in rights, should the franchise be terminated.

III. Covenants Against Competition in New Zealand

It is essential for the franchisor to be protected from a terminated franchisee continuing the business in a similar vein from a new location. It is undoubtedly recognized in franchising[27] that it is reasonable for franchisees to enter into franchise agreements containing robust covenants against competition following the expiration of a franchise agreement through the effluxion of time or termination of a franchise for breach.

During the term of the franchise agreement, the franchisee is normally prevented from carrying on any competing business by contract. Further, the franchisee, as a practical matter, may also be prevented from carrying on any other business, as his or her full time and attention is critical to the success of the franchise business.

23. *Id.* at [33].
24. Klissers Farmhouse Bakeries Ltd v. Harvest Bakeries Ltd [1985] 2 NZLR 140 (CA).
25. *Id.* at [40] (c), (d).
26. *Id.* at [46].
27. Am. Bar. Ass'n, Covenants Against Competition (4th ed. 2022).

The franchise agreement will also almost invariably contain a restraint of trade that will apply to the franchisee following the termination or expiration of the agreement or the sale of the franchise business to a third party. The length and area provisions of the restraint will normally be set out in a schedule, and they will be subject to general legal principles governing restraints of trade.

As it relates to franchising, the courts have recognised that it is reasonable for a person in the position of the franchisor to impose a contractual restraint upon any competitive conduct by the franchisee. Contractual restraints of this type are known as "restrictive covenants" or "agreements in restraint of trade." Such agreements must not exceed the boundaries of the courts' notion of reasonableness. Two competing principles govern the courts' decision-making process. The first principle is that it is reasonable for a person to stipulate that if he or she is willing to disclose all secrets of how to establish a particular business enterprise, then the recipient of the information cannot immediately terminate the contract and set up a competitive business, using the information that it has received during the course of the educational process. If the courts did not provide protection to franchisors in such situations, there would be no incentive for the owners of established businesses to share their secrets with others and enhance their business skills.

The competing principle is that it is important for the well-being of the community that every individual should, in general, be free to advance his or her skills and earning capacity.[28] The way that these two conflicting principles are resolved is to require that a restrictive covenant must be "reasonable" in its terms before it will be enforced.

The current position in New Zealand is set out in section 83 of the Contract and Commercial Law Act 2017, which states as follows:

> (1) *The court may, if a provision of a contract constitutes an unreasonable restraint of trade,—*
>
> *(a) delete the provision and give effect to the contract as amended; or*
>
> *(b) modify the provision so that, at the time the contract was entered into, the provision as modified would have been reasonable, and give effect to the contract as modified; or*
>
> *(c) decline to enforce the contract if the deletion or modification of the provision would so alter the bargain between the parties that it would be unreasonable to allow the contract to stand.*
>
> *(2) The court may modify a provision even if the modification cannot be effected by deleting words from the provision.*[29]

What this means in practice is that if a franchise agreement provides for a three-year period of restraint when a two-year period would be considered to be reasonable, the covenant would be enforced to the extent that it

28. Deidre Watson, *Franchise Agreements and Penalty Clauses*, N.Z. L. Soc'y (May 4, 2018), https://www.lawsociety.org.nz/news/publications/lawtalk/issue-917/franchise-agreements-and-penalty-clauses.

29. Contract and Commercial Law Act 2017, s 83.

could be rewritten by the court as being confined to a two-year term. The ability of the courts to modify excessive restraints is constrained by the principle that terms that could never have been considered reasonable will not be modified. The reason for this is that it is contrary to public interest that a person should be able to intimidate a contracting party by stipulating for a wholly unreasonable constraint and then have the court come to its rescue and rewrite the contract so that it falls within the boundaries of reasonableness. This is the doctrine of restraints that are *in terrorem* (i.e., contracts that 'terrorise' a contracting party). If the franchisor could only ever have reasonably sought a two-year restraint within a five-kilometre radius of the business premises from which the person established goodwill, a nationwide restraint for six years could never be regarded as reasonable, and the courts would refuse to enforce a clause to implement the latter restraint, even if it was in the franchise agreement.

What then is a reasonable restraint? There are two factors: area and time. For a franchise that teaches making coffee and running a café, an area of restraint would typically be confined to the area in which the franchisee is likely to establish goodwill. A person who establishes a café in a city is likely to establish goodwill that extends perhaps 200 to 400 metres from the site. There are so many other competing cafés that the goodwill would not extend much further than that.

The duration of a restrictive covenant should be such as will enable the franchisor to interpose a new operator who will have a reasonable time to secure the retention of the customers. In the case of a café, it is unlikely that this will extend beyond two years.

A recent case involving restraints and their impact on premises of franchised locations is *Mad Butcher Holdings Limited v. Standard 730 Limited & Ors.*[30] This case relates to the enforceability of restraint of trade clauses in relation to the Mad Butcher franchise system.

Standard 730 Limited, as the franchisee, had been the franchisee of the Mad Butcher franchise system at Whangarei since 1987, and the franchise agreement came to an end on January 4, 2019.[31] Mr. Wightman, a representative of the franchisee, initially indicated to Mad Butcher that he intended to set up a butcher's training school post-termination.[32] However, on January 7, 2019, he advised the franchisor that instead he would continue to trade as an independent butcher.[33]

Mr. Wightman had by then arranged with the landlord to stay in the premises on a monthly tenancy after the lease expired.[34] After the franchisee commenced trading as an independent butcher, the franchisor filed legal

30. Mad Butcher Holdings Ltd. v. Standard 730 Ltd. & Ors [2019] NZHC 589.
31. *Id.* at [2].
32. *Id.* at [12].
33. *Id.*
34. *Id.*

proceedings seeking an interim injunction to restrain the franchisee from trading.[35]

The franchisee argued that he was not in breach of the restraint of trade clause because there was no other Mad Butcher franchise store in the Whangarei area and he was not in competition with the franchisor.[36] He said that the franchisor had no intention of establishing another Mad Butcher franchise in Whangarei and therefore there was no legitimate interest to protect in the Whangarei area.[37]

Justice Gault found there was a strong argument that the plain meaning of the restraint of trade clause was that it applied regardless of whether there was an existing Mad Butcher franchise store in the designated area.[38] The judge did acknowledge, however, that there was some force in the franchisee's alternative argument that the restraint could be unreasonable if the franchisor had no intention of competing or continuing business in the region.[39]

The judge also dealt with the issue of whether, if the franchisee was able to establish a breach by the franchisor that would have justified cancellation of the franchise agreement, the franchisee would not be bound to perform the ongoing restraint and he accepted that such a proposition was arguable and referred to *Health Club Brands Limited v. Colven Botany Limited & Ors*.[40]

As such, Justice Gault concluded that his initial impression was that the franchisee would have an uphill battle establishing breaches by the franchisor sufficient to release the franchisee from performing ongoing obligations in the franchise agreement; and he determined that the balance of convenience lay in favour of the franchisor, finding that damages would not necessarily be an adequate remedy for the franchisor.[41]

The franchisee subsequently filed an application for leave to appeal the interlocutory judgment issued by Justice Gault to the Court of Appeal and for a stay, which Mad Butcher opposed. At the hearing, the judge gave his reasons in more detail for an interim injunction and then looked at the argument for leave to appeal. The judge dismissed the application for leave to appeal and the previous orders were confirmed.[42]

How do the New Zealand Courts handle post-termination issues involving real estate? A good example is the case of *Supatreats Asia Pte Ltd. v. Grace & Glory Ltd*.[43]

35. *Id.* at [13].
36. *Id.* at [20].
37. *Id.* at [21].
38. *Id.* at [27].
39. *Id.* at [25].
40. Health Club Brands Limited v. Colven Botany Limited & Ors [2013] NZHC 428.
41. Mad Butcher Holdings Ltd. v. Standard 730 Ltd. & Ors [2019] NZHC 589 at [27].
42. *Id.*
43. Supatreats Asia Pte Ltd v. Grace & Glory Ltd [2018] NZHC 1612.

This case involved the Wendy's Sundae franchise.[44] The head franchisor advised the New Zealand master franchisee and all franchisees that they were wanting to change their approved supplier for ice cream.[45] The franchisor proposed to change to a new Australian supplier, away from the existing New Zealand supplier.[46] This was challenged by the master franchisee and the franchisees, and the master franchisee and franchisees treated the agreement as being at an end and set up a competing brand.[47] Individual franchisees purported to surrender their agreements and converted their stores to the new brand, Shake Shed.[48] Wendy's took action to restrain the master franchisee and the franchisees from these competitive activities.[49] After being served with interim injunction proceedings, the franchisees continued rebrand, with the effect that by the time of the hearing, most had rebranded from Wendy's Sundae to Shake Shed.[50]

One commentator explained that "materials put in evidence by the master franchisor supported the assertion that there was a marked similarity between the master franchisor's stores and the stores run by the franchisees under the new branding."[51] Most franchisees leased premises from their respective landlords, but the franchise agreements contained step-in rights. Individual franchisees had the option of continuing with the businesses under the Wendy's Sundae brand or exiting and allowing the franchisor to take over the lease using the step-in rights. With the master franchise agreement having been terminated, the master franchisor sought to enforce one of the post-termination provisions that all franchise agreements held by the master franchisee would need to be assigned to the master franchisor.[52] The master franchisor sought orders from the court seeking to restrain any of the defendants from trading as the new branded business.[53] The court found in favor of the master franchisor, ultimately finding that the others parties had breached their contract and had taken the act to rebrand while well-aware of the risks.[54]

This case showed the significance of having robust leases that contain step-in rights so that the franchisor could control the premises that, after all, were displaying the brand and logo of the franchisor.

44. *Id.* at [10].
45. *Id.* at [13].
46. *Id.*
47. *Id.* at [21].
48. *Id.*
49. *Id.* at [28].
50. *Id.*
51. Deidre Watson, *Good Faith in Franchising Part 2*, N.Z. L. Soc'y (Feb. 8, 2019), https://www.lawsociety.org.nz/news/publications/lawtalk/issue-925/what-is-good-faith-in-franchising-part-2.
52. Supatreats Asia Pte Ltd v. Grace & Glory Ltd [2018] NZHC 1612 at [44].
53. *Id.* at [81](a).
54. *Id.* at [74].

Conclusion

Since franchisors invest considerable time and money protecting their trademarks, logos, and brands which comprise goodwill, it is imperative that franchise agreements contain clauses affecting real estate that restrain competition from non-complying franchisees. Such terms are necessary to protect a franchisor's rights and intellectual property. But, like elsewhere, any covenants not to compete must be fair. If they are, the courts in New Zealand will have no problem enforcing such covenants and using Section 83 of the Contract and Commercial Law Act 2017 to achieve that purpose.

LADR Case Notes (August 2022–October 2022) and FLJ Currents (Winter 2023)

*Matthew S. DeAntonio, Matthew Gruenberg & Vanessa Wheeler**

AUGUST 2022 LADR CASE NOTE

***Core Progression Franchise LLC v. O'Hare*, 2021 WL 1222768 (D. Colo. Apr. 1, 2021), *aff'd*, 2022 WL 1741836 (10th Cir. May 31, 2022).**

A gym franchisor recently secured a preliminary injunction against its former franchisee prohibiting the franchisee from operating an independent gym on the same location and using the franchisor's trade secrets.

Chris O'Hare, along with his company, (O'Hare), was a former Core Progression gym franchisee. A few months after the opening of his Core Progression gym in North Carolina, O'Hare stopped paying the royalties and began to convert the Core Progression gym to an independent gym called Altru Fitness. The plaintiff Core Progression Franchise LLC (Core Progression) filed suit alleging that O'Hare breached the non-compete covenant in the franchise agreement and infringed on Core Progression's trademarks in violation of the Lanham Act. O'Hare alleged that the franchise agreement was unenforceable as it was induced by Core Progression's fraudulent representation of future profit. Core Progression filed a motion for preliminary injunction to prohibit O'Hare from operating an independent gym in the same location and continuing to use its trademarks and trade secrets. The U.S. District Court for the District of Colorado granted the preliminary injunction, and the decision was affirmed the Tenth Circuit.

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To obtain a preliminary injunction, the moving party must establish "(1) a substantial likelihood that the movant eventually will prevail on the merits; (2) that the movant will suffer irreparable injury unless the injunction issues; (3) that the threatened injury to the movant outweighs whatever damage the proposed injunction may cause the opposing party; and (4) that the injunction, if issued, would not be adverse to the public interest." *NRC Broad. Inc. v. Cool Radio, LLC*, 2009 WL 2965279, at *1 (D. Colo. Sept. 14, 2009). "As a preliminary injunction is an extraordinary remedy, the right to relief must be clear and unequivocal." *Schrier v. Univ. of Colo.*, 427 F.3d 1253, 1258 (10th Cir. 2005). The Tenth Circuit applies a heightened standard for "[d]isfavored preliminary injunctions." *Free the Nipple-Fort Collins v. City of Fort Collins*, 916 F.3d 792, 797 (10th Cir. 2019).

Based on the overwhelming evidence submitted by Core Progression, the district court found that it satisfied all elements for a preliminary injunction. Certain critical evidence stands out:

1. Likelihood of success on the merits: Core Progression alleged that Altru Fitness used its trademarks (e.g., Altru Fitness's profile online showed the Core Progression marks, the Google Maps result for Altru reads "Altru Fitness (formerly Core Progression)," and O'Hare subsequently stipulated to the preliminary injunction prohibiting him from using Core Progression's trademark. O'Hare did not dispute that he took steps to build a competing business out of the same location as the Core Progression gym, downloaded the customer list from the Core Progression database, and contacted customers to say that the gym was transitioning to a competing software while it was still a franchise of Core Progression. The district court and Tenth Circuit also found O'Hare's reliance on Core Progression's misrepresentations in entering the agreement to be unsupported by evidence.
2. Irreparable harm: the district court and Tenth Circuit agreed with Core Progression that O'Hare caused confusion in customers and damaged Core Progression's goodwill. At the time, Core Progression only had locations in Colorado. Core Progression's witnesses testified that O'Hare was its "boots on the ground" in North Carolina, received extensive training and assistances, and that O'Hare made it look like Core Progression "went to North Carolina and failed and was a fraud" by posting on Google Maps that Core Progression was a "fake franchise" in response to a customer's inquiry on the confusion as to whether this location was Altru Fitness or Core Progression.
3. Balance of harm: the non-compete clause prohibits O'Hare from operating a competing business within twenty-five miles of the franchised location within one year. The courts found this "temporary closure of Altru Fitness" (if O'Hare is unwilling to relocate) was "discounted by the fact that the defendant brought that injury upon itself."

4. Public interest: the court found Colorado statutes expressly permit such noncompete agreements; therefore, an injunction was not adverse to the public interest. E.g., Colo. Rev. Stat. Ann. § 8-2-113.

While whether to grant a preliminary injunction is a case-by-case analysis, this case provides valuable insights to both franchisors and franchisees as to how to make strategical plans when the latter considers exiting the system.

SEPTEMBER 2022 LADR CASE NOTE

***Planet Fitness International Franchise v. JEG-United, LLC*, --- F. Supp. 3d ----, No. 20-cv-693-LM, 2022 WL 4484477 (D.N.H. Sept. 27, 2022).** In the wake of a franchisor's changed business strategy for developing foreign markets, a large franchisee with hopes of developing the entire Mexico market for Planet Fitness gyms asserted claims against Planet Fitness International Franchise (Planet Fitness) and its Chief Development Officer after the parties failed to reach an area development agreement for any part of Mexico. On Planet Fitness's motion for summary judgment, the U.S. District Court for the District of New Hampshire examined what kind of development deal the parties would have made and how profitable that deal would have been for franchisee JEG-United, LLC (JEG-United) had the parties concluded such a deal. The court also considered whether any of the franchisee's efforts to develop the market might reasonably have resulted in contracts with third parties giving rise to a claim against Planet Fitness for tortious interference after the area development deal fell through.

In April 2017, Planet Fitness and U.S.-based JEG-United entered into a franchise agreement for a single Planet Fitness unit in Monterrey, Mexico. When they executed the franchise agreement, the parties also executed a side letter agreement granting JEG-United exclusive rights to certain municipalities within Monterrey and a right of first refusal to develop Planet Fitness franchises in Monterrey. The 2017 side letter agreement also discussed terms for an Area Development Agreement (ADA) for Mexico if the parties concluded an ADA deal by the end of 2018. JEG-United strongly hoped at that time to obtain an ADA for all of Mexico.

Soon after JEG-United opened its Monterrey unit in April 2018, Planet Fitness hired a new Chief Development Officer, Ray Miolla (Miolla), and modified its strategy for expanding into foreign markets, including Mexico. Planet Fitness shifted away from having U.S.-based franchisees develop foreign markets—a strategy Planet Fitness believed had not been successful in many markets. Planet Fitness decided to develop Mexico with U.S.-based JEG-United as well as a separate Mexico-based franchisee, offering JEG-United an ADA only for northern Mexico, which Planet Fitness believed could be developed by a U.S.-based company. Miolla targeted the Mexico-based Ibarra Group to develop central and southern Mexico.

Around the same time, JEG-United was looking for real estate opportunities for additional units in Mexico and, specifically, was in discussions with a Mexico-based grocery store chain, Soriana, about leasing Soriana properties for Planet Fitness locations within and outside of Monterrey. By June 2018, JEG-United had executed an agreement to lease property from Soriana for a second franchise unit in Monterrey. Discussions as to other properties remained at a "pretty high level." In late August 2018, Miolla corresponded with Carlos Ibarra of Ibarra Group to raise concerns about how JEG-United was handling the Monterrey lease deal with Soriana, and JEG-United asserted (though the evidence on this point was disputed) that someone at Planet Fitness told Soriana not to deal with JEG-United. By the end of 2018, Soriana was no longer engaging with JEG-United as to any other lease deals.

After receiving franchise presentations from both JEG-United and Ibarra Group in September 2018, Miolla told JEG-United that Planet Fitness was now talking with a second franchise applicant (Ibarra Group) and that Planet Fitness would consider negotiating an ADA with JEG-United for northern Mexico.

The April 2017 side letter agreement between Planet Fitness and JEG-United expired at the end of 2018 with no ADA in place between the parties. Continued negotiations for an ADA for Northern Mexico resulted in a second side letter agreement in March 2019. The March 2019 side letter agreement required the parties to negotiate in good faith consistent with a non-binding term sheet attached to the agreement. The agreement contemplated a development schedule of thirty franchises over eight years, but the term remained open for discussion. The 2019 side letter agreement also contained a put option allowing JEG-United to sell its Mexico franchises to Planet Fitness at book value if no ADA were reached.

In May 2019, JEG-United was in discussions with a Planet Fitness competitor to purchase five gyms in Mexico. JEG-United asked Planet Fitness to approve the negotiations under multiple potential purchase scenarios, including JEG-United purchasing and fully owning the gyms, JEG-United entering a joint venture with Ibarra Group to acquire the gyms, or Planet Fitness purchasing and operating the gyms. However, a strained dynamic between Planet Fitness and the competitor due to then-pending litigation meant that purchase negotiations did not progress.

Planet Fitness continued to negotiate ADA terms with JEG-United and Ibarra Group for their separate Mexico territories through the summer of 2019. In June, JEG-United and Planet Fitness were discussing the development schedule, with JEG-United requesting to change the schedule to twenty units over ten years. The parties ultimately agreed to a twenty-unit schedule, but continued to disagree about the timeframe.

The relationship between Planet Fitness and JEG-United's CEO had long since soured, and by late 2019 JEG-United believed that Planet Fitness preferred Ibarra to take the entire Mexico territory. JEG-United stopped engaging in ADA negotiations with Planet Fitness and began instead to pursue a joint venture with Ibarra Group. While JEG-United and Ibarra were discussing terms in principle, Miolla raised concerns to Ibarra that JEG-United would seek equal partnership in the venture. He made clear that Planet Fitness would require Ibarra to maintain majority control. JEG-United and Ibarra Group never concluded a joint venture deal. Planet Fitness ultimately concluded an ADA with Ibarra Group for all of Mexico.

In March 2020, JEG-United exercised its put option as to its Mexico franchises. Planet Fitness sued JEG-United in June 2020. JEG-United asserted counterclaims against Planet Fitness for breach of contract, breach of the implied covenant of good faith and fair dealing, tortious interference with prospective economic relationships, and violation of the New Hampshire Consumer Protection Act. On summary judgment, Planet Fitness challenged (among other things) JEG-United's lost-profits damages model for its breach of contract and implied covenant claims and argued that none of JEG-United's development activities generated a sufficiently certain expectation of any future contract to give rise to a tortious interference claim.

JEG-United's breach of contract and implied covenant claims—the substance of which was not challenged on summary judgment—asserted that Planet Fitness breached an obligation in the March 2019 side letter agreement to negotiate in good faith towards the execution of an ADA with JEG-United. JEG-United argued that the parties would have agreed to terms if Planet Fitness had negotiated in good faith. Its expert opined that JEG-United suffered lost profits between $46 million, if the ADA were limited to twenty units, and $232 million, if the ADA development schedule reached as many as 100 units.

So, what deal would the parties have made had both parties negotiated in good faith? The court found no evidence to suggest that the parties ever considered a 100-unit development schedule, and thus found JEG-United's $232 million claim too speculative to present to a jury. Conversely, the court found evidence that the parties were reasonably certain to have reached a twenty-unit deal had both parties negotiated in good faith. The court could not say as a matter of law that JEG-United could not recover lost profits of $46 million in connection with the twenty-unit deal the parties might have reached.

JEG-United's tortious interference claims asserted that Planet Fitness improperly interfered with the negotiations between JEG-United and: (a) Soriana; (b) the competitor who sought to sell several gyms in Mexico; and (c) Ibarra Group. The court determined that none of these negotiations had yielded sufficiently certain prospective deals such as to support a claim for tortious interference with future economic advantage. As to the potential purchase of several gyms from Planet Fitness's competitor, it was significant to the court that JEG-United had asked to include Planet Fitness in the negotiations and proposed transaction, with one potential scenario being that Planet Fitness itself purchase and operate the gyms. The court found that the involvement of Planet Fitness in the purchase discussions undercut any claim that Planet Fitness improperly interfered with the discussions by declining to engage in the relationship.

The court also found that JEG-United's conversations with Soriana to lease other properties were too "high level" to create a reasonable expectation that any such leases would actually be executed. The hope of future negotiations for additional Soriana properties without any specific locations, rental rates, or other terms could not, as a matter of law, support a claim for tortious interference with a concrete prospective economic relationship. The court could not say that these parties would have entered any leasing deals but for the alleged interference.

Lastly, the court found no evidence that Planet Fitness or Miolla improperly interfered with JEG-United's failed efforts to obtain a joint venture arrangement with Ibarra Group to develop franchises in Mexico. JEG-United argued that it had reached a deal in principle with Ibarra. But there was no evidence to show any wrongful conduct by Planet Fitness or Miolla to interfere with that deal, as would be necessary to recover for tortious interference with a *prospective* contract under New Hampshire law. Miolla's communication that Planet Fitness would not accept a joint venture arrangement in which the two franchisees were equal partners did not constitute any tort. Planet Fitness was under no obligation to allow franchisees to agree to fifty-fifty partnerships. Nor did any comments by Miolla about the potential purchase price arise to "improper" interference because there was nothing tortious about Miolla opining on the purchase price for the contract. The court thus granted summary judgment to Planet Fitness and Miolla on all JEG-United's tortious interference claims.

OCTOBER 2022 LADR CASE NOTE

***Arrington v. Burger King Worldwide, Inc.*, 47 F.4th 1247 (11th Cir. 2022).** From at least 2010 until September 2018, as part of Burger King franchise agreements, Burger King and its franchisees entered into "No-Hire Agreements" under which each agreed not to hire any employees of another Burger King restaurant for at least six months after the employee left employment at another Burger King restaurant.

In October 2018, three former employees of Burger King franchise restaurants brought suit against Burger King, on behalf of a class of employees of Burger King franchise restaurants, alleging antitrust violations. They asserted that the No-Hire Agreements prevented them from being able to obtain employment at other Burger King restaurants and, as a result, caused them to be paid artificially depressed wages, suffer decreased benefits, and be deprived of job mobility. They claimed the No-Hire Agreements amounted to an unreasonable restraint on trade, in violation of Section 1 of the Sherman Act, and prohibit Burger King franchisees from competing with each other, and with the franchisor, in attracting and retaining labor.

In response to the lawsuit, Burger King filed a motion to dismiss for failure to state a Section 1 Sherman Act claim. Burger King argued that it and its franchisees constituted a single economic enterprise and were not capable of the concerted action that a Sherman Act Section 1 violation requires.

The district court agreed with Burger King, granting Burger King's motion and dismissing the action on the grounds that the complaint failed to state a Section 1 Sherman Act claim because Burger King and each of its franchisees together constituted a single economic enterprise, so they were not capable of conspiring under the Sherman Act.

The plaintiffs appealed to the Eleventh Circuit, and the Eleventh Circuit reversed the district court's decision. The Eleventh Circuit held Burger King and its franchisees compete against each other for employees, so the No-Hire Agreements deprived the marketplace of potentially different hiring decisions by each of the separate restaurant owners. Consequently, the plaintiffs plausibly alleged Burger King and its franchisees engaged in "concerted action" in violation of Section 1 of the Sherman Act.

The Eleventh Circuit reasoned while Burger King and its franchisees have some economic interests in common, each separately pursues their own economic interests when hiring employees. The Eleventh Circuit relied on language in Burger King franchise agreements that emphasized the independent nature of each franchisee's relationship with Burger King and that no fiduciary relationship between the parties exists. The court also relied on Burger King's Franchise Disclosure Document, which expressly warned that other Burger King restaurants may compete with a franchisee's restaurant, and franchisees may face competition from other franchisees, from outlets the franchisor owns, or from other channels of distribution or competitive brands the franchisor's parent company owns or controls.

The Eleventh Circuit further reasoned Burger King's franchisees' independence expressly extends to hiring decisions, relying on language in the Burger King franchise agreements stating each franchisee is solely responsible for all aspects of the employment relationship with its employees, and each franchisee enjoys the sole right to hire and establish wages, hours, benefits, employment policies, and other terms and conditions of employment for its employees without consultation with or approval of the franchisor. The Eleventh Circuit also highlighted statements on Burger King's website stating that job descriptions, compensation, benefits, and other employment terms and conditions applicable to positions at franchised Burger King restaurants will vary and are determined solely by each franchisee.

Finally, according to the Eleventh Circuit's opinion, the plaintiffs' allegations that several franchisees had different approaches to employee recruitment and retention were an additional significant consideration.

Based on the foregoing, the Eleventh Circuit held, in the absence of the No-Hire Agreements, each independent Burger King restaurant would pursue its own economic interests and therefore potentially and fully make its own hiring decisions, including about wages, hours and positions, and they might even attempt to entice employees to leave one restaurant and join their own. The Eleventh Circuit reasoned the No-Hire Agreements removed that ability. Accordingly, the court concluded the plaintiffs had plausibly alleged the No-Hire Agreement qualifies under Section 1 of the Sherman Act as "concerted activity," such activity constituted an allegation of a Sherman Act Section 1 violation, and the district court should not have dismissed the plaintiffs' complaint.

The Eleventh Circuit declined to address the alternative argument by Burger King that the dismissal of the complaint was proper because any restraint on trade was not unreasonable. The court held that argument is best left to the district court in the first instance.

CURRENTS

ANTITRUST

Deslandes v. McDonald's US, LLC, Bus. Franchise Guide ¶ 17,129, 2022 WL 2316187 (N.D. Ill. June 28, 2022)
This case is discussed under the topic heading "Non-compete Agreements."

ARBITRATION

Callen v. ILKB, LLC, Bus. Franchise Guide (CCH) ¶ 17,115, 2022 WL 2079651 (E.D.N.Y. June 9, 2022)
This case is discussed under the topic heading "Statute of Limitations."

CHOICE OF FORUM

C21FC LLC v. NYC Vision Capital Inc., Bus. Franchise Guide (CCH) ¶ 17,132, Case No. cv-22-00736-PHX-SPL, 2022 WL 2646168 (D. Ariz. July 7, 2022)
A federal district court in Arizona granted the defendants' motion to transfer to the U.S. District Court for the Southern District of New York, where defendants had earlier filed a case involving the same parties and related legal claims.

C21FC LLC (C21FC) entered into a franchise agreement with NYC Vision Capital Inc. (NYCVC) to franchise a New York optometry store, The Eye Man. Shortly thereafter, C21FC entered into a purchase and sale agreement with C21VX LLC (C21VX) for the existing The Eye Man store, but then agreed to amend the agreement to substitute NYCVC as the buyer. NYCVC subsequently opened its own independent The Eye Man store in New York City. The parties disputed whether C21FC had sold NYCVC all assets, including the trademark, or just the physical assets of the business.

On April 13, 2022, NYCVC filed claims in the U.S. District Court for the Southern District of New York against C21FC and several of its chief officers asserting nine counts of fraud, breach of contract, misrepresentation, and franchise law and consumer protection violations. Sixteen days later, C21FC and C21VX brought claims in the U.S. District Court for the District of Arizona against NYCVC and its owners for six counts of declaratory relief, lien foreclosure, trademark infringement, reformation, and breaches of contract and covenants of good faith and fair dealing.

NYCVC filed a motion to transfer or dismiss C21FC and C21VX's claims based on the first-to-file rule. Generally, courts must analyze three factors to determine whether to apply the first-to-file rule: the timing of the lawsuits, the similarity in parties in each case, and the similarity of issues in each case. However, C21CF and C21VX conceded that the three requirements were met. Rather they argued that the first-to-file rule was overridden by the forum selection clause in the parties' franchise agreement, which stated that C21FC may institute any action arising out of the agreement in state or federal court in Arizona. The court found that because the forum-selection clause was clearly permissive, rather than mandatory, the courts of Maricopa County were not the exclusive forum for litigation. The court further concluded that because the forum-selection clause was only permissive, and NYCVC had filed first in another permitted forum, the first-to-file rule would apply. In the interests of justice and efficiency, the court decided to transfer the case to New York rather than stay or dismiss it.

CONTRACT ISSUES

***JTH Tax LLC v. Agnant*, Bus. Franchise Guide ¶ 17,096, 2022 WL 1556656 (E.D.N.Y. May17, 2022)**

This case is discussed under the topic heading "Injunctive Relief."

***Callen v. ILKB, LLC*, Bus. Franchise Guide (CCH) ¶ 17,115, 2022 WL 2079651 (E.D.N.Y. June 9, 2022)**

This case is discussed under the topic heading "Statute of Limitations."

***Baymont Franchise Systems v. SB Hospitality Palm Springs, LLC*, Bus. Franchise Guide ¶ 17,116, 2022 WL 2063623 (June 8, 2022)**

In a dispute involving an alleged defective hotel reservation system, the U.S. District Court for the District of New Jersey partially granted a franchisor's motion for summary judgment, thus narrowing the matters remaining in dispute for trial.

The Plaintiff was Baymont Franchise Systems (Baymont), a hotel franchisor. In 2016, Baymont entered into a franchise agreement with the defendant, SB Hospitality Palm Springs, LLC (SB Hospitality), to operate a Baymont hotel in Palm Springs, California. SB Hospitality's individual members, also defendants, personally guaranteed performance of the franchise agreement. SB Hospitality and its members also gave Baymont a $50,000 promissory note that would immediately come due upon termination of the franchise agreement.

The franchise agreement required Baymont to operate and maintain a computerized reservation system, known as SynXis. Baymont and SB Hospitality entered a second SynXis agreement under which Baymont agreed to use commercially reasonable efforts to always make the reservation system available. Baymont offered a warranty that the reservation system would perform in a workmanlike manner and that it would use reasonable efforts to remedy nonperformance. Also in this agreement, SB Hospitality waived any claims arising out of the SynXis system except those due to Baymont's willful misconduct.

In 2018, due to alleged performance issues with SynXis, SB Hospitality terminated the franchise agreement with approximately eighteen years remaining on its term. Baymont then sued SB Hospitality and its guarantors to recover contractually prescribed liquidated damages, unpaid recurring fees, and payment on the promissory note. The defendants countersued for breach of contract, breach of the SynXis warranty, violation of the New York Franchise Sales Act (NYFSA), and tortious interference with prospective economic advantage. Baymont moved for summary judgment, asking the court to enter judgment in its favor on four of its claims, and against the defendants on their counterclaims and affirmative defenses.

The court granted Baymont summary judgment on two of the defendants' counterclaims and one of its affirmative defenses. It first held that the NYFSA did not apply because no part of the parties' transaction occurred in New York. The fact that one of SB Hospitality's members was a New York resident was not sufficient to bring the transaction within the scope of the NYFSA. Next, the court concluded SB Hospitality could not establish a claim for tortious interference with prospective economic advantage. It presented no evidence of Baymont's malice or of lost bookings. Finally, the court rejected the defendants' argument that the franchise agreement was unconscionable because SB Hospitality's member could not speak or read English and was never presented with a translation of the Franchise Agreement. Under New Jersey law, a party's inability to speak English is not sufficient to void a contract. Furthermore, the member had a copy of the Franchise Disclosure Document and franchise agreement for three weeks before signing it and therefore had ample opportunity to obtain a translation.

The court denied summary judgment as to the parties' remaining claims and defenses. The court found disputed issues of fact as to whether Baymont breached the franchise agreement by failing to provide a working SynXis system, or whether SB Hospitality's problems were due to user error. Because Baymont's breach would have justified SB Hospitality's early termination, the court could not conclude Baymont was entitled to judgment in its favor on its claims premised on SB Hospitality's wrongful termination of the franchise agreement.

The court next concluded the disclaimer in the SynXis agreement, under which SB Hospitality waived all claims arising out of the SynXis system except due to Baymont's "willful misconduct," did not preclude SB

Hospitality's claim for breach of the SynXis warranty. Applying principles of contractual interpretation, the court found this disclaimer did not cover a claim for breach of the warranty that the reservation system would perform in a workmanlike manner and that Baymont would use reasonable efforts to remedy nonperformance. The court reasoned that if willfulness was required to bring a claim for breach of these warranties, the warranties would be rendered meaningless.

Finally, the court found that disputed factual issues precluded summary judgment on SB Hospitality's defense that it was fraudulently induced to enter into the franchise agreement. Here, Baymont relied on a merger clause and another provision in the franchise agreement where SB Hospitality disclaimed reliance on any oral or written representations. Under New Jersey law, this kind of general statement in a contract does not bar the introduction of parol evidence to determine whether a party was fraudulently induced to enter a contract. Thus, the court permitted this affirmative defense to stand.

DAMAGES

***The Cleaning Authority, LLC v. Hunsberger Enterprises, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,146, Case No. CCB-20-3360, 2022 WL 2344169 (D. Md. June 29, 2022)**

The U.S. District Court for the District of Maryland granted a motion for default judgment on one count and summary judgment on all remaining counts in a lawsuit arising from the termination of a franchise agreement.

The Cleaning Authority (TCA) and Hunsberger Enterprises, Inc. (Hunsberger) entered into a franchise agreement with a fifteen-year term for residential and commercial cleaning. The sole owner of Hunsberger personally guaranteed performance of the agreement and signed both a confidentiality and noncompetition agreement. TCA had a right to terminate the agreement if any payment was refused by Hunsberger's bank three of more times during a twelve-month period. In 2019 and 2020, Hunsberger failed to make the required payments on at least three occasions during a twelve-month period, and TCA terminated the agreement, triggering a post-term non-competition covenant. Despite the non-compete agreement, Hunsberger continued to advertise and provide cleaning services in its prior territory after its termination in August 2020.

TCA filed claims against Hunsberger and its owner in November 2020, alleging breach of contract. A default was entered against Hunsberger. After conducting discovery, TCA moved for default judgment on its claim for breach of the franchise agreement and summary judgment on its remaining claims related to breach of the personal guaranty and confidentiality and noncompetition agreement.

On the motion for default judgment, the court found that there were no material facts in dispute and that the evidence was sufficient. The court next calculated damages based both upon amounts that had been refused by

Hunsberger's bank and the liquidated damages provision of the agreement. The liquidated damages provision was found to be valid and enforceable under Maryland law because it was mandatory and provided both a clear and unambiguous sum and reasonable compensation. As a result, the court required Hunsberger to pay two years of royalties.

On summary judgment, the court found that there was no genuine dispute as to the two breach of contract claims. The breach of the franchise agreement from the failed payments subjected the owner to personal liability under the guaranty, and Hunsberger's continued operation and solicitation of former clients after termination violated the non-competition provisions. The court further found that the non-compete provisions were, which restricted Hunsberger's ability to operate a cleaning service within twenty miles of his former territory for twenty-four months, were reasonable in scope and thereby enforceable. The court entered an injunction enforcing the noncompete against Hunsberger and its owner for the full term of the covenant.

FRAUD

***Callen v. ILKB, LLC*, Bus. Franchise Guide (CCH) ¶ 17,115, 2022 WL 2079651 (E.D.N.Y. June 9, 2022)**
This case is discussed under the topic heading "Statute of Limitations."

***Baymont Franchise Systems v. SB Hospitality Palm Springs, LLC*, Bus. Franchise Guide ¶ 17,116, 2022 WL 2063623 (June 8, 2022)**
This case is discussed under the topic heading "Contract Issues."

INJUNCTIVE RELIEF

***Gurcharan Brothers Oil Co., Inc. v. Sei Fuel Services, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,140, Case No. 22-cv-3345 (JMW), 2022 WL 2359597 (E.D.N.Y. June 30, 2022)**
The U.S. District Court for the Eastern District of New York granted a motion for a preliminary injunction enjoining the non-renewal of a franchise agreement under the Petroleum Marketing Practices Act (PMPA).

The plaintiff was a franchisee that had operated a Shell-branded gas station and convenience store in New York since 1996. The franchisee's lease for the gas station premises was not clear as to the termination date. The franchisor, who was also the supplier, issued the franchisee a notice of non-renewal of the franchise agreement on the basis that low volume sales and rent concessions made it uneconomical to renew. The notice did not identify expiration of the lease as a basis of non-renewal but did state that the lease would terminate at the same time. The parties signed a mutual termination agreement; the franchisee received the fully executed agreement two months later and then repudiated two days after such receipt.

The franchisor made what it claimed to be a bona fide offer to sell the relevant equipment and leasehold rights, but no agreement was reached. The franchisee filed for an injunction against the nonrenewal and/or termination of the franchise agreement, claiming that the nonrenewal was not valid or in good faith, that the offer to sell was not a bona fide offer, and that the franchisee was willing and capable of continuing the relationship.

The court found that the mutual termination was valid, but that it was timely repudiated under the PMPA. In determining whether the franchisee had repudiated within the seven days allowed after receipt of the mutual termination agreement, the court first considered whether the agreement received had to be fully executed to start the clock. The court found that for the purposes of repudiation under the PMPA, a franchisee has only received a mutual termination agreement when it receives a version that has been signed by the parties. Prior to execution, there could be no agreement to repudiate. The franchisee had repudiated within two days of receipt of the fully executed agreement, so the repudiation was valid even though the document had actually been signed two months earlier.

Having determined that the mutual termination was repudiated, the court turned to the validity of the nonrenewal or termination itself. First, the court examined the offer that was made to franchisee, which was, by its terms, for whatever rights the franchisor might have in the equipment and the lease. Because the franchisor could not identify those rights, and thus what was being offered, with any certainty, the court found that there were serious questions as to whether the offer was bona fide. Second, the court found that there were questions regarding whether the nonrenewal had been made in good faith. Although the court acknowledged that the franchisor put forth evidence that a continued franchise relationship would be uneconomical, the court found it concerning that the alleged economic failings of the franchisee were never raised with the franchisee at all prior to the nonrenewal.

Finally, the court balanced the hardships as required for a preliminary injunction under the PMPA and found that it weighed in favor of the franchisee, given the length of the relationship and the fact that franchisee would only be entitled to continue the relationship while fulfilling the obligations of the franchise agreement. Based upon these factors, the court granted the preliminary injunction against nonrenewal or termination. The court required that a bond be posted in the amount of ten thousand dollars.

***Fursyth Petroleum Foundation Inc. v. PMIG 1025, LLC*, Bus. Franchise Guide (CCH) ¶ 17,108, Case No. PWG 21-cv-2433, 2022 WL 1663564 (D. Md. May 25, 2022)**

A petroleum franchisee's motion for a preliminary injunction enjoining the non-renewal of a franchise agreement under the Petroleum Marketing Practices Act (PMPA) was granted.

In 2004, PMIG 1025, a franchisor, acquired a contract to operate a gas station, car wash, convenience store, and air cargo complex food facility at

Baltimore Washington International Airport (BWI) and took over the subcontract with the Airport Concession Disadvantaged Business Enterprise (ACDBE) that had been operating the facility. In 2009, ACDBE was acquired by Fursyth, a franchisee, who signed a petroleum franchise agreement with the franchisor for renewable three-year terms. Upon renewal in 2014, the franchisor raised the rent to an amount that exceeded what the franchisor had to pay to the Maryland Aviation Administration (MAA) for its lease. The franchisor continued to increase rents in subsequent years, and the renewed 2019 franchise agreement was explicitly subject to the franchisor's underlying lease with MAA.

In November 2020, the franchisor notified Fursyth that the franchise agreement would terminate in January 2021, purportedly based on the expiration of its lease with MAA, a new version of which had gone into effect in January 2020. After the Fursyth requested a bona fide offer to sell the franchisor's interests in the improvements and equipment at the station, the franchisor rescinded the termination. The franchisor issued a new notice of termination for February 2021, but the parties continued to operate as usual after the noticed termination date. The franchisor eventually offered Fursyth a new franchise agreement to operate a 7-Eleven franchise at the station, but the proposed rent was significant and non-negotiable, and Fursyth declined.

On August 19, 2021, the franchisor sent a final notice of nonrenewal effective November 22, 2021. The stated basis for nonrenewal under the PMPA was failure of the parties to agree upon changes or additions to the franchise agreement. The franchisee then initiated this action seeking a preliminary injunction to enjoin the nonrenewal.

In ruling on the motion, the federal district court determined that the franchisee met the reduced standards for a preliminary injunction under the PMPA. There was no dispute that the franchisor was not renewing, and the court found that there were serious questions as to whether the proposed changes to the lease agreement were made in subjective good faith. The court determined that the evidence that the franchisee put forward related to past attempts to terminate the relationship and the communications around those attempts were enough to create a reasonable chance that the franchisor was acting in bad faith.

Further, in weighing the hardships for each party, the court found that the potential loss to the franchisee if the injunction was not granted outweighed the potential loss to the franchisor if it were. As a result, the court granted the motion for the preliminary injunction; the court also held that the franchisor had not made a showing that a bond was necessary and so did not require that the franchisee post any bond.

***JTH Tax LLC v. Agnant*, Bus. Franchise Guide ¶ 17,096, 2022 WL 1556656 (E.D.N.Y. May17, 2022)**

Against the backdrop of a Department of Justice (DOJ) investigation for improper tax preparation practices, a franchisor of tax preparation services terminated a New York franchisee for alleged compliance errors. The U.S. District Court for the Eastern District of New York refused to enter a preliminary injunction enforcing the franchise agreement's post-termination obligations, finding the franchisor had not established likelihood of success on the merits or likely irreparable harm.

The plaintiff in this case is JTH Tax, LLC (Liberty Tax), which franchises income tax preparation services under the Liberty Tax brand. Liberty Tax was the subject of a DOJ investigation into franchisees' preparation of tax returns for self-employed individuals who report Form 1040, Schedule C income on their tax returns.

The DOJ found Liberty Tax's franchisees, with Liberty Tax's actual or constructive notice, falsely reported Schedule C income over several tax seasons. On December 20, 2019, the U.S. District Court for the Eastern District of Virginia entered a consent decree under which Liberty Tax agreed to implement an internal review system to address fraudulent Schedule C filings, disclose the consent decree to prospective franchisees, and notify franchisees of their obligation to safeguard against inaccurate, false, or fraudulent federal tax returns.

The defendant, Alexia Agnant, purchased three new Liberty Tax franchises on November 1, 2019. She acquired four existing Liberty Tax locations on December 31, 2019. The parties disputed whether Liberty Tax disclosed the existence of the DOJ investigation prior to Agnant entering into the franchise agreements. Liberty Tax submitted provisions of the Franchise Disclosure Document (FDD) purportedly containing disclosure of the DOJ investigation. Agnant claimed she never received a copy of these provisions or of the entire FDD. The parties submitted competing versions of the FDD that they each claimed Liberty Tax provided to Agnant.

Beginning in July 2021, Liberty Tax began notifying Agnant of compliance issues at her franchised locations and issuing "notices to cure" and a "notice of default." The court noted that some of these issues were deemed closed, but the status of other issues was unclear. Agnant repeatedly requested clarification from Liberty Tax as to how to come into compliance with the franchisor's requirements. The court documented several communications revealing that Agnant did not understand from Liberty Tax's responses how to come into compliance.

In February 2022, Liberty Tax conducted an audit of two of Agnant's locations, which revealed compliance error rates of fifty percent for 2021 and forty-one percent for 2022. The next month, based on these error rates, Liberty Tax terminated Agnant's franchise agreements effective immediately. Agnant continued to operate at the franchised businesses' same locations, used the same phone numbers, and eventually stopped using Liberty Tax's trademarks and rebranded to Rocket Tax. Meanwhile, Liberty Tax withheld between $500,000 to $1 million that it owed to Agnant for tax preparation services.

After Liberty Tax filed suit against Agnant, the U.S. District Court for the Eastern District of New York entered a temporary restraining order requiring Agnant and her entity, Demetress, to comply with the franchise agreement's post-termination obligations. The court then conducted a hearing to determine whether it should issue a preliminary injunction. The court ultimately concluded that Liberty Tax had not demonstrated a likelihood of irreparable harm or a likelihood of success on the merits. The court therefore denied Liberty Tax's request for a preliminary injunction.

Regarding irreparable harm, the court held that Agnant and Demetress had already ceased using Liberty Tax's trademarks. Thus, there was no evidence of ongoing trademark infringement. Furthermore, beyond conclusory affidavit testimony, Liberty Tax did not offer any evidence that Agnant's use of the former franchise locations and phone numbers would cause irreparable harm, particularly because Liberty Tax had locked Agnant out of its computer systems. Liberty Tax could not claim irreparable harm in the form of lost customers since Liberty Tax demonstrated no intent to imminently re-enter Agnant's markets. Finally, the court determined any harm to Liberty Tax could be remedied by monetary damages and was not irreparable.

The court also concluded Liberty Tax was not likely to succeed on the merits of its claims. The court observed that Agnant had repeatedly "requested guidance on compliance" when Liberty Tax issued notices regarding compliance with federal laws, regulations, and the franchise agreements, but Liberty Tax did not respond with clear guidance. The evidence showed Liberty Tax used inconsistent standards for assessing compliance and withheld tax preparation fees contractually owed to the franchisee.

Because Liberty Tax could not establish either required element, the court denied its motion for a preliminary injunction.

JURISDICTION

***Callen v. ILKB, LLC*, Bus. Franchise Guide (CCH) ¶ 17,115, 2022 WL 2079651 (E.D.N.Y. June 9, 2022)**

This case is discussed under the topic heading "Statute of Limitations."

NON-COMPETE AGREEMENTS

***The Cleaning Authority, LLC v. Hunsberger Enterprises, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,146, Case No. CCB-20-3360, 2022 WL 2344169 (D. Md. June 29, 2022)**

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

***Deslandes v. McDonald's US, LLC*, Bus. Franchise Guide ¶ 17,129, 2022 WL 2316187 (N.D. Ill. June 28, 2022)**

This case examined the antitrust implications of no-hire provisions in franchise agreements. The United States District Court for the Northern District of Illinois ultimately held two McDonald's employees had no valid claim that these no-hire provisions violated Section 1 of the Sherman Antitrust Act.

Plaintiff Leinani Deslandes worked for a McDonald's franchisee near Orlando, Florida. She alleged that all McDonald's franchisees sign franchise agreements with no-hire restrictions prohibiting franchisees from employing, or seeking to employ, any person who has been employed by a different McDonald's restaurant within the previous six months. She claimed these provisions prevented her from taking a better-paying job at a different McDonald's location. She filed a putative class action complaint against two franchisor defendants, McDonald's Corporation and McDonald's USA, LLC, alleging violations of the Sherman Antitrust Act.

In her pleading, Deslandes alleged the no-hire provisions were unlawful *per se* or under a quick-look analysis. She did not allege they were unlawful under a rule-of-reason analysis, which would have required pleading facts about the market power in the relevant market.

After McDonald's filed a motion to dismiss, the court held the no-hire provisions were not *per se* invalid because they were ancillary to an output-enhancing agreement, namely, the franchise agreements, which increase output of burgers and fries. The court allowed the quick-look theory to proceed to discovery.

This gave Deslandes an opportunity to amend her complaint to lodge market power allegations that would support a rule-of-reason theory, but Deslandes chose not to do so, likely because proceeding under the rule-of-reason analysis would make it difficult to certify a nationwide class, the court speculated.

Turner, employed by a company-owned location in Covington, Kentucky, filed similar claims and consolidated her case with Deslandes's. She likewise did not assert a rule-of-reason theory.

After discovery, the court denied class certification. In that certification ruling, the court concluded the no-hire provisions could not be analyzed under the quick-look theory. Rather, the rule of reason applied. The court based its decision on recent Supreme Court guidance that restraints of trade "presumptively" call for rule-of-reason analysis; many of these restraints were in vertical agreements between franchisors and franchisees, which require rule-of-reason analysis; and McDonald's had presented evidence that its no-hire provisions had procompetitive effects, which required rule-of-reason analysis. Because individual issues would dominate under a rule-of-reason analysis, the court denied class certification.

Following these two interlocutory orders, McDonald's moved for judgment on the pleadings. It argued the court's previous rulings had eliminated all theory other than the rule of reason. Plaintiff did not plead the rule of reason because it alleged no facts regarding market power in the relevant market. The court agreed and dismissed the plaintiffs' claims for violation of Section 1 of the Sherman Antitrust Act.

Deslandes and Turner attempted to argue dismissal was inappropriate because a plaintiff is not required to formulaically plead legal theories. The court rejected this argument. The court explained that the reason for dismissal was not the failure to include a formal "rule of reason" label. Rather, dismissal was appropriate because the plaintiffs failed to plead specific facts regarding market power in the relevant market that are necessary to establish a plausible claim.

The court also concluded it would be futile for the plaintiffs to amend their complaints to allege the missing market power allegations. It observed that within ten miles of Deslandes's home, there were 517 quick-serve restaurants. Within ten miles of Turner's home, there were 253 quick-serve restaurants. The court reasoned that based on the high volume of restaurants, the plaintiffs could not plausibly allege McDonald's had sufficient market power to suppress their wages through the no-hire provisions.

Turner and Deslandes have since filed an appeal, which is currently pending before the Seventh Circuit.

PETROLEUM MARKETING PRACTICES ACT

***Fursyth Petroleum Foundation Inc. v. PMIG 1025, LLC*, Bus. Franchise Guide (CCH) ¶ 17,108, Case No. PWG 21-cv-2433, 2022 WL 1663564 (D. Md. May 25, 2022)**

This case is discussed under the topic heading "Injunctive Relief."

***Gurcharan Brothers Oil Co., Inc. v. Sei Fuel Services, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,140, Case No. 22-cv-3345 (JMW), 2022 WL 2359597 (E.D.N.Y. June 30, 2022)**

This case is discussed under the topic heading "Injunctive Relief."

STATE DISCLOSURE/REGISTRATION LAWS

***Baymont Franchise Systems v. SB Hospitality Palm Springs, LLC*, Bus. Franchise Guide ¶ 17,116, 2022 WL 2063623 (June 8, 2022)**

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

***Callen v. ILKB, LLC*, Bus. Franchise Guide (CCH) ¶ 17,115, 2022 WL 2079651 (E.D.N.Y. June 9, 2022)**

This case is discussed under the topic heading "Statute of Limitations."

STATUTE OF LIMITATIONS

***Callen v. ILKB, LLC*, Bus. Franchise Guide (CCH) ¶ 17,115, 2022 WL 2079651 (E.D.N.Y. June 9, 2022)**

This case arose out of sixteen alleged misrepresentations and omissions during the franchise sales process. Some of the defendants, all of whom were affiliated with the franchisor, moved to dismiss the complaint on jurisdictional and substantive grounds. Although these moving defendants prevailed on a handful of arguments, the plaintiff franchisee's claims remained largely intact.

In 2015, Thomas and Courtney Callen (Callens) began communicating with a franchisor, ILKB, LLC, (ILKB) about the potential purchase of an iLoveKickboxing franchise in Colorado Springs, Colorado. The Callens alleged ILKB and three of its executives made sixteen misrepresentations and omissions during the courting phase. These entailed oral misrepresentations, omissions from the franchise disclosure document, and false statements at a "Discovery Day" when the Callens and other prospects visited ILKB's New York offices to learn more about the franchise. The Callens signed their franchise agreement on February 29, 2016. Shortly thereafter, they formed Golden Polar Bear, LLC (Golden Polar Bear) to conduct the business of the franchise. They alleged ILKB authorized them to assign their franchise rights to the entity.

The Callens alleged that, when their franchise struggled to remain viable after opening, they learned the falsity of the sixteen misrepresentations and omissions. Pursuant to the franchise agreement's arbitration agreement, the Callens and Golden Polar Bear filed a demand for arbitration with JAMS against ILKB and the executives. But ILKB and the executives refused to pay their portion of the arbitration fees, so JAMS held the arbitration in abeyance.

Subsequently, ILKB Too, LLC (ILKB Too) acquired ILKB's assets. The Callens alleged ILKB Too and its three individual members took "full control" of the franchisor, thereby becoming its successor.

On July 24, 2020, the Callens and Golden Polar Bear filed a lawsuit in the U.S. District Court for the Eastern District of New York against ILKB, the executives, ILKB Too, and the members. When the court asked the parties whether the litigation should be stayed pending the outcome of the arbitration, they all responded that the court should hear and decide the litigation. The court deemed these responses to constitute a waiver of the right to arbitrate. ILKB, ILKB Too, and the members then moved to dismiss the complaint pursuant to Federal Rules of Civil Procedure 12(b)(1), 12(b)(2), and 12(b)(6).

ILKB Too and the members first argued they were not subject to personal jurisdiction in New York. The court disagreed, finding it could exercise "successor liability" jurisdiction. This is a theory under New York law by which a successor entity inherits its predecessor's jurisdictional status. Because the plaintiffs plausibly alleged a successor liability claim against ILKB Too and the members based on a the "de facto merger" and "mere continuation" theories, the court could exercise successor liability jurisdiction. The court therefore denied these defendants' motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(2).

Next, the court turned to the moving defendants' argument that Golden Polar Bear, which was not an original signatory to the franchise agreement, had no standing. The court construed this argument as a motion to dismiss for lack of subject matter jurisdiction pursuant to Federal Rule of Civil Procedure 12(b)(1), which allowed the court to consider extrinsic evidence. While the plaintiffs generally alleged the franchisor authorized the Callens' assignment to Golden Polar Bear, they neither submitted a copy of any written authorization nor alleged the specific terms of the assignment. Without this detail, Golden Polar Bear could not establish standing. The court dismissed Golden Polar Bear's claims pursuant to Federal Rule of Civil Procedure 12(b)(1).

The moving defendants also sought dismissal of the Callens' claims for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6). First, they argued the Callens' claims for violations of the New York Franchise Sales Act (NYFSA) and the Colorado Consumer Protection Act (CCPA) were time barred. The moving defendants argued the Callens signed their franchise agreement on February 29, 2016, but did not file the litigation until July 24, 2020, thus running afoul of the relevant three-year statutes of limitation.

The court disagreed and refused to dismiss these claims. Under a New York tolling statute, the statute of limitations on the NYFSA claim was tolled for the time that elapsed between the Callens' demand for arbitration, on February 26, 2019, and the final determination that there was no right to arbitrate. And in Colorado, a statutory discovery rule prevented the Callens' CCPA claim from accruing until the Callens discovered, or reasonably should have discovered, the illegal conduct. Thus, both tolling rules brought the Callens' NYFSA and CCPA claims within the three-year statutes of limitation.

The court also rejected the moving defendants' arguments that the NYFSA and CCPA did not apply to this dispute. Although NYFSA only applies to sales or offers to sell franchises in New York, the Callens sufficiently alleged an offer in New York by virtue of their visit to ILKB's New York offices for a Discovery Day. As for CCPA, while that statute is designed to remedy injuries to the public rather than private wrongs, the court found ILKB plausibly alleged a public injury by claiming ILKB sold dozens of franchises to the public and held a public Discovery Day attended by Colorado residents.

The moving defendants also moved to dismiss the Callens' claim for breach of the franchise agreement. This claim was partially premised on ILKB's failure to participate in the arbitration. The moving defendants argued the court should dismiss this claim because the Callens failed to allege the necessary element that they performed their obligations under the contract. But the Callens' complaint demonstrated they performed their obligations by bringing a JAMS arbitration action. This step established the essential element of performance.

The court then analyzed the moving defendants' arguments that the alleged misrepresentations and omissions could not support a fraud claim. For one of the misrepresentations, the Callens did not identify the speaker or the time of the misrepresentation and thus failed to satisfy the particularity requirements of Federal Rule of Civil Procedure 9(b). Two of the alleged omissions were not actionable because they concerned matters of public record. And two more alleged misrepresentations referred to what ILKB *would* do, which was a prediction of future events and therefore not actionable. But the court rejected the moving defendants' arguments that the remaining alleged misrepresentations were not actionable. Thus, the Callens' fraud claim survived as to the twelve remaining misrepresentations.

STATUTORY CLAIMS

***Callen v. ILKB, LLC*, Bus. Franchise Guide (CCH) ¶ 17,115, 2022 WL 2079651 (E.D.N.Y. June 9, 2022)**
This case is discussed under the topic heading "Statute of Limitations."

***The Watch Co., Inc. v. Citizen Watch Co. of America, Inc.*, Bus. Franchise Guide ¶ 17,095, 2022 WL 1535262 (7th Cir. May 16, 2022)**
After a watch manufacturer terminated a retailer as an authorized seller of its products, the retailer sued for violations of the Wisconsin Fair Dealership Law. The Seventh Circuit affirmed the district court's dismissal of the retailer's claims, agreeing that it was not a dealer under the statute.

The defendant, Citizen Watch Company of America, Inc. (Citizen), manufactures and sells watches. For nearly thirty years, the plaintiffs (WatchCo) sold Citizen watches as an authorized retailer pursuant to Citizen's retail-distribution policy. As of February 2021, Citizen's watches accounted for 10.7% of WatchCo's sales. Five WatchCo employees and an outside firm helped WatchCo sell Citizen watches and service warranty issues. WatchCo estimated that since 1993, it had invested "many thousands of hours" into the Citizen product line.

On March 1, 2021, Citizen updated its policy to prohibit retailers from selling watches through third-party websites, rather than the retailer's own websites, unless the retailer could meet certain exceptions. Despite not meeting any of the exceptions, WatchCo continued to sell Citizen watches on Amazon.com in violation of the policy. As a result, Citizen terminated WatchCo as an authorized retailer. WatchCo retained 808 Citizen watches in its inventory, which it was free to sell despite the termination.

WatchCo sued Citizen alleging violation of the Wisconsin Fair Dealership Law, claiming that Citizen terminated its dealership without good cause or sufficient notice. Citizen removed the case to the U.S. District Court for the Eastern District of Wisconsin and moved to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6). The district court granted the motion and dismissed WatchCo's claim after finding that WatchCo did not satisfy the statutory definition of a dealer, which precluded application of the statute. WatchCo appealed, and the appellate court affirmed dismissal of the claims.

The dispute turned on whether WatchCo sufficiently pleaded it had a "community of interest" with Citizen. The test for what constitutes a community of interest boils down to two questions: (1) Does the alleged dealer derive a large proportion of its revenues from the dealership? and (2) Has the alleged dealer sunk substantial, unrecoverable investments into the dealership? As for the first question, the appellate court observed that although WatchCo derived 10.7% of its revenue from selling Citizen watches, that amount was insufficient to establish a community of interest. The court cited another case where 23% of revenue was "not dispositive." It concluded that, while the termination of the relationship would cause WatchCo to suffer some lost profits, the termination would not threaten its economic viability.

Turning to the second question, the appellate court concluded WatchCo had not alleged that it sank unrecoverable investments into the Citizen relationship. Despite alleging expenditures of "tens of thousands of dollars annually on advertisements" to benefit the Citizen brand, WatchCo failed to specify whether those expenditures were for multiple brands or exclusively for the Citizen brand. The court also observed that WatchCo could recoup its costs by selling the remaining inventory, potentially at a premium.

Because WatchCo failed to allege a community of interest, it was not a dealer and could not assert claims under the Wisconsin Fair Dealership Law. The appellate court affirmed dismissal of WatchCo's claims.

TORTIOUS INTERFERENCE

***Baymont Franchise Systems v. SB Hospitality Palm Springs, LLC*, Bus. Franchise Guide ¶ 17,116, 2022 WL 2063623 (June 8, 2022)**

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