# Franchise Law Developments and Current Status

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## **Background – Structure and Organization of U.S. Franchise Law**

For those new to dealing with U.S. franchise law, a short review of the structure and organization of the U.S. legal system, and the relevant franchise laws, may be helpful.

As most international lawyers are aware, the U.S. legal system is organized on a federal structure, with both the federal and state governments having authority in the area of regulation of franchises and similar distribution arrangements. The subject matter of U.S. franchise law primarily focuses on pre-sale disclosure (and, in some cases, related filings with state governmental bodies – no such filings are required with federal authorities) and related state and federal enforcement efforts, with a secondary focus on relationship issues, such as termination and renewal.

### **Federal**

#### Disclosure

At the federal level, the relevant regulations are contained within the Federal Trade Commission's Franchise Rule (16 Code of Federal Regulations 436.1 *et seq.*), effective October 1, 1979, and often referred to by practitioners as the "FTC Rule." The FTC Rule mandates pre-sale disclosure by Franchisors to prospective Franchisees, applies throughout the U.S. and its territories and was last revised in 1994.

Fortunately, the same disclosure document (the Uniform Franchise Offering Circular or "UFOC") can be used to satisfy both state and federal pre-sale disclosure requirements, materially simplifying the tasks of practitioners and allowing essentially the same disclosure document to be used throughout the United States.

UFOCs are required to be updated on an annual basis or when material changes occur, and financial statements of the Franchisor must meet U.S. Generally Accepted Accounting Principles ("GAAP"), normally necessitating the formation of a U.S. entity for franchising of foreign-based systems.

Unlike the case with a number of the states, no filing of the UFOC is made with the Federal Trade Commission nor does the FTC normally review a franchisor's UFOC, limiting its primary activity to enforcement actions in the event that a Franchisor provides inadequate disclosures or otherwise violates the FTC Rule.

The courts have uniformly held that there is no federal private right of action by a disappointed Franchisee for a violation of the FTC Rule, although the Federal Trade Commission can itself maintain enforcement actions and a violation of the FTC Rule can serve as a basis for legal action by a disappointed Franchisee under various state consumer protection and similar laws, even where a state may not have its own law with respect to pre-sale disclosure or registration.

Practitioners should note that the FTC Rule effects only partial preemption of state franchise disclosure laws; disclosures by Franchisors must, at a minimum, meet the standards set by the FTC Rule – if state laws mandate additional disclosures or other steps designed to provide Franchisees with greater levels of protection in the are of franchise offers and sales, then Franchisors must also meet those higher standards.

### Relationship

While there are industry-specific federal laws governing relationships in various business fields (such as the petroleum distribution and motor vehicle sales industries), there is, perhaps surprisingly, no federal law generally regulating relationships between Franchisees and Franchisors, nor are there any meaningful current proposals for such legislation.

Other non-franchising specific federal laws do have an impact on franchising, of course, the two primary ones being antitrust and trademarks laws, areas not generally within the scope this paper.

## State

### Registration and Disclosure

Depending on the particulars of the franchise offering involved, 13 states may require filings of documents before a Franchisor may offer or sell franchises subject to the laws of those states. In fact, state regulation of franchise offers and sales (beginning with California) pre-dated federal regulation. Additional states may require filings depending on various factors, including the trademark status of the Franchisor.

State review of filings varies from cursory to highly detailed, and various exemptions from registration may be available but, sadly, are not uniform from state-to-state.

State review generally consumes 30 – 60 days per state, although filings can be made in any number of the states simultaneously and proceed in parallel. This process often results in generally minor changes to the UFOC, as compared to the version that would otherwise be used in non-registration states.

Filings are required to be updated on an annual basis or when material changes occur.

Note that if the offering falls under the definition of a "business opportunity" in various states and is not subject to a relevant exemption (as many, but not all, franchise offers are), filings may be required in far more than the thirteen states referenced above.

Failure to comply with state franchise registration and disclosure laws can subject a Franchisor and its personnel to significant criminal and civil penalties, as well as providing a disappointed Franchisee with remedies of damages and rescission.

<u>Relationship Laws</u>

Twenty states, and the Virgin Islands and Puerto Rico, (and not necessarily the same jurisdictions that regulate pre-sale disclosure) have laws specifically regulating one or more aspects of the relationship between Franchisees and Franchisors. California's law is relatively typical, addressing issues such as termination, non-renewal, and succession, as well as venue.

Far more common are industry-specific relationship statutes, governing industries such as petroleum, motor vehicles, mobile homes, farm and industrial equipment and alcoholic beverages.

Although additional franchise relationship laws (or modifications to existing ones) are occasionally proposed in various states, legislative activity in this area has been generally quiescent, and experienced practitioners do not anticipate any significant proposals to be adopted in the near-term future.

**<u>Recent Regulatory Developments</u>**

<u>Federal Statutes and Regulations</u>

No new federal franchise relationship laws have been enacted or are being seriously considered for adoption.

Similarly, no new federal franchise disclosure statutes have been enacted or are being seriously considered for adoption, but the situation is significantly different with respect to the primary federal franchise disclosure <u>regulations</u>.

<u>Revisions to FTC Franchise Rule Still Pending</u>

For many years, the FTC has been considering significant changes to the FTC Rule, primarily with respect to the content of the required disclosure document. If enacted, almost every disclosure item in the UFOC would undergo revision and the content of the disclosure document used by nearly all

Franchisors would be significantly changed, as well as changing the rules relating to when disclosure documents are delivered, among other things. The details of such changes are outside the scope of this paper, although extensive discussion of the proposed changes is available through materials published in connection with past sessions of the American Bar Association's annual Franchise Forum meetings and the International Franchise Association's annual Legal Symposiums. Please contact the author of this article if further details are needed.

Of note to international franchise lawyers, the proposed revisions to the FTC Rule would expressly exclude from coverage "outbound" international transactions; those where a U.S.-based Franchisor is offering franchises to residents of other countries and where the units concerned will be located outside the United States, an issue which had previously been the subject of some litigation.

Other changes would be to allow electronic disclosures, already allowed to a somewhat limited degree.

These changes have been the subject of voluminous public comment and related hearings, evaluation and review for a number of years (the process reaching back to 1997) and remain pending.

Knowledgeable observers predict that the changes will be enacted in something very close to the form currently proposed, but as a result of continuing delays are no longer willing to predict a possible effective date, or the exact final form the rule changes will take. In the past, the FTC has used the ABA Franchise Forum in October to announce such rule changes, and, as of the time of writing of this article (early August, 2006), we will simply have to wait until that time to see if they follow that past practice.

When and if such rule changes are finalized, there will be a "phase-in" period of probably a year to a year and a half during which Franchisors can continue to use the present form of disclosure document and can prepare to gather the information necessary to comply with a revised disclosure rule.

As currently contemplated, the changes to the FTC Rule would not include the introduction of any federal franchise relationship component.

Pending Revisions to FTC Rule re Business Opportunities

Since its inception, the FTC Rule has not merely regulated pre-sale disclosure with respect to franchises. The Rule has also regulated the offer and sale of business opportunities, a significantly different form of product and service distribution, generally using different business models than are common in franchising.

Note that this is a substantially different approach than under most states' laws, which separately regulate offers and sales of business opportunities, and often mandate a form of disclosure document markedly different than the UFOC.

The FTC, in April of this year, proposed to modify its regulatory approach and has formally commenced a rulemaking procedure under which business opportunity offerings would be separately regulated.

Among other things, the proposal would mandate a one page (!) disclosure document addressing only five items:

1. Earnings claims.
2. A list of certain legal actions involving the seller.
3. Any cancellation or refund policies of the seller.
4. The number of purchasers in the last two years and the number seeking cancellation or refunds.
5. A list of references.

In addition, the proposed rule would prohibit various deceptive sales practices, including various misrepresentations (such as with respect to earnings, costs, promised assistance, the likelihood of finding locations and territorial exclusivity) and failing to make promised refunds.

The comment period with respect to the proposed FTC business opportunity rule had been extended from June 16 to July 17, 2006, with rebuttal comments due on or before August 7, 2006.

It is clearly premature to speculate as to the form that a final FTC business opportunity rule will take, or its effective date, but it seems likely that it will be adopted at some point and international franchise lawyers whose client's business models might fall under the classification of "business opportunity" should be mindful of its possible impact, as well as the current level of regulation by the states.

## Recent Representative Case Law Developments

As a common law system (with the exception of the state of Louisiana, which operates largely on the civil law model), many of the most significant franchising legal developments take place as a result of court decisions. Among the hundreds (if not thousands) of franchise law cases decided by federal and state courts during the past year, we've selected a very few that may give international practitioners a general sense of the more important developments in this area.

Good Faith and Fair Dealing

One of the most active areas of litigation concerns Franchisee's attempts to impose an obligation of "good faith and fair dealing" on the conduct of Franchisors, whether in areas of termination, alleged encroachment or otherwise.

The tension in this area of the law has been between the principle that parties to a contract (including a franchise agreement) are under an implied obligation to deal with one another on the basis of good faith and fair dealing, and the somewhat contrary principle that the doctrine of "good faith and fair dealing" cannot be used to vary the express terms of a contract.

While nearly all state and federal courts would probably agree with these general principles, their application (perhaps not surprisingly) varies from court to court and seems to be driven at least as much by the specific facts of each case, and the court's perception of the relative equities between the disputants, as by application of any general legal theory.

A few cases may give the reader a sense of how these cases play out, noting that Franchisor's exposure in this area can often be substantially reduced through careful drafting of the Franchise Agreement and UFOC.

RHC v. Quizno's Franchising (CCH Bus. Fran. Guide ¶ 13,119) held that a sandwich shop franchisor did not violate the implied covenant of good faith and fair dealing in its agreements with two Franchisees by approving the award of franchises for sites which the Franchisees claimed were not economically viable due to their geographic proximity to other sandwich shops in the same system.

Good contract drafting allowed the Franchisor to prevail in this case. The court noted that the parties had expressly agreed that the Franchisor owed no duty with respect to site selection, and that site selection criteria did not form part of the parties' agreements. In addition, the franchise agreements expressly placed responsibility for site selection on the Franchisee, stated that the Franchisor's approval of a proposed site provided no "recommendation, endorsement or guarantee by [the Franchisor] with respect to the suitability" of the proposed location and that the Franchisees had no territorial protection. To a similar effect and applying comparable principles, and involving the same franchise system, see C.K.H. v. The Quizno's Master (CCH Bus. Fran. Guide ¶ 13,027)

Note however that good faith and fair dealing cases in the franchising context are highly fact specific, and allegations of inappropriate conduct may allow a plaintiff to avoid a summary judgment or similar pre-trial motion, and perhaps allowing the Franchisee to place the factual issues before a jury, the court deferring its decision until all relevant facts have been introduced at trial, as was the case in Travelodge Hotels v. Honeysuckle Enterprises (CCH Bus. Fran. Guide ¶ 13,015) a dispute which involved allegations of wrongful denial of participation in a hotel chain's reservation system and which was allowed to proceed to trial.

Antitrust – Tying Arrangements

Tying is the commercial practice of a seller, having sufficient economic power in one product (whether due to patent or other legal rights, or simple commercial realities), conditioning the sale of that product on the buyer also purchasing, from the same seller or an affiliate, a separate product where the seller does not have such power in the market for that second product. Such arrangements, assuming they meet certain tests, are illegal under the Sherman Act, a primary federal antitrust law, with analogs under various state antitrust laws.

Tying cases are probably the most common form of antitrust dispute to arise in franchising, since a number of Franchisors condition the award of a franchise on the Franchisee's agreement to purchase certain products or services only from the Franchisor or an affiliate.

However, not all restrictions on sources of supply violate tying rules, as was demonstrated in Sean Julian v. George Weston Bakeries (CCH Bus. Fran. Guide ¶ 13,148) in which the seller allegedly tied the sale of distribution routes to the financing of those routes by an affiliate. The court found that there was, effectively, no tie between the two "products," since the seller had merely threatened to terminate distributorship rights for failure to meet conditions in the financing arrangement, and that no tie could be present unless the seller actually improperly imposed illegal conditions.

Arbitration

One of the tools regularly employed by U. S. attorneys representing Franchisors to reduce exposure to claims by Franchisees has been the use of arbitration clauses, avoiding the possibility of a trial to a jury. In general, these efforts have been successful, in part due a federal law (the Federal Arbitration Act - Title 9, US Code, Section 1-14) requiring both state and federal courts to enforce the parties' selection of arbitration as the appropriate means of dispute resolution.

However, the case law is clear that franchise agreements containing arbitration clauses can be challenged, and the arbitration provision possibly ignored, where there exists a traditional basis under state law for challenging the contract as a whole or the arbitration cause in particular, such as failure of consideration, absence of an agreement in fact or (as we will see later) unconscionability.

Such principles were recently applied, and the arbitration clause not enforced, in Surface Materials Sales v. Surface Protection Industries (CCH Bus. Fran. Guide ¶ 13,090) in which the parties failed to initial (as the contract provided) the arbitration clause, notwithstanding that other portions of the contract, which were not required to be initialed, referred to disputes being submitted to arbitration; the court's theory being that the parties simply had not reached agreement as to arbitration. The lessons of the case are twofold: (1) Franchisors should be careful that all clauses to be initialed actually are initialed and (2) appropriate language inserted in the franchise agreement may save provisions which have been accidentally not initialed.

However, in a surprisingly pro-arbitration decision, a Federal appeals court (reversing a decision by the trial court) determined (in CD Partners v. Jerry W. Grizzle CCH Bus. Fran. Guide ¶ 13,163) that non-signatories to the franchise agreement could enforce its arbitration provisions. The non-signatories were officers of the Franchisor, the claims were related to their activities as such officers and, on that basis, the court concluded that they were sufficiently aligned with the Franchisor to benefit from the arbitration clause. An objective observor might find this decision somewhat difficult to reconcile, at least on the level of policy analysis, with the decision in CD Partners as cited above. Clearly, a better drafted arbitration clause might have avoided the issue even being raised.

Similarly, in a federal trial court case, Miron v. Sloan (CCH Bus. Fran. Guide ¶ 13,101), the Franchisor was successful in, at least initially, compelling arbitration, notwithstanding the fact that the current Franchisor was not a party to the franchise agreement containing the arbitration clause (the original Franchisor having been dissolved) and the current Franchisor was a successor company. In spite of those facts, the court directed that the issues raised by the Franchisees were to be decided by the arbitrator.

In a non-franchise case John G. Ryan v. Molson USA (CCH Bus. Fran. Guide ¶ 13,207), which should give comfort to Franchisors, a federal trial court in New York held that a New York statute banning pre-dispute arbitration clauses in agreements between beer brewers and wholesalers was preempted, and therefore ineffective, by the Federal Arbitration Act and its related national policy in favor of arbitration, including in a case such as this relating to termination.

Unconscionability as a Basis for Limiting Arbitration and Other Franchise Agreement Provisions

Challenges continue to be made, sometimes successfully and sometimes unsuccessfully, to at least some of the dispute resolution clauses traditionally used by Franchisors to provide protection against Franchisee lawsuits. One of the most important tools used by Franchisees in this effort has been the common law doctrine of "unconscionability": the concept that a particular contract provision is, in the view of the court, so unfair that notwithstanding the agreement of a party to be bound by it, the court will not enforce it.

An effective use of this approach was involved in Independent Association of Mail Box Owners v. San Diego Superior Court (CCH Bus. Fran. Guide ¶ 13,158), a case growing out of the acquisition by UPS of Mail Boxes, Etc., and the subsequent re-branding of many Mail Boxes, Etc. ("MBE") units as UPS Stores.

An intermediate California appellate court, in a class action brought by a group of MBE Franchisees, decided that:

A. The court, and not an arbitrator, would decide if the arbitration clause, or any portions of it, were unconscionable. (Note that, under general principles of U.S. law, a challenge, whether based on alleged unconscionability or otherwise, to the Franchise Agreement as a whole would normally be decided by the arbitrator. Good drafting should assure that result and might even cause a challenge to the arbitration clause to be decided by the arbitrator.)

B. The arbitration clause's ban on class-wide arbitration was stricken as unconscionable.

C. To the extent that the franchise agreement purported to deny the Franchisees access to statutory remedies, such a limitation was also unconscionable.

D. So as to not allow fee-shifting provisions in the Franchise Agreement to unduly impact the Franchisee's ability to pursue statutory claims, the trial court will be required to determine how much of the costs of arbitration will be shifted from the Franchisees to the Franchisor.

Note that the case was decided under California law, since the Franchise Agreements at issue had a California choice of law clause. Since California has one of the most pro-Franchisee sets of laws in the United States, one lesson of the case, for Franchisors generally and certainly for inbound foreign Franchisors, is to not use a choice of law clause designating California law as applicable and to take care in determining which set of laws should apply to any dispute with a Franchisee.

The final case in this area is Grafton Partners v. Superior Court of Alameda County (CCH Bus. Fran. Guide ¶ 13,125), a non-franchise case decided by the California Supreme Court. Relying on specific (and relatively unique) provisions of the California Constitution, the court held that a pre-dispute jury trial waiver (such as might be contained in a franchise agreement) was unenforceable.

Again, note that the case was decided under California law and under state constitutional provisions which may not be present in other states. Also, the case serves as additional support for the general policy of not using a California choice of law clause and, even in California, the effect of the case may be avoided through appropriate contract draftsmanship and selection of non-jury detemination of fact and law as permitted by specific statutory provisions.

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Mr. Holmes is a founding partner of Holmes & Lofstrom, LLP, a law firm specializing in franchise law and related areas and practicing throughout the United States, as well as internationally. He has been practicing franchise law for over 30 years and his biography can be found at www.HolmesLofstrom.com. Additional information from regarding any of the topics covered can be obtained by contacting him at D.Holmes@HolmesLofstrom,com.