

Hot Topics In Franchise Litigation

Rights and Remedies of Franchisees and Franchisors

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The Franchise Law Committee's presentation entitled "Franchising Fundamentals" is intended to identify basic principles which apply to the vertical distribution method known as franchising. Other speakers will address strategic planning and transactional issues, including what constitutes a "franchise" within the meaning of applicable law, and the consequent registration and disclosure requirements which are imposed upon franchisors.

My presentation at the annual meeting -- and the focus of this paper -- involves the enforcement of rights and the availability of remedies where one party or the other has failed to comply with the responsibilities which it has assumed under either the applicable statutory and common law or the franchise agreement itself. I have identified issues which predictably arise -- or which are now being developed -- in the area of franchise litigation.

Overview

Federal and state statutes govern the pre-sale disclosure requirements imposed upon franchisors. Additionally, many individual state statutes require a pre-sale franchise registration, and thereafter regulate the franchise relationship following the purchase of the franchise and concomitant execution of the franchise agreement. Among other things, violations of the disclosure, registration and factual honesty requirements, as well as subsequent relationship disputes -- involving both termination and non-termination issues -- very often result in litigation.

This paper will address various issues involving the rights and remedies of franchisees and franchisors, and will emphasize the following:

- Government enforcement and available private rights of action under the California Franchise Investment Law ("CFIL")² and the

¹ I wish to acknowledge with appreciation the assistance of my law clerks James Hornbuckle and Emily Wood.

- Federal Trade Commission (“FTC”) Rule³;
- Government and private remedies;
- The franchise relationship under the California Franchise Relations Act (“CFRA”)⁴;
- Vertical price and non price restrictions;
- The statute of limitations; and
- Other hot topics.

The FTC Rule

The FTC requires that franchisors provide a disclosure document to potential franchisees. This disclosure document must be formatted either according to the FTC Rule or the Uniform Franchising Offering Circular (UFOC) Guidelines.⁵ The required disclosure document must be given to the potential franchisee either at the first face-to-face meeting to discuss the potential agreement, or 10 days in advance of signing any binding contract, whichever occurs first.⁶

Section five of the FTC Rule provides that it is unlawful for a franchisor to do -- or fail to do -- any of the following:

- Fail to provide the disclosure document within the statutory time period;
- Make any representation concerning potential sales, income, or the like except as set forth in Section 436.1(b-e)⁷;
- Make a claim which is inconsistent with the disclosed information;
- Fail to provide copies of the standard (and final) franchise agreement to the franchisee; or
- Fail to return any funds or deposits which are considered refundable in the disclosure document.

Government Enforcement and Remedies: Unlike violations of the CFIL,⁸ there is no private right of action for the franchisor’s violations of the FTC Rule -- *i.e.*, the FTC alone has standing to seek redress for the failure of the franchisor to comply with the FTC

² Cal. Corp. Code, §§ 31000-31516.

³ 16 C.F.R. § 436.

⁴ Cal. Bus. & Prof. Code §§ 20000-20043.

⁵ 16 C.F.R. § 436.

⁶ See, *Fundamentals of Franchising* (Barkoff, Rupert M. and Andrew C. Selden, eds. American Bar Association 1997) p.91.

⁷ FTC Rule, § 436.1(b-e) states that such statements regarding potential sales are only valid if: a reasonable basis for such representation exist and the supporting material is provided to the Commission; underlying data supporting such a statement has been prepared according to generally accepted accounting standards; the franchisor illustrates the statements with examples of its franchisees; there is a caution statement; or, a data sheet is prepared for the franchisee illustrating how the potential sales estimate was calculated.

⁸ See, *infra* at p. 3-7.

Rule. While civil penalties can bring fines of up to \$10,000 per violation,⁹ the FTC may also seek the following remedies under the FTC Rule:

- Restitution for the victims;
- Attorney’s fees and costs may be awarded;
- Preliminary or permanent injunctions;
- Freezing of assets; and
- The award of pre-judgment interest is not precluded.

Statute of Limitations for Government Enforcement: All actions by the FTC for civil penalties must be brought within five years, as stated in 28 U.S.C. § 2462, rather than the three-year period identified in 15 U.S.C. § 57b(d), which relates to consumer redress.¹⁰ Under this standard, tolling does not occur during administrative hearings unless the defendant is purposefully stalling the proceedings. There are no limitations periods governing actions by the FTC for injunctive relief.¹¹

The California Franchise Investment Law

In addition to the nation-wide application of the FTC Rule, individual states may -- and in many cases do -- enact state legislation that regulates the pre-sale conduct of franchisors within each respective state. In California, a franchisor must register with the California Department of Corporations (“California DOC”),¹² and thereafter must provide a disclosure document to potential franchisees at least ten days before entering into any franchise agreement.¹³ Problems can arise when the franchisor fails to meet the registration requirements, fails to provide the disclosure document, or makes misrepresentations (or omissions) either within the required disclosure document or otherwise.¹⁴ Actionable misrepresentation or fraud under the CFIL is broader than, and not limited to, common law fraud.¹⁵

Government Enforcement (Section 31400): The California DOC may file a civil action against a franchisor for violating the CFIL. There are three main options that the California DOC Commissioner may pursue in response to a franchisor’s violation of the CFIL:

- The Commissioner may file a claim for ancillary relief, such as for restitution or damages on behalf of the persons injured;¹⁶

⁹ *Franchise Desk Book*. (Garner, W. Michael, ed. American Bar Association 2001) p. 878.

¹⁰ *Id.* at 883.

¹¹ *Id.* at 909.

¹² Cal. Corp. Code § 31110.

¹³ *Id.* at § 31119.

¹⁴ *Id.* at §§ 31200, 31201. Unless otherwise noted, “violations” will refer to CFIL violations by the franchisor regarding these three issues.

¹⁵ *Id.* at § 31012.

¹⁶ *Id.* at § 31400(b).

- The Commissioner may order the franchisor to desist and refrain from operations until duly registered;¹⁷
- The Commissioner may refer the case to the District Attorney, who may then institute criminal proceedings.¹⁸

Failure to comply with the CFIL also may constitute a criminal offense,¹⁹ punishable by up to \$10,000, up to one year in a county jail, or a combination of a monetary fine and imprisonment for each offense. Willful violations of the CFIL²⁰ and intentional fraud relating to the sale of a franchise may be classified as criminal action and result in the imposition of these penalties.²¹

Statute of Limitations for California DOC Action: Section 31405 of the CFIL addresses the statute of limitations for government action. Subsection (c) provides that “no action shall be maintained to enforce any liability created under subdivision (a) unless brought before the expiration of four years after the act or transaction constituting the violation.”²²

Private Right of Action and Remedies (Section 31300): There are a number of potential remedies available to the franchisee when a franchisor violates the provisions of the CFIL. When a franchisor fails to register or provide disclosure documents, the franchisee may recover damages and – if the violation is “willful” – may rescind the franchise agreement. In addition, the franchisee has the right to recover the franchise fee, and any other damages associated with operating the franchise, as a result of a franchisor’s fraudulent behavior.²³

As suggested above, a franchisee may rescind the franchise agreement if the franchisor’s violation of the provisions of the CFIL was “willful.”²⁴ Although on its face the term “willful” may seem to require unlawful subjective intent, it does not: a “willful” violation does not necessitate an intention to deceive, nor does the franchisor need to know that he is violating state law.²⁵ In *The People v. John Gonda*,²⁶ the California Court of Appeal for the First Appellate District explained that “‘willful’ does not require

¹⁷ *Id.* at § 31402.

¹⁸ *Id.* at § 31404.

¹⁹ *Id.* at § 31404.

²⁰ *Id.* at § 31410. *See, infra, Private Right of Action and Remedies*, p. 4, for discussion of what constitutes a “willful” violation.

²¹ *Id.* at § 31411.

²² *Id.* at § 31405(c); § 31405(a) states that any person who violates any provision of this law, or who violates any rule or order made under this law, shall be liable for a civil penalty... which shall be assessed and recovered in a civil action brought in the name of the people of the State of California by the commissioner in any court of competent jurisdiction.

²³ *Runyan v. Pacific Aid Industries, Inc.*, 2 Cal. 3d 304, 319 (1970) (“In sum, plaintiff recovered his original consideration [*i.e.* the franchise fee] and the damages he sustained in reliance on the contract [*i.e.* lost wages].”).

²⁴ Cal. Corp. Code, § 31300.

²⁵ *The People v. John Gonda* 138 Cal. App. 3d 774, 779 (1982); *Dollar Sys. Inc. v. Avcar Leasing Sys. Inc.*, 890 F.2d 165, 170-172 (9th Cir. 1989).

²⁶ 138 Cal. App. 3d 774 (1982).

any intent to violate the law, or to injure another, or to acquire any advantage.”²⁷ In addition, a failure by the franchisor’s counsel to guide or inform his client provides no excuse for violating Sections 31110 or 31119. These interpretations of the “willful” component of Section 31300 were reemphasized in *Dollar Systems, Inc v. Avcar Leasing Systems, Inc.*,²⁸ in which the United States Court of Appeals for the Ninth Circuit stated that Dollar Systems, Inc. “knew what it did and did not disclose, even though it was not specifically aware of the laws that were violated in the process.”²⁹ Dollar Systems, Inc.’s actions, according to the Ninth Circuit, were found to be “willful.”

Statute of Limitations for Private Action: Sections 31303 and 31304 of the CFIL address the statute of limitations for filing a private action. Section 31303 addresses the limitations period for filing actions against a franchisor for its failure to register, failure to disclose, and for misrepresentation in connection with an official written document. Section 31303 provides that “if the offer to sell a franchise is in violation of Sections 31101, 31110, 31119, 31200, or 31202,³⁰ then liability may be enforced when brought before the expiration of four years after the act creating the violation, the expiration of one year after the discovery of the fact constituting the violation, or 90 days after the delivery of a written notice disclosing the violation, which shall be approved as to form by the commissioner, whichever shall first expire.”³¹ (Emphasis added).

Section 31304 addresses a franchisor’s alleged misrepresentations in other written or oral communications. Section 31304 states that “if the offer to sell a franchise is in violation of Section 31201,³² then liability may be enforced when brought before the expiration of two years after the act creating the violations, the expiration of one year after the discovery of the fact constituting the violation, or 90 days after the delivery of a written notice disclosing the violation, which shall be approved as to form by the California DOC Commissioner, whichever shall first expire.”³³ (Emphasis added).

²⁷ Pen. Code § 7 at *Id.* at 779. The Court in *Dollar Sys. Inc.* justifies the translation of criminal definitions to civil cases stating that “[i]f a franchisor can properly be convicted of a crime for conduct that is “willful” under the standard articulated in *Gonda*, it surely can be subject to a civil judgment for rescission pursuant to section 31300.” See, *infra* note 28 at 173.

²⁸ *Dollar Sys. Inc. v. Avcar Leasing Sys. Inc.*, 890 F.2d 165, 170-172 (9th Cir. 1989).

²⁹ *Dollar Sys. Inc.* 890 F.2d at 172; See also, Root, Stephen C. *The Meaning of ‘Franchise’ Under the California Franchise Investment Law: A Definition in Search of a Concept*. 30 McGeorge L. Rev. 1164, 1168 at n61.

³⁰ As set forth in *Franchise Desk Book*. *supra* note 9 at 21-30, § 31101 addresses the minimum net worth, experience, disclosure, and notice filing requirements; § 31110 emphasizes the mandatory requirement of franchise registration; § 31119 requires a minimum of ten days to share all related materials in the agreement between the franchisor and franchisee; § 31200 and § 31202 state the illegality of making any untrue statement or purposefully omitting information in any documents filed with the Commissioner or in any written material relating to the franchise.

³¹ See, § 31300 and § 31303 in *Franchise Desk Book*. *supra* note 9 at 31-2.

³² As set forth in *Franchise Desk Book*. *supra* note 9 at 30, § 31201 makes it unlawful for a franchisor to omit information or make an untrue statement in any written or oral communication not enumerated in § 31200.

³³ See, § 31301 and § 31304 in *Franchise Desk Book*. *supra* note 9 at 31-2.

While Sections 31303 and 31304 address similar misrepresentations, the allowed length of time for filing an action differs. Thus, it is essential to recognize which sections apply to various alleged misconduct. It also is important to recognize that the four-year outside time period is actually a statute of repose -- *i.e.*, it does not matter whether or not the franchisee has become aware of the violation; after four years the claim is time barred. Additionally, while plaintiffs may file a claim within four years, one of the shorter time frames for filing may have expired and provide a basis for the dismissal of the action.³⁴

The Discovery Rule: The statute of limitations usually begins to run from the occurrence of the last necessary element for the cause of action.³⁵ While the plaintiff's ignorance usually does not toll the statute, the discovery rule permits tolling if the defendant took active steps to conceal the violation. The discovery rule assists in cases in which it would be unjust to deny the plaintiff's claim before there is any recognition of injury.³⁶ Behavior, such as misrepresentation and fraud, provides a potential justification for tolling the statute.

The application of the discovery rule arose in *People, v. Speedee Oil Change Systems, Inc.*³⁷ In this case, the California Court of Appeal for the Second Appellate District determined that the delayed discovery and tolling rules did not apply because Section 31306 expressly limits the tolling of the statute of limitations to the specific provisions of the California Corporations Code. The Court relied on Section 31306, which states that "except as explicitly provided in this chapter, no civil liability in favor of any private party shall arise against any person by implication from or as a result of the violation of any provision of this law . . . [but] nothing in this chapter shall limit any liability which may exist by virtue of any other statute."³⁸ Following this rationale, the Court applied the four-year statute of repose and the two-year statute of limitations in Sections 31303 and 31304 to dismiss the franchisee's claim for damages.

Common Law Fraud

In addition to statutory claims of fraud under the CFIL,³⁹ common law fraud issues may arise because the CFIL does not limit otherwise actionable common law claims available to the franchisee -- *i.e.*, the CFIL expands those common law claims by providing for additional statutory rights.⁴⁰

Common law fraud claims may arise in connection with the franchisor's alleged oral or written misrepresentations (or omissions where a duty to disclose is present) regarding earnings claims or other similar representations. In *Wang Labs, Inc. v. Ma*

³⁴ *The People, ex rel Dept. of Corps. v. Speedee Oil Sys. Inc.* 95 Cal. App. 4th 709, 723-727 (2002).

³⁵ *El Pollo Loco v. Hashim*, 316 F.3d 1032, 1039 (9th Cir. 2003).

³⁶ *See*, 316 F.3d at 1038-1039.

³⁷ 95 Cal. App. 4th 709, 726-727 (2nd App. Dist. 2002).

³⁸ Cal. Corp. Code, § 31306.

³⁹ *Id.* at § 31200-31202.

⁴⁰ *Id.* at § 31306.

*Labs, Inc.*⁴¹, a case involving a common law fraud claim, the United States District Court for the Northern District of California stated that “to prove fraud Ma [the franchisee] must establish that: (1) Wang [the franchisor] made a false representation of a material fact, (2) with knowledge of its falsity and for the purpose of inducing Ma to act thereon, and (3) that Ma relied upon the statement to its detriment.”⁴² The reasonableness of the statements, reliance upon the statements, and the statements' relation to past or present conduct are all key elements in common law fraud cases.⁴³ Under common law, the Court explained, “ordinarily, false statements that concern matters of opinion, conditions to exist in the future, or matters promissory in nature are not actionable.”⁴⁴ Under the CFIL, however, claims for fraud or deceit are not so limited.⁴⁵ Thus, while a “misrepresentation” may not constitute fraud under common law, the same “misrepresentation” may nevertheless constitute actionable fraud under the CFIL.

The California Franchise Relations Act

The CFRA governs the relationship between the franchisor and the franchisee after the franchise agreement has been signed by both parties. It is important to understand the terms and conditions contained in each franchise agreement because they can be the basis for non-trivial litigation between franchisees and franchisors.

The CFRA, like the CFIL, is incorporated in every franchise agreement by legal implication. To the extent that the statutory provisions may conflict with the terms of the franchise agreement, the statutory provisions control. Notably, for example, the franchisor may not terminate a franchise agreement during its term without “good cause.”⁴⁶ This requirement obtains without regard to contradictory language contained within the four corners of the franchise agreement.

Termination: Section 20020 of the CRFA provides that “no franchisor may terminate a franchise prior to the expiration of its term, except for good cause. Good cause includes, but is not limited to, the failure of the franchisee to comply with any lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure the failure.”⁴⁷ However, pursuant to Section 20021 of the CFRA, a franchisor may immediately terminate a franchise agreement for the following reasons:

- Franchisee declares bankruptcy;

⁴¹ 1995 U.S. Dist. LEXIS 18054 (N.D. Cal. 1995).

⁴² *Id.* at 39.

⁴³ *Id.* at 38-39. *See also, Piantes v. Pepperidge Farm, Inc.* 875 F. Supp. 929 (D. Mass. 1995).

⁴⁴ *Id.* at 41. (Even under common law, however, “statements of present intention as to future conduct may be the basis for a fraud action if . . . the statements misrepresent the actual intention of the speaker and were relied upon by the recipient to his damage”).

⁴⁵ Cal. Corp. Code §§31012 and 31306.

⁴⁶ Cal. Bus. & Prof. Code §20020

⁴⁷ *See, Franchise Desk Book*. supra note 9 at 91.

- Franchisee abandons the franchise by failing to operate for five consecutive days;
- Franchisor and franchisee agree in writing to terminate the contract;
- Franchisee makes any material misrepresentations relating to the acquisition of the franchised business or engages in conduct that reflects poorly upon the franchisor;
- Franchisee fails to comply with any federal, state or local law applicable to the operation of the franchised business after having received a 10-day notice of noncompliance;
- After previously curing any failure under Section 20020, the franchisee repeats the same noncompliance;
- Franchisee repeatedly fails to comply with a material requirement of the franchise agreement, whether or not it has been corrected by the franchisee;
- Franchised business is taken over or seized or foreclosed by the government or judgment creditor;
- Franchisee is convicted of a felony or criminal misconduct relevant to the operation of the franchise;
- Franchisee fails to pay any franchise fees within 5 days after receiving written notice; and
- Continued operation of the franchise will result in an imminent danger to public health or safety.

Non-renewal: Often, a franchisor may choose not to renew the franchise agreement following the expiration of its stated term. Unlike in-term terminations of the franchise, which generally require a showing of “good cause,” the franchisor may fail to renew a franchise as long as the franchisor provides the franchisee at least 180 days prior written notice of its intention not to renew (the “Non-renewal Notice Period”);⁴⁸ and:

- During the Non-renewal Notice Period, the franchisor permits the franchisee to sell its business to a prospective purchaser who meets the franchisor’s then current qualifications and requirements; ***or***
- The franchisor has not refused to renew the franchise for the purpose of converting the business to a franchisor - owned/operated business - although the franchisor may exercise a valid right of first refusal agreement - ***and*** the franchisor does not seek to enforce any covenant against competition by the non-renewed franchisee; ***or***
- The franchisor has “good cause” or other independent and reasonable grounds for termination of the franchise; ***or***
- The parties have mutually agreed to the non-renewal; ***or***

⁴⁸ Cal. Bus. & Prof. Code, § 20025.

- The franchisor withdraws its franchise method of distribution from the franchisee’s relevant market; provided that (i) the franchisor must agree not to enforce any covenant against competition by the franchisee; (ii) the franchisor does not intend to convert the business to a franchisor-owned/operated business; and (iii) if the franchisor intends to sell or otherwise transfer the franchisee’s marketing premises or the franchisor’s interest in other controlled marketing premises, the franchisor must give the franchisee a right of first refusal or a third-party offer of a franchise on substantially the same terms currently being offered by the transferee franchisor, where applicable; *or*
- The franchisor and franchisee are unable to agree to changes or additions to terms of the franchise agreement during the renewal period which are substantially similar to those terms made available to all franchisees in their franchise agreements.⁴⁹

CFRA Franchisee Remedies: The CFRA differs from the CFIL in that there is no general provision granting the franchisee the right to recover damages. Nevertheless, violations of the CFRA either by the franchisee or the franchisor may result in the recovery of damages by the wronged party. The franchisee, however, may not recover damages from the franchisor resulting from its failure to provide sufficient notice of non-renewal, provided that the franchisee has had an opportunity to resell the business and the franchisor has offered to repurchase the franchisee’s inventory.

For example, in *Boat & Motor Mart v. Sea Ray Boats, Inc.*,⁵⁰ the United States Court of Appeals for the Ninth Circuit held that, although Sea Ray violated the CFRA by not giving the plaintiff 180 days’ notice of its intent not to renew the agreement between the parties, the plaintiff had no damages remedy because Sea Ray offered to repurchase Boat & Motor Mart’s inventory upon expiration of the franchise agreement, consistent with the remedy available to Boat & Motor Mart under Section 20035.⁵¹

The franchisor must repurchase the franchisee’s inventory in all cases where the franchisor either seeks to terminate or to non-renew the franchise agreement. Thus, Section 20035 of the CFRA provides as follows:

In the event a franchisor terminates or fails to renew a franchise other than in accordance with the provisions of this chapter, the franchisor shall offer to repurchase from the franchisee the franchisee's resalable current inventory meeting the franchisor's present standards that are required by the franchise agreement or commercial practice and held for use or sale in the franchised business at the lower of the fair wholesale market value or

⁴⁹ *Id.* at § 20025.

⁵⁰ *Boat & Motor Mart v. Sea Ray Boats, Inc.*, 825 F.2d 1285, 1288 (9th Cir. 1987).

⁵¹ *Id.* Notwithstanding this, Section 20037 of the CFRA reserves to the franchisee the right to sue the franchisor “under any other law” -- *i.e.*, the CFRA statutory claims do not represent the franchisor’s exclusive remedy.

the price paid by the franchisee. The franchisor shall not be liable for offering to purchase personalized items which have no value to the franchisor in the business which it franchises.⁵²

The franchisor, however, “may offset against any repurchase offer made pursuant to [the CFRA] any sums owed the franchisor ... by the franchisee...”⁵³

CFRA Franchisor Remedies: The franchisee’s violations of the CFRA typically consist of a failure to pay royalties and market fees; a failure to submit required financial reports; and, other violations of a material term or condition of the franchise agreement. In cases where the franchisor has performed its obligations under the franchise agreement, but the franchisee has materially breached one or more of its performance obligations, the franchisor’s remedy is to terminate the franchise agreement pursuant to Sections 20020 and 20021. A failure by the franchisee to comply with a material term or condition of the franchise agreement usually is a legitimate justification for termination.⁵⁴

Antitrust: Price and Nonprice Vertical Restrictions

Very often, a franchisor will insist that the franchisee comply with various restrictions related to the franchisee’s wholesale purchase and retail reselling activities. For example, the franchise agreement may provide that the franchisee may only sell the franchisor’s products from the franchisee’s “authorized location” or within a specified “primary area of responsibility” or other defined territory. Additionally, the franchisor may reserve to itself certain customers or classes of customers. The franchisor also may demand that the franchisee agree not to handle any products which compete with the franchisor’s products.

In other instances, the franchisor may condition the franchisee’s purchase of one product from the franchisor or designated supplier upon the purchase of some other product from the same supplier or, alternatively, that the franchisee carry not only the franchisor’s “fast moving” models, but also, the “slow moving” items within the franchisor’s entire product line.

Finally, in some other instances, the franchisor may want the franchisee to establish resale prices at certain minimum levels so as to avoid “discounting” which may “cheapen” the consumer’s perception of the franchisor’s brand or negatively impact the franchisee’s “profitability.”

Arrangements such as these that restrict or limit conditions of purchase or sale between a franchisor and franchisee are called vertical restraints. Under the federal

⁵² *Id.* at § 20035.

⁵³ Cal. Bus. & Prof. Code, § 20036.

⁵⁴ Cal. Bus. & Prof. Code, § 20021. *See also* discussion, in section entitled “Future Profits/PIP v. Sealy,” *infra* at p. 15-16.

antitrust laws⁵⁵ -- here, principally Section 1 of the Sherman Act -- the reasonableness of vertical restraints is analyzed under one of two different tests, depending on the nature of the restraint.

Per se analysis: Certain restraints on competition are treated as “per se” illegal. The most common examples are minimum resale price maintenance and price-fixing among competitors. Other per se illegal activities include allocating customers or markets, bid rigging, and group boycotts. These practices are so clearly injurious to competition that a court will find them illegal on their face. Once the conduct itself has been established, the court will not hear evidence that justifies or explains it. Per se violations often result in criminal prosecution.

Rule of reason analysis: Practically every commercial contract “restrains” trade to some extent. The Supreme Court recognized many years ago that only agreements which “unreasonably” restrain trade are banned. Most restraints are, therefore, tested under the “rule of reason,” and when courts are uncertain as to the competitive significance of a particular restraint, they will apply the rule of reason rather than the per se analysis. Under this standard, a business arrangement or practice is determined to be unreasonable only if, on balance, its negative effect on competition in a relevant market outweighs the pro-competitive benefits that it might produce. Generally speaking, if the benefits outweigh the detriments, the restraint will be found to be reasonable.

Since 1977, nonprice vertical restraints must be evaluated under the rule of reason.⁵⁶ The various forms of vertical restraints, except for vertical price fixing (“resale price maintenance”), certain joint refusals to deal (“boycotts”), and certain tying arrangements, are evaluated under the so-called “rule of reason.”

Pricing Agreements: Agreements between franchisors and franchisees regarding the franchisees’ minimum resale prices are prohibited absolutely -- *i.e.* they are unlawful (and illegal) per se.⁵⁷ Conversely, vertical ***maximum*** resale price maintenance agreements are not illegal per se -- they now are evaluated under the “rule of reason.”⁵⁸ Franchisors may, of course, set the prices at which it sells its products to others, but the franchisor may not set or control the minimum price at which any franchisee resells the products.

Having said this, discussion by the franchisor of suggested minimum retail prices, markups, margins of profit and special discounts with franchisees may be reasonable and

⁵⁵ The federal antitrust laws include the Sherman Act, 15 U.S.C. §§1-7, the Clayton Act, 15 U.S.C. §§12-27, and the Federal Trade Commission Act, 15 U.S.C. §§41-58.

⁵⁶ *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977) (rule of reason analysis applicable to all vertical nonprice restraints -- including the location clause at issue -- and thus the legality of such restraints tested on a case-by-case balancing of competitive effects).

⁵⁷ *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911) (series of vertical resale price maintenance agreements with authorized wholesalers and retailers were per se unlawful).

⁵⁸ *State Oil Co. v. Khan*, 118 S. Ct. 275 (1997) Note, however, that this might still be an open issue under certain state antitrust or “Little FTC” laws.

lawful. However, suggested retail prices are no more than the name implies and no threats or other coercion should be communicated or applied to any franchisee. The establishment of actual minimum retail prices must remain the sole discretion of the franchisee.

Conditioning Sales of One Product On the Franchisee's Agreement to Purchase Another (Product Tying and Full-Line Forcing): A tying arrangement occurs when a franchisor offers a product or service for sale on the condition that the franchisee also purchases another product or service. Certain other conditions must exist, however, before a tie-in will be declared illegal. The franchisor must have sufficient market power over the desired, or tying, product to force the franchisee to also take the second, tied product. Market power may be found where the desired product is patented, or where there are few franchisors of competing products. While certain severe instances of tying are still treated as illegal *per se*, the analysis that must be undertaken to justify application of the *per se* rule borders on a full-blown "rule of reason" inquiry.

Full-line forcing is a variation of tying that almost always is judged under the "rule of reason." "Full-line forcing" occurs when a franchisor requires a franchisee to carry a full line of the franchisor's products. Instead of conditioning the sale of one particular product on the franchisee's purchase of another product, the franchisor conditions the entire franchise relationship on the franchisee's willingness to handle the complete line of the franchisor's products. Full-line forcing, judged under the "rule of reason," usually is found to be a reasonable means of protecting the franchisor's interest in the efficient distribution of all its products.

Territorial and Customer Restrictions: As a general matter, a franchisor may adopt, by agreement with its franchisee, restrictions on the distribution of the franchisor's products. A franchisor thus may limit its franchisee to selling designated products only; within assigned territories only; or to designated customers or categories of customers. Assignments of territories, customer categories or products by a single franchisor to its franchisee are judged under the "rule of reason" standard, and generally are found reasonable so long as they are justified by a legitimate business purpose.

Although restrictions on resale tend to restrict competition among franchisees of the same products ("intra-brand" competition), they also can enhance the competitiveness of the franchisor's products as compared with products of other franchisors ("inter-brand" competition). Exclusive territories, for example, provide incentives for dedicated franchisees to invest in promotional, warranty, service and safety activities.

In evaluating the reasonableness of a restriction on resale, the courts frequently will look, not only for a business justification for the practice, but also for a reasonable relationship between the particular restraint adopted and the business justification. Consequently, it is preferable to adopt less restrictive means of achieving the business purpose when such means are available. Rather than assigning inviolable sales territories, for example, a franchisor can achieve protection of product promotion and

support services by assigning “primary areas of responsibility,” and by requiring franchisees to share profits with other franchisees into whose territories they sell.

Location clauses: Location clauses provide that the franchisee is only authorized to sell the franchisor’s product or services from the place identified in the franchise agreement. Failure to comply with the provision may provide grounds for termination of the franchise agreement. These clauses, standing alone, uniformly have been upheld, often as a matter of law.⁵⁹ For the most part, these clauses have not been challenged for more than a decade.

Exclusive Dealing and Requirements Contracts: Exclusive dealing provisions and requirements contracts are other types of restrictions that a franchisor may impose upon its franchisees by agreement. An exclusive franchise provision prohibits a franchisee from dealing in goods that compete with those of its franchisor. Under a requirements contract, a franchisee must buy all of its requirements for a specified product or product line from the designated franchisor. Exclusive franchise and requirements contracts have similar effects on competition, and are analyzed in similar fashion under the “rule of reason.”

Unlike territorial and customer restrictions, an exclusive franchise arrangement may have a direct impact on inter-brand competition because it forecloses a franchisee from dealing in goods of competitors. Similarly, a requirements contract may foreclose a franchisee, for the duration of the contract, from purchasing competing goods from other manufacturers and competitors of the franchisor. Despite these foreclosure effects, both requirements contracts and exclusive franchise arrangements can promote reasonable and legitimate business ends. A requirements contract, for example, guarantees the franchisor a certain level of demand for its product, and so encourages investment in product development and productive capacity.

The courts generally have approved exclusive franchise arrangements so long as they do not unreasonably restrict competition. The legality of such arrangements will turn on a multitude of factors, including the franchisor’s market power, whether the restraint facilitates collusion among franchisees or resale price maintenance by the franchisor, whether the restraint forestalls entry by competing franchisors and manufacturers into the exclusive franchisee’s territory, and, finally, whether the restriction enhances inter-brand competition and efficient distribution of the product.

Discrimination In Price, Promotional Allowances or Services: Section 2 of the Clayton Act, amended in 1936 by the Robinson-Patman Act, prohibits discrimination in price between different purchasers of commodities of like grade and quality where the effect of the price differential may be to substantially lessen competition or to tend to create a monopoly in any line of commerce.⁶⁰ Under this provision, the franchisor generally must make the same prices available to all franchisees and other purchasers at

⁵⁹ See e.g. *Golden Gate Acceptance Corp v. General Motors Corp.*, 497 F.2d 676 (9th Cir. 1979)

⁶⁰ 15 U.S.C. §13(a)

the same level of distribution. There are two recognized exceptions to the rule against price discrimination. First, a franchisor can justify charging a lower price to a particular franchisee by showing that there is an actual cost savings associated with the lower priced sale. Such savings frequently result from large volume sales or reduced packaging and shipping costs. Second, a lower price may be offered to a particular franchisee in order to meet prices or favorable selling terms offered by a competitor. Note that the franchisor may only offer to meet -- not beat -- prices and other terms offered by the competitor.

The Robinson-Patman Act further requires that promotional allowances or services furnished to franchisees in connection with the resale of a product must be made available on a proportionally equal basis. Thus, while large volume franchisees may receive greater discounts and more ancillary services from the franchisor, these benefits may not be denied to other, smaller volume franchisees. Rather, promotional allowances and services must be conferred in proportion to the volume of sales to each franchisee.

Promotional allowances and services include advertising allowances, sales incentives, catalogs, displays, sales literature, warehousing facilities, storage and display cabinets, credits on returned merchandise, and volume discounts. Generally, the franchisor must inform all of its franchisees of the availability of such allowances, services or facilities.

Enforcement and Remedies: The Department of Justice, the FTC, and private individuals enforce federal anti-trust laws. This differs from violations of the FTC Rule, which only allow for governmental action. Violations can result in both monetary fines and imprisonment. While the FTC and private parties may seek injunctive relief and damages in civil suits, only the Department of Justice can bring both criminal and civil charges against violators of federal anti-trust legislation.

Other Hot Topics:

Expansion: While state statutes generally control any conflicting provision in a franchise agreement, expansion and encroachment issues tend not to be legislated by the state. Rather, expansion and encroachment are usually addressed in specific provisions of the franchise agreement. If the franchise agreement does not grant to the franchisee a specific exclusive geographic territory, the franchisee may, with varying degrees of success, claim the right to an implied exclusive territory under a covenant of good faith and fair dealing theory of liability.⁶¹

The Right to Transfer: Depending upon the terms of the franchise agreement, a franchisee usually will have the right to transfer the franchise to another party, subject to the franchisor's prior right of approval. However, a franchisor cannot withhold its approval of the transfer of the franchise for an unreasonable period of time.

⁶¹ See, *In re Vylene Enterprises, Inc.* 90 F.3d 1472, 1477 (9th Cir. 1996).

In many instances, the franchisor reserves to itself in the franchise agreement a right of first refusal. This right of first refusal requires the franchisee to permit the franchisor to match all bona fide offers to purchase the franchise prior to any putative sale or transfer of the franchise. Should the franchisor decide to exercise its right of first refusal, the franchisor then has the option of operating the franchise itself, closing the franchise location, or selecting a new franchisee for the franchise location.

Non-competition: Franchisors usually insist upon a non-compete clause in the franchise agreement, which prevents a franchisee from operating a competing business during the term of the franchise agreement (“in-term non-competition”), and/or from opening and operating a competing business after the termination of the agreement (“post-term non-competition”).

Under California law, "every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void."⁶² Section 16600 of the California Business and Profession’s Code generally invalidates post-term non-competition agreements, except in limited circumstances. However, in-term non-competition agreements are usually upheld because they do not restrict the franchisee from pursuing an *entire* business, trade or profession, but only a competing business during the term of the franchise agreement.⁶³

In *Scott v. Snelling and Snelling, Inc.*,⁶⁴ the United States District Court for the Northern District of California upheld a post-term non-competition covenant where the subsequent competition involved the unauthorized use of trade secrets and confidential information. The Court in *Scott v. Snelling and Snelling, Inc.* stated that, “under California law . . . a covenant restraining competition will be enforced when the subsequent competition constitutes unfair competition, such as the unauthorized use of trade secrets or confidential information.”⁶⁵ However, the court reiterated that section 16600 would apply to limit post-term covenants not to compete absent the unauthorized use of trade secrets and confidential information. The Court indicated that “that the California courts would apply [Cal. Bus. & Prof. Code] section 16600 to a franchise agreement containing a covenant restraining competition. . . . A simple reading of this statute, giving the words their ordinary meaning, demonstrates that the California state legislature intended section 16600 to apply to any sort of contract which contains a covenant restraining competition.”⁶⁶

Future Profits/PIP v. Sealy: In *Postal Instant Press ("PIP") v. Sealy*,⁶⁷ the trial court awarded the franchisor all past and future royalty and advertising fees in compensation for the franchisee's breach of the franchise agreement by failing to make royalty payments. The California Court of Appeal for the Second Appellate District

⁶² Cal. Bus. & Prof. Code § 16600.

⁶³ See, *Scott v. Snelling and Snelling, Inc.*, 732 F. Supp. 1034, 1043 (N.D. Cal. 1990).

⁶⁴ 732 F. Supp. at 1043

⁶⁵ *Id.* at 1038.

⁶⁶ *Id.* at 1040.

⁶⁷ 43 Cal. App. 4th 1704 (2nd App. Dist. 1996).

affirmed the award of past unpaid royalty and advertising fees, but reversed the lower court's award of future unpaid royalty fees because the franchisor terminated the franchise agreement.⁶⁸ The Court suggested that the franchisor could have remained entitled to future royalties for the full term of the franchise agreement if it had not terminated the franchise agreement, but instead sued to collect the past payments as they came due. The court found that the franchisee's failure to make past royalty payments was not the "natural and direct" cause of the franchisor's failure to receive future royalty payments; rather, it was the franchisor's decision to terminate the franchise agreement which resulted in the loss of its right to future royalties.⁶⁹

Nevertheless, the question whether a franchisor may recover future lost profits when a franchisee anticipatorily repudiates the franchise agreement remains an open issue in California. Thus, in *Remedytemp, Inc. v. Taylor*⁷⁰, the defendant franchisee, relying upon the rationale employed by the Court in *PIP v. Sealy*, argued that the franchisor was not entitled to recovery of lost future profits.⁷¹ The district court in Pennsylvania specifically indicated that "[i]f the jury ultimately finds that it was the defendant, not the plaintiff, that terminated the franchise agreement, nothing in [*PIP v. Sealy*] rules out the possibility of plaintiff's recovery of lost future profits."⁷²

Arbitration/Forum Selection: In a typical franchise agreement, the parties have agreed to resolve any disputes "arising under" or "relating to" the franchise agreement or the relationship of the parties by arbitration and, further, to restrict such arbitration to a particular forum. In California, Section 20040.5 of the CFRA provides that that "[a] provision in a franchise agreement restricting venue to a forum outside this state is void with respect to any claim arising under or relating to a franchise agreement involving a franchised business operating within this state."⁷³ If the parties have agreed in the franchise agreement to an arbitration venue outside California, Section 20040.5 would appear to invalidate such a provision in the arbitration agreement.

Nevertheless, the United States Court of Appeals for the Ninth Circuit has held in *Bradley v. Harris Research*⁷⁴ that -- to the contrary -- Section 20040.5 is preempted by the Federal Arbitration Act ("FAA")⁷⁵ -- *i.e.*, the California state law may not invalidate a pre-dispute mandatory arbitration provision in a franchise agreement which is otherwise valid under federal law.⁷⁶ As a result, the Ninth Circuit reversed the lower court's decision requiring the parties to arbitrate their dispute in California.

⁶⁸ *Id.* at 1717-1719.

⁶⁹ *Id.* at 1709-1712.

⁷⁰ 1998 U.S. Dist. LEXIS 1474 (E.D. Penn. 1998).

⁷¹ *Id.* at 6.

⁷² *Id.*

⁷³ Cal. Bus. & Prof. Code, § 20040.5.

⁷⁴ 275 F.3d 884 (9th Cir. 2001).

⁷⁵ 9 U.S.C. § 2.

⁷⁶ *See, Bradley v. Harris Research*, 275 F.3d at 890-892.

In so holding, the Ninth Circuit distinguished its earlier opinion in *Laxmi Investments, LLC v. Golf USA*,⁷⁷ which held that the FAA does not preempt Section 20040.5 where there is no "meeting of the minds on the forum selection clause" in the franchise agreement between the parties.⁷⁸ The holding in *Laxmi* was based on the fact that: (1) the franchisor had given the franchisee a UFOC that stated in part that the franchise agreement required binding arbitration in Oklahoma, but that this requirement "may not be enforceable under California law," a reference to Section 20040.5; (2) there was no evidence that the franchisor "ever indicated that it would insist upon an out-of-state forum despite the contravening California law," referred to in the UFOC; and (3) the franchisee had no reason to expect that it had agreed to an out-of-state forum.⁷⁹ The Ninth Circuit therefore held that the district court erred in enforcing the arbitration provision in the franchise agreement which required arbitration in Oklahoma.⁸⁰

Arbitration/Class Action: There is currently a split between the Fourth and Second Appellate Districts in the California Court of Appeal as to the validity of a contract provision barring class arbitration in an arbitration agreement. In *Mandel v. Household Bank*,⁸¹ the California Court of Appeal for the Fourth Appellate District found a provision barring class arbitration unconscionable.⁸² In *Mandel*, the plaintiff argued that a provision in the credit card agreement requiring that "no class actions or joinder or consolidation of any Claim with the claim of any other person are permitted without written consent of [plaintiff] and [defendant]" is unconscionable and invalidates the entire arbitration agreement.⁸³ The court found the provision barring class arbitration unconscionable, ordered it severed pursuant to the terms of the contract, and held that the remainder of the arbitration agreement was valid.⁸⁴

The provision barring class arbitration was found to be unconscionable because the defendant was "fully aware that few customers would go to the time and trouble of suing in small claims court" and "sought to create for itself virtual immunity" from class actions.⁸⁵ In evaluating the unconscionability of the provision, the court indicated that a party may not be forced to abide by contract terms obtained through the unfair bargaining power of one of the parties and are so one-side and oppressive as to "shock the conscience."⁸⁶

Although the defendant vaguely argued that the FAA should be applied to enforce the parties agreement, the court noted that its decision was "perfectly consistent" with the FAA, which provides that arbitration agreements involving commerce are fully enforceable except on any grounds -- *i.e.* unconscionability -- that exist at law or equity

⁷⁷ 193 F.3d 1095 (9th Cir. 1999).

⁷⁸ *Id.* at 1097.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ 105 Cal. App. 4th 75 (4th App. Dist. 2003).

⁸² *Id.* at 83.

⁸³ *Id.* at 82.

⁸⁴ *Id.* at 83.

⁸⁵ *Id.*

⁸⁶ *Id.*

for the revocation of any contract.⁸⁷ The *Mandel* court ordered the superior court to strike the term prohibiting class arbitration and held that the agreement was otherwise enforceable and binding on the plaintiff, requiring her to arbitrate her claims.

In *Discover Bank v. Superior Ct. of Los Angeles Co.*,⁸⁸ a case not citable because it has been superseded by grant of review, the California Court of Appeal for the Second Appellate District held that the FAA preempts any otherwise applicable California judicial law finding class action waivers to be substantially unconscionable and invalid.⁸⁹ Subsequently, the California Court of Appeal decision in *Discover Bank* was highly criticized by the United States Court of Appeals for the Ninth Circuit in *Ting v. AT&T*⁹⁰ and in *Ingle v. Circuit City Stores, Inc.*⁹¹ According to the Ninth Circuit in *Ingle*, the California Court of Appeal contradicted its own precedent in *Szetela v. Discover Bank*⁹², with a decision that, "runs contrary to the plain text of Section 2 of the FAA in addition to "established federal judicial precedent interpreting this section."⁹³ In holding the provision prohibiting an employee's ability to initiate class arbitration as "shockingly one-sided" and "substantively unconscionable,"⁹⁴ the Ninth Circuit noted that while the FAA does express Congress's intention to generally give effect to arbitration agreements, it does not supplant state law governing the unconscionability of adhesive contracts.⁹⁵

In *Green Tree Financial Corp. v. Bazzle*⁹⁶, the United States Supreme Court recently held that when the parties have agreed to arbitration, the arbitrator should decide the question of contract interpretation as to whether the contract between the parties provides for class arbitration. In *Green Tree*, the parties agreed to arbitrate "all disputes, claims, or controversies arising from or relating to [the] contract or the relationship which result from [the] contract."⁹⁷ Accordingly, the Court held that a dispute about what the arbitration contract means is a dispute "relating to this contract" and the resulting "relationships" and is therefore one in which the parties have agreed that an arbitrator and not a judge would resolve the question.⁹⁸ The Court noted that had the dispute been whether the parties had a valid arbitration agreement or whether the arbitration provision applied to a certain type of controversy,⁹⁹ then, in these "certain limited circumstances," "courts assume that the parties [intend that the] courts, [and] not arbitrators" should decide the particular arbitration-related matter.¹⁰⁰

⁸⁷ *Id.*

⁸⁸ 105 Cal. App. 4th 326 (2nd App. Dist. 2003).

⁸⁹ *Id.* at 345.

⁹⁰ 319 F.3d 1126 (9th Cir. 2003).

⁹¹ 328 F.3d 1165 (9th Cir. 2003).

⁹² 97 Cal. App. 4th 1094 (4th App. Dist. 2002).

⁹³ *Ingle v. Circuit City Stores*, 328 F.3d at 1176, n.15.

⁹⁴ *Id.* at 1176.

⁹⁵ *Id.* at 1175, n. 10.

⁹⁶ 123 S. Ct. 2402 (2003).

⁹⁷ *Id.* at 2407.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

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