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Evidentiary Requirements To Recover Lost Future Royalties

By Jay W. Schlosser

When franchisors enter into long-term franchise agreements, they expect to receive a steady stream of royalties for the duration of the agreement. In some cases, that can mean 20 years of royalty revenue from one franchise location. However, if the relationship sours and the agreement is terminated prior to expiration, the franchisor faces the prospect of losing the anticipated stream of royalties for the remaining term of the agreement. More and more often, franchisors are turning to the courts to attempt to recover those lost future royalties.

Most courts agree that if a franchisee terminates the franchise agreement, a franchisor is permitted to recover lost future royalties. *See*, *Healy v. Carlson Travel Network Assocs.*, 227 F.Supp.2d 1080, 1094 (D. Minn. 2002); *Vino 100, LLC v. Smoke on the Water, LLC*, 864 F.Supp.2d 269, 286 (E.D. Pa. 2012). However, if the franchisor terminates the franchise agreement due to misconduct or a breach by the franchisee, the issue remains unsettled. *See*, *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704 (1996) (court, applying a proximate cause analysis, refused to allow franchisor to recover lost future royalties when

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Emergence of State Initiatives Could Change Franchising

By Kevin Adler

In the last two years, many state legislatures have considered new franchise laws. Few of these bills have been passed or enacted, but some of the bills represent the potential for significant changes in treatment of franchising as a unique business model and of the franchisor-franchisee relationship. At the very least, franchisors need to be more aware of state legislators' interest in franchising than in the past.

Franchising Business & Law Alert surveyed leaders in franchising about whether the trend toward greater involvement in franchising at the state level would be beneficial or harmful for the industry.

DR. MARK ABELL
BIRD & BIRD

All of the recent activity at a state level creates a feeling among foreign franchisors looking to enter the U.S. market that there is a volatile and unpredictable legal environment in the U.S. for franchisors. An environment that at best leads to an extraordinarily high need for legal advice and, hence, legal fees in order to ensure compliance, or, at worst, presents significant barriers to effective market penetration.

I know of many foreign franchisors who have taken a look at the U.S. market over the past two years, but decided that it would easier and ultimately more profitable for them to enter markets with a more stable regulatory environment — like China and the Middle East!

CHARLES S. MODELL
LARKIN HOFFMAN

Even the best franchise systems have failures. Sites go bad, people do not follow systems, and some people get into a business that is not suitable for them. And yes, some franchisors have poor systems and should not be franchising.

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I believe the reason for the recent increase in legislative proposals to regulate franchising is twofold. First, people in the U.S. [including business owners] are short on teaching accountability and long on blaming others when something goes wrong. So long as we have that mindset, people will go to court and to their local legislator to seek redress for their losses. Second, with the significant setbacks suffered by the Republican Party in recent years, Democrat-controlled legislatures are more receptive to what they see as bills to protect "the little guy."

No, this activity is not good for franchisors. It is also not good for the vast majority of franchisees who want their franchisors to protect the system in which they invested. Federal law is based on providing complete disclosure to prospective franchisees. To the extent that is not happening, that is what the focus of legislative reforms should be. The government should not be trying to protect people from their own failures, from investing in unproven systems, or from investing in one with a documented history of failures. And judges and juries should not be put in a position of second-guessing business decisions made by people responsible for developing, maintaining and/or expanding businesses.

Joel Buckberg
Baker, Donelson, Bearman, Caldwell & Berkowitz

State legislative activity falls into four buckets. Bucket 1 is conformity to the 2007 FTC franchise rule changes and exemption definitions, and this bucket is quite empty. Bucket 2 is the legislation seeking to stop or enact attempts by state unemployment and workers' compensation trust funds from defining franchises as employment, and forcing franchisors to pay unemployment taxes and workers' compensation premiums based on the net revenue distributed to franchisees after franchise fees are paid or deducted. These are revenue plays, pure and simple, for exhausted trust funds that have lost revenue as employees convert to entrepreneurs, and manufacturers leave the state. Bucket 3 is directed at the franchise relationship and the so-called "level the playing field" limitations on contractual rights and terms that affect the franchise agreement or its enforcement. These range from benign or procedural safeguards that give franchisees more time or better notice, to more extensive changes that shift risk and reward. Bucket 4 is the most extreme, seeking to reverse court decisions that would be enforceable outside the franchise context, and make huge changes in risk, certainty and reward to the point where franchising is too risky. Bucket 4 means that growth will be accomplished with company stores financed by securities and real estate offerings, not franchises.

Rupert Barkoff
Kilpatrick, Townsend & Stockton

It is time to replace our franchise regulatory system.

At a colloquium sponsored by the Franchise Law Institute in March 2012, as well as at the recent ABA Forum on Franchising in Orlando, strong sentiments were expressed about the deficiencies in the current U.S. regulatory scheme. Our Constitution was designed to give only specified powers to the federal government and to reserve for the states the remaining powers.

It is finally time for us to realize that when it comes to franchise regulation, the Commerce Clause, which allows the federal government to regulate commerce, should trump the reserved power principle. While I would not go so far as to say that the dual levels of regulation in franchising will kill the goose that lays the golden eggs, the regulatory scheme does inhibit franchising in the United States. My recent trip to Australia only confirmed my thoughts on this subject. The Aussies (and certainly business people in other countries), looking at our

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franchise regulatory scheme, think we are mad. The federal budget fight and debt default scare only further confirm this view generally.

Franchise regulation in the U.S. is broken and has been broken for over 40 years. The addition of any more state legislation will only exacerbate the problem. It is time for the franchise sector to call for full federal pre-emption and to develop, with the participation of all stakeholders, a system that is efficient and an enforcement process that has teeth when egregious violations occur. The baby steps in regulation we are now taking will just make the situation worse.

MATT HALLER
INTERNATIONAL FRANCHISE ASSOCIATION

Is there a need for more franchise legislation? Absolutely not. Franchising is already highly regulated by the Federal Trade Commission (FTC), and most states have laws governing franchise relations and disclosure laws regulating the sale of franchises. State legislatures have recognized franchising is highly regulated, and when coupled with built-in dispute resolution procedures in franchise contracts, believe expanded government regulation would be unnecessary, duplicative and potentially impact franchise development.

IFA believes that when there are the occasional disputes between franchisees and franchisors, the solution should be found between these two parties, and not through legislation. Once government gets involved in a business, it is very hard to extract it.

As an alternative to governmental intervention, the IFA has a long-established ombudsman program to help franchisees and franchisors resolve their differences. Additionally, the IFA commissioned a task force that produced a document reflecting guiding principles between franchisees and franchisors that will be released soon. Further, the IFA has had a long-standing Franchise Relations Committee consisting of franchisees and franchisors to address issues facing our industry.

STANLEY M. DUB
LAW OFFICES OF STANLEY M. DUB

I'm a franchise attorney in private practice, and I've represented both franchisors and franchisees. I don't think this latest wave of regulatory activity at the state level amounts to much. Just because a new law is proposed, doesn't mean it will pass — most don't. And even if some pass, most of these proposed laws are very limited.

Broadly speaking, state franchise laws are divided into disclosure laws, which regulate the way franchisors sell their franchises, and relationship laws, which control some of the restrictions that franchisors might otherwise put in their agreements. Franchise sellers are required to comply with FTC disclosure rules when they sell franchises, but the FTC leaves the enforcement to the states, and many states don't regulate franchises at all. I think every state should at least require that franchisees receive a disclosure document that complies with FTC rules. However, franchisees as a group lack power and a voice within state legislatures, and the franchisor-oriented business community typically opposes any new franchise laws.

Franchise agreements are loaded with terms and requirements that are slanted in favor of the franchisor. Often, some of these terms cannot be justified. A potential franchise buyer offered such an agreement can choose only to take it or leave it. Buyers of successful franchises like McDonald's may thrive despite these one-sided agreements, but other franchisors write similar agreements even though they don't deliver similar results. State laws may eventually address some of these imbalances, but no forces are in place to suggest these changes will occur soon.

PETER LAGARIAS
LAGARIAS LAW OFFICES

Opponents of legislation do not want to address the overreaching of franchisors in franchising. To them, all legislation is excessive regulation and a drag on the economy. Yet how can they ignore franchise systems, including nationally touted franchisors, with large numbers of franchisee failures?

Bad behavior by franchisors is compounded by the ever-prevalent, one-sided franchise agreements prepared by and for franchisors. Franchisees need legislation to protect their investments and equity in their franchise businesses. A franchisee with multiple-six-figure investment of her life savings should not be terminated or not renewed for minor violations. Nor should she have her franchise business cannibalized by franchisor encroachment or be forced to buy overpriced product from vendors paying kickbacks to her franchisor. But franchise agreements almost never provide real rights for franchisees over these and many other fundamental issues.

Franchise agreements and disclosure documents should not allow franchisors to disclaim responsibility for marketing franchises with phony earnings claims and promises. Such fine-print sales documents should not absolve franchisors, especially when they market their franchises as successful and proven business models. Statutory protections with private rights of action are essential to confirm to courts that Franchise Disclosure Documents and representations may be relied upon by franchisees. The days of "Franchise Disclaimer Documents" should end.

Adequate franchise legislation, like securities and antitrust laws, is warranted to curb marketplace abuses.

MATTHEW J. KREUTZER
ARMSTRONG TEASDALE LLP

The uptick in proposed franchise legislation is part of a vicious cycle: the proposed laws are a symptom of a continuing frustration on the part of franchisees with what they view as increasingly unfair franchise agreements. Those agreements, in turn, are a reflection of the need by franchisors to account for and address risks presented by adverse court decisions industry-wide. But, by trying to bring balance to the

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franchise relationship, some of the proposed laws may cause harm.

As an example, if passed, California Assembly Bill 1141 (2013) (as amended, http://bit.ly/1c2WR70) would make certain individuals associated with the franchisor jointly and severally liable to franchisees for any violation of California's Franchise Investment Law. It would also seek to prohibit a franchisor to refuse to renew a franchise, possibly creating a perpetual relationship. These and other aspects of that law could have an anti-business effect.

As we have seen with California's law regarding negotiated sales (which has chilled negotiations between franchisees and franchisors), sometimes laws that are intended to bring balance and fairness to the relationship can have the opposite effect. A broad-sweeping, pro-franchisee law may protect existing franchisees. But, at the same time, it may also harm people who want to buy franchises: If the law discourages franchisors from doing business in the state, it may prevent new franchise relationships from forming.

MAISA JEAN FRANK
GRAY PLANT MOOTY

There does appear to be somewhat of a recent uptick in attempted state legislation governing the franchise relationship, but as has been noted, legislators have not been successful in passing proposed legislation. Many of these bills seem to have been proposed by franchisees and/or their attorneys, and this may simply represent an increasing level of sophistication and organization among franchisees and their attorneys.

Both franchisors and franchisees should take an interest in proposed changes or additions to laws that govern their relationship because such laws could have an impact on the quality of the system. For example, both franchisors and franchisees ultimately opposed the [California A.B. 1141] because they recognized the importance of preserving franchisors' ability to enforce the provisions in the franchise agreement. The bill would have limited a franchisor's ability to terminate or refuse to renew a franchise agreement and would have imposed a good faith standard of dealing between the parties. A franchisor needs to be able to protect the quality and reputation of its system by taking necessary actions, including termination, with underperforming franchisees. Franchisees have an interest in protecting the quality of the system and their investment in it, and so they, too, should want franchisors to have the ability to deal with underperforming franchisees. Thus, both franchisors and franchisees had an interest in preventing the passage of [California A.B. 1141]. In addition, franchisors and franchisees both likely recognized that the imposition of the good faith standard may have potentially increased the cost of resolving disputes between the parties.

Ultimately, it does not appear likely that many (or any) of the bills related to the franchise relationship will pass.

ERIK WULFF
DLA PIPER

Are these shots across the bow? We are experiencing an unusually high level of state legislative efforts to tilt the playing field more towards franchisees. If enacted, these laws would be detrimental to the franchising business model. Franchisors — and those who believe in franchising — as a strong engine for economic growth need to pay heed. All is not well.

The economic downturn and slow recovery has not spared many small businesses, including franchised businesses. Is enough being done to help franchisee networks (which are imperative for the success of a franchisor) survive and flourish during these challenging times?

Franchisee lawyers tell us that franchise agreements are becoming more onerous on franchisees. Do these agreements reflect the franchisees' legitimate interests? Is a proper balance being struck?

Anecdotal evidence indicates that franchisee organizational activity is on the rise. Are there effective channels of communications, and are franchisee concerns being heard and respectfully dealt with?

Although the current state legislative efforts appear less coordinated than the federal efforts in the 1990s (and, therefore, perhaps less likely to succeed), one can never discount the possibility that some of these efforts will pass. Franchisors need to continue to improve their franchise models in order to ward off legislation that will adversely affect franchising. One need only consider the state of the automobile industry and its dealership regulatory regime to envision how legislation has the potential to straight-jacket business format franchising. Positive steps can — and need — to be taken to ward this off.

DAVID KOCH
PLAVE KOCH

I don't see the current level of state legislative activity as unusual. If anything, the period of relative quiet that preceded this latest round was unusual.

Some of the individual proposals have merit — in particular, bills to clarify that franchisees are not employees. But as a whole, the state proposals are not particularly good for franchising, for the same reasons as in other industries. First, they introduce a businessperson's worst enemy: uncertainty. Second, in the worst cases (especially [California A.B. 1141] and Maine's [proposed LD 1458, The Small Business Investment Protection Act, http://bit.ly/I7Kxcy]), the proposals have the potential to fundamentally alter the allocation of risks and rewards in franchise contracts. Their effect, if not the purpose, is to shift risk from the franchisee to the franchisor. What the proposals fail to recognize is that the initial franchise fee, ongoing royalty and other commercial terms have been structured based on a whole set of assumptions — such as whether the franchisor will be able to protect the brand by enforcing non-compete obligations. If legislation shifts risks and compliance costs to franchisors, it likely means increased fees for franchisees to offset the new obligations. And at an extreme, the new

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News Brief

Maryland Franchise Attorneys Discuss Possible Law Changes

Franchise attorneys in Maryland have been evaluating revisions to the Maryland Franchise Registration and Disclosure Law, 02.02.08.00, *et seq.*, during the fall of 2013. While the proposed changes have yet to yield a recommended bill, the effort has already resulted in a mechanism to streamline the state's franchise registration and renewal process.

In early October, a member of the Maryland House of Representatives, Rep. John S. Cardin, met with franchise lawyers to discuss details of a bill he was interested in putting before the legislature. He indicated that he would propose it if it received an endorsement from the Maryland State Bar Association. And so the group's Franchise and Distribution Law Committee went to work to see if it could agree on language that it could support and send to the Business Law Section.

Among the key discussion points at the meeting and in follow-up meetings were: exempting Maryland-based franchisors from jurisdiction under the Maryland Franchise Act when selling to out-of-state franchisors; restricting the Maryland Securities Commissioner's review of FDDs when evaluating registration or renewal amendment applications; allowing recovery of attorneys' fees by prevailing claimants in private civil litigation brought under the Act; and creating a Franchise Advisory Committee to advise the Maryland Securities Commissioner on franchise matters.

"The discussions with Rep. Cardin, Maryland regulators, and attorneys for franchisors and franchisees were productive," said franchise attorney David Cahn (Whiteford Taylor & Preston), who worked on the initial legislative language discussed by the committee. "We found areas of agreement, and there were benefits for franchisors and benefits for franchisees. But to date there has not been enough agreement for an endorsement." Discussions are continuing around a bill of more limited scope that might gain enough support from the committee, he added.

One concrete benefit from the effort is that Dale Cantone, deputy commissioner in the Maryland Attorney General's Office, and Maryland Securities Commissioner Melanie Lubin have agreed to lead an ad hoc committee to discuss franchise registration and renewal issues. The first meeting date will be Dec. 16.

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risks and costs reduce the incentive to franchise at all. We already counsel franchisor clients that they might want to consider omitting certain states from their franchising plans.

I don't deny that franchisees are sometimes injured by irresponsible franchisors, and it is natural for legislators to respond to complaints from constituent franchisees by introducing a bill. But a legislative solution hits everyone, good and bad, and legislators lose sight of the potential ramifications for future franchisees.

Domonic Mochrie
Osler, Hoskin & Harcourt

Changes to state-level franchise legislation can have interesting trickle-down effects in other countries. Speaking from the Canadian perspective, when faced with new or proposed legislation that would impact the operation of the franchise program in the U.S., franchisors with operations in Canada often enquire with local Canadian counsel whether similar legislation is under consideration in any provinces or at the federal level. As our provincial franchise legislation focuses on disclosure, and, other than imposing a duty of fair dealing on the parties, does not regulate the relationship between the franchisor and the franchisee, the answer is usually no.

Even still, given the general similarities between the two countries, franchisors may still be sensitive to developing issues in the U.S. and may consider mirroring any changes to its U.S. program in Canada to maintain system uniformity. In other instances, the introduction (or even the threat of) legislation which would have a fundamental impact on the structure of a franchise program in the U.S. can result in the franchisor diverting greater resources to jurisdictions, like Canada, where the original business model can operate without requiring any modification.

Beata Krakus
Greensfelder, Hemker & Gale, P.C.

The pending Maine [LD 1458], Massachusetts [S. 1843; http://1.usa.gov/1i1DemQ] and Pennsylvania [H.B. 1620; http://bit.ly/I7LAZX] bills are, in some regards, similar to the franchise relationship statutes that many other states already have. However, they go significantly further in providing franchisee protection. This is done in a rather heavy-handed manner, and one that is not appropriate for a diverse business model such as franchising. While it is unlikely such one-sided bills will pass, if they did, they are likely to have a chilling effect on franchising in those states and, consequently, wouldn't benefit franchisors or franchisees. Franchisors are likely to avoid those states because of the significant loss of freedom of contract that the bills entail.

The proposed bills apply as if franchising was a uniform industry and not a business model. Franchise programs vary exceedingly because the industries in which they operate do, too. However, the bills contain detailed provisions that treat all franchisors as if they

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it terminated the agreement); *but see*, *American Speedy Printing Centers, Inc. v. AM Marketing, Inc.*, 69 F.Appx. 692 (6th Cir. 2003) (court, following traditional contract principles, allowed franchisor to recover lost future royalties even though it terminated the agreement).

Recovery of future royalties by a franchisor is a two-step process: 1) establishing the legal right to recover future royalties; and 2) submitting sufficient evidence to establish the amount of future royalties to a reasonable degree of certainty. Although several articles have looked at step one, less consideration has been given to step two. This article focuses on step two and some of the obstacles a franchisor may face in submitting adequate evidence to support an award of future royalties. This specific issue was addressed in a recent decision by U.S. District Court for the District of Minnesota, and it illustrates the potential hurdles a franchisor may face — even if the matter is unopposed by the franchisee. *See*, *Novus Franchise, Inc. v. AZ Glassworks, LLC*, Civil No. 12-1771 (MJD/TNL), 2013 WL 1110838 (D. Minn., March 18, 2013).

Novus v. AZ Glassworks

In *Novus*, the franchisees stopped submitting revenue reports and stopped paying monthly royalties. Novus Franchise, Inc. (Novus) learned that the franchisees had abandoned the franchise and had started operating a competing business. Novus filed a lawsuit against the franchisees to seek injunctive relief to enforce a post-term non-compete provision. Novus also sought to recover past due royalties as well as future royalties for the remaining term of the franchise agreement.

The defendants failed to answer or otherwise respond to the complaint. Novus moved for entry of default judgment. The court entered judgment for the full amount of past due royalties and a permanent injunction enforcing the non-compete provision. However, the court refused to enter an award for future royalties for the remaining term of the franchise agreement, despite the fact that the defendants/franchisees did not oppose the motion.

Novus had asked the court to award all future royalty and maintenance fees required under the terms of the franchise agreement from the date of termination until the end of the term of the franchise agreement in 2019 — a total of $68,040. The court cited two reasons for rejecting Novus's unopposed motion.

First, the court found that Novus had failed to take into account any costs that it saved as a result of the early termination of the franchise agreement. Without those included in the equation, the court determined that Novus was overstating its future profits.

Second, the court noted that Novus had requested future profits for the entire remaining term of the franchise agreement. The court found that it was highly likely that Novus would establish a new franchisee in that geographic area to replace the defendants prior to 2019 and that the replacement franchisee would eliminate, or at least reduce, future damages. The court stated that awarding future damages for the entire remaining term of the agreement would encourage Novus to "commit economic waste by putting forth no efforts to mitigate its damages."

Days Inns v. Investment Properties

In reaching this decision, the *Novus* court cited to a previous decision it had issued, *Days Inns Worldwide, Inc. v. Investment Properties of Brooklyn Center, LLC*, No. 10-609 (MJD/JJK), 2011 WL 4538076 (D. Minn. Aug. 26, 2011) adopted 2011 WL 4537934 (Sept. 29, 2011). Similar to *Novus*, in *Days Inns* the franchisee had defaulted and had not opposed the franchisor's request to recover future royalties. The court in *Days Inns* rejected the request for the recovery of future royalties by noting that the franchisor had failed to submit sufficient evidence to support an award and, thus, future royalties could not be established with a reasonable degree of certainty. The court noted, among other things, that Days Inns had failed to submit any evidence as to how long it would likely take to locate a new franchisee for the geographic area in question, and awarding future royalties for the remainder of the term would encourage Days Inns to put forth no efforts to mitigate its damages.

Conclusion

The *Novus* and *Days Inns* decisions serve as an important reminder to franchisors and their counsel. If a franchisor seeks the recovery of lost future royalties, it must make sure that it provides a thorough submission to support such an award that includes, but is not limited to, specifically addressing saved costs and mitigation due to replacement franchisees. Those reductions may decrease the amount ultimately awarded to the franchisor, however, they will avoid situations like *Novus* and *Days Inns* in which the court refused to award any future royalties. While courts are willing to award lost future royalties to a franchisor, the franchisor must be submit sufficient evidence to establish the lost royalties with a reasonable degree of certainty, even if the franchisee has defaulted and/or does not oppose the request.

Jay W. Schlosser is a partner in the Minneapolis office of Briggs and Morgan, P.A. He is a member of the firm's Franchise, Antitrust and Distribution Practice Group and provides counseling and litigation services to various franchise, manufacturing and distribution entities. He can be reached at jschlosser@briggs.com or 612-977-8539.

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COURT WATCH

By Cynthia M. Klaus and Susan E. Tegt

Franchisor's Operation of Online Store does not Violate Exclusivity

The United States District Court for the District of Minnesota recently granted in part a franchisor's motion to dismiss a franchisee's claims for breach of contract and breach of the duty of good faith and fair dealing, holding that the franchisor acted within the bounds of the franchise agreements between the parties when the franchisor commenced the operation of an online store. *Newpaper, LLC v. Party City Corp.*, No. 13-1735 ADM/LIB, 2013 U.S. Dist. LEXIS 137796, at 16 (D. Minn. Sept. 25, 2013).

In *Newpaper*, a party supply retail franchisee operating 25 Party America retail locations entered into an agreement (the "Agreement") to convert its Party America locations to Party City stores, also agreeing to terminate all of its Party America franchise agreements and execute new Party City franchise agreements. *Id.*, at 2. Said conversions were the result of the sale of Party America Corporation and Party City Corporation to a parent company. *Id*. The Agreement granted to the franchisee the exclusive right to operate Party City retail stores in Minnesota, Iowa, North Dakota, South Dakota, and 12 Wisconsin counties bordering Minnesota and Iowa. *Id.*, at 3. In the Agreement, the franchisor reserved the right to sell its products as well as products sold by the franchisee through other distribution channels, including the Internet. *Id*.

In 2009, the franchisor launched an Internet store, "caus[ing] a backlash among its franchisees." *Id.*, at 4. When several franchisees sent a demand for mediation related to the franchisor's Internet sales, the franchisor filed suit against those franchisees, including the plaintiff franchisee in *Newpaper*, alleging tortious interference. *Id*. Several months later, purportedly as a part of the settlement of the franchisor's lawsuit, the plaintiff franchisee and other franchisees executed addenda to their franchise agreements, affirming the franchisor's right to sell products online in exchange for a share of revenue from Internet sales made within a three-mile radius of each franchised retail location. *Id*. Approximately three years after executing the addenda to the franchise agreements, the plaintiff franchisee filed suit against the franchisor, alleging, among others, that the franchisor: 1) breached the exclusivity clause of the Agreement by conducting online sales through an online "store"; 2) breached the covenant of good faith and fair dealing; and 3) converted the franchisee's property interest in the territory by selling products online. *Id.*, at 5. After removal of the lawsuit to federal court, the franchisor moved to dismiss the claims. *Id.*, at 5-6.

Dismissing the franchisee's claim for breach of the exclusivity clause of the Agreement for failure to state a claim, the federal district court held that the Agreement "unambiguously and unqualifiedly states [the franchisor] shall have the right to sell its goods 'by or through the Internet.'" *Newpaper*, at 13. The district court furthered the explanation by indicating that the franchisee's handwritten identification in the addenda of the "territory" subject to compensation for Internet sales did not alter the material terms of the contracts between the parties, and it dismissed the franchisee's claim for compensation for Internet sales for its entire exclusive geographic territory, instead of the more limited three-mile radii defined in the addenda. *Id.*, at 15-16.

In dismissing, in part, the franchisee's claim for breach of the duty of good faith and fair dealing on the basis that the franchisor forced the franchisee to accept customer returns for online purchases, used the franchisee's ad fund contributions to promote the Internet store, and undercut the franchisee's retail prices via the online store, the district court held that the franchisee's complaint failed to state a claim on most of those theories. *Id.*, at 26. The district court held that the addenda expressly required the franchisee to accept Internet returns and that the ad fund claim should not have been stated as a breach of the covenant of good faith and fair dealing claim, but rather as a breach of contract claim. *Id.*, at 26-28. However, with respect to the allegation that the franchisor was underpricing its franchisees, the court declined to dismiss the claim — asserting that, if true, the franchisor "may be using its website, and its own products, to compete against franchisees, who are also largely buying and then selling the same products. Such competition could amount to an evasion of the spirit of the bargain…." *Id.*, at 30.

Newpaper provides strong support for franchisors facing claims of breach of exclusivity agreements by franchisees resulting from the operation of online retail stores. Franchisors are advised to articulate in their agreements the right to operate online retail stores or other distribution channels and also articulate whether franchisees will assume any obligations from these alternate forms of distribution, such as accepting returns or contributing advertising funds that may benefit an online store. Franchisors should similarly exercise caution when pricing goods for sale online so as not to undermine its franchisees and subject itself to claims for breach of the covenant of good faith and fair dealing, among others.

Federal Court Declines To Enjoin Franchisee from Violating Non-Compete

The United States District Court for the District of Maryland recently denied a pizza restaurant franchisor's

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Movers & Shakers

In October, **Beata Krakus** was named the recipient of the American Bar Association (ABA) Forum on Franchising Chair's Future Leader Award. She is an officer in the Franchising & Distribution and Corporate practice groups at Greensfelder, Hemker & Gale, P.C.

The award recognizes Forum members who have demonstrated a substantial commitment to the Forum by undertaking significant leadership initiatives. An active member of the Forum since 2003 and a member of the Steering Committee for the Forum's Women's Caucus, Krakus has spoken numerous times at the annual Forum on Franchising. She has been an associate editor for the Forum's publications and contributed articles to *FBLA*.

State Initiatives

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were operating in an identical fashion. For example, franchisors could not require franchisees to operate evening hours. Presumably, this provision would protect franchisees from operation during hours of low profitability. But how will hotel, night-time nursing franchises or other businesses that, by default, are open at night operate?

Court Watch

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motion for injunctive relief to enforce a franchisee's post-termination covenant not to compete, holding that the court's grant of an injunction to prohibit the franchisee's trademark infringement effectively protected the franchisor and precluded a finding of irreparable harm with respect to the restrictive covenant claim. *Ledo Pizza System, Inc. v. Singh*, No. WDQ-13-2365, Bus. Franchise Guide (CCH) ¶ 15,145 (D. Md. Oct. 10, 2013).

In *Ledo Pizza System*, a franchisor terminated a franchisee after several defaults by the franchisee. *Id*., at 2. Upon expiration of two agreed-upon forbearance periods, the franchisee continued to operate its franchised restaurant after termination and continued to use the franchisor's trade name and trademarks. *Id*. The franchisor moved to immediately restrain the franchisee from further trademark infringement and to enforce the franchisee's post-termination obligations not to compete with the franchisor. *Id*.

The district court granted the franchisor's motion for injunctive relief with respect to the franchisor's trademark infringement claims, but denied to grant the motion for preliminary relief with respect to the enforcement of the post-termination covenant not to compete. *Id*., at 6-7. Applying Maryland law, the district court held that the franchisor failed to establish imminent irreparable harm on the basis that, because the court granted the franchisor's request for immediate injunctive relief on the trademark infringement claims, any continued operation of a restaurant without the franchisor's name or trademarks is not likely to harm the franchisor. *Id*., at 6. The district court refused to distinguish the harm argued to be suffered by the franchisor by the former franchisee's continued operation of a pizza restaurant, with or without the franchisor's trade name and trademarks, indicating that the franchisor failed to show how the violation would prevent the franchisor from soliciting new franchisees, "given that the defendant is prohibited from associating any new future restaurant with the Ledo pizza brand." *Id*. The district court further indicated that the grant of injunctive relief on the trademark claims will "prohibit the defendant from offering 'products and services in essentially the same manner'" as it had before, thereby not causing harm to the franchisor's reputation. *Id*., at 6-7. In so ruling, the district court appeared to disregard the franchisor's arguments that "the ability of a franchisee to terminate a franchise agreement and continue to offer products and services similar to the franchisor is likely to send a clear signal to other franchisees that they can terminate their franchise agreements and continue to [offer] such products and services in essentially the same manner." *Id*., at 6.

Ledo Pizza System serves as yet another reminder to franchisors of the high burden placed on franchisors to prove irreparable harm when seeking preliminary injunctive relief. Courts will occasionally refuse to distinguish between the harm caused by trademark infringement and the separate harm caused by violation of a covenant not to compete, such as the signal sent to other franchisees that they can easily thwart their post-termination obligations or the continued association of the franchisee or the franchisee's business location in the mind of the public, undermining a franchisor's goodwill and reputation. Franchisors and their counsel are encouraged to articulate the different forms of irreparable harm faced by franchisors when seeking preliminary relief for both trademark infringement and violations of covenants not to compete.

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