New England Franchise Association
September Dinner Meeting
September 18, 2007

Legal and Legislative UPDATE

LEGISLATIVE

- **Massachusetts Legislative Proposal** – Senate Docket 1981
  - Proposal: Relationship Statute. Would prohibit franchisor from terminating, canceling, or failing to renew a franchise without "good cause." Good cause includes "franchisee's refusal/failure to comply substantially with any material and reasonable obligation of the franchise agreement," with certain exceptions
  - Requires fair market value compensation for inventory, supplies and equipment franchisee purchased from franchisor or its designated sources *and goodwill* (exemption from payment for goodwill if at least 1 year notice of non-renewal and franchisor agrees not to enforce non-compete covenant).
  - Prohibits termination or nonrenewal if franchise fails to sell products at suggested pricing.
  - Prohibits Franchisor notifying franchisee of a claimed breach of the franchise agreement for good cause more than 6 months from the date good cause arises or franchisor knew "or in the exercise of reasonable care should have known" of the claimed good cause.
  - Entitles franchisor or franchisee to have the question of good cause submitted to arbitration under the rules of the American Arbitration Association – nonbinding decision.
  - Requires franchisors to provide support for warranty support franchisee provides to franchisor's products
  - In Joint Committee on Community Development and Small Business as of June 20, 2007. Heard and eligible for executive session.
- **Massachusetts Health Care Reform Law**
  - Every Massachusetts *resident* is required to have health insurance by July 1, 2007 – the "individual mandate." Must have "minimum creditable coverage." Standard starts as very basic but after December 31, 2008 it will get more strict and a broader range of medical benefits must be

offered. HIRD form to be required – to be filed with individual tax returns. Employers must keep copies for 3 years.

  - Employers have to play a part by offering coverage or facilitating access. Applies to employers with 11 or more full time employees ("FTE"). FTE *generally means* minimum of 35 hours per week. Beware contractors (MGL c. 149, Section 148B!!!), seasonal and temps. "Fair share premium contribution" (two distinct tests – primary (25% take up rate) or secondary (offer to pay at least 33% of premium cost for group health plan offered to FTE's – but may be different definition of FTE) or a $295 per year contribution for each FTE required.
  - The Massachusetts Health Insurance Connector – a public corporation - (i) facilitates access to insurance (see the "Connector"), (ii) defines "minimum creditable coverage," (iii) administers Commonwealth Care, (iv) establishes "affordability" standards, (v) promulgates cafeteria plan regulations, and (vi) administers waivers and appeals.
  - Free rider surcharge – for state funded costs in excess of $50,000 if employee not offered participation in a 125 plan. Plan must have premium only feature – other features are options.
  - ERISA preemption for parts of the new law?
  - Get your 125 plan adopted!!! State filing is not required unless requested.
  - Beware different definitions of contractor – status versus federal. May meet federal definition but not the state.
  - September 30th is the end of the first "Fair Share" determination period – HIRD forms will be mailed this week to employers (11 or more FTE's) throughout the state. 45-day period to submit HIRD information and to verify compliance.

- **Rhode Island Fair Dealership Act** – Public Law No. 2007-36
  - RI enacted "Fair Dealership Act" on June 14, 2007. First state to do so since Iowa in 1992. Almost identical to Wisconsin's law. Very little publicity.

- Requires the grantor of a dealership to provide a dealer at least 90 days' prior written notice of the termination, cancellation, non-renewal or *substantial change in competitive circumstances* of a dealership and to provide the dealer with at least 60 days in which to rectify any claimed deficiency (10 days for payment defaults). *(italics added)*
- While Act does not explicitly require "good cause," it does define "good cause." It is intended to be a relationship statute with broad remedial scope.
- It is uncertain whether good cause will be implied as courts begin to interpret the act. In addition, the RI legislature may always revisit the Act to more clearly apply "good cause" language.
- Purportedly applies to existing contracts – but that may be unconstitutional.
- Be aware that the obligation of "good faith" usually found in all agreements is not the equivalent of "good cause."

REGULATORY

- **New FTC Franchise Disclosure Rule. 16 C.F.R. Part 436.**
  - Separate franchise and biz op disclosure
  - Only regulates offers and sales – no relationship regulation
  - Applies only in the US
  - Goodbye UFOC – Hello "Franchise Disclosure Document" ("FDD")
  - Mandatory compliance by July 1, 2008
  - Simplified timing – 14 days before paying or signing a contract. Delivery can be in any form the franchisor wants – including electronic.
  - Substantive disclosure is meant to be more on point:
    - Litigation more focused on franchisor-initiated litigation
    - Territorial disclosures are enhanced – especially other channels of distribution by the franchisor

        - Clearer disclosure of what a "renewal" means – particularly if a new contract with materially different terms is required.
        - Can provide likely franchisee expenses alone without it being considered an "earnings claim"
        - Must disclose any "gag" clauses in effect
        - Must disclose contact information with associations within the brand
    - Slightly less difficult 3-year phase in for new franchisors to use audited financial statements
    - 3 exemptions available only to new franchisors or those using the FDD:
        - Large investment exemptions for initial investments exceeding $1 million
        - Large franchisee exemption for franchise sales to someone (or an entity) with 5 years of experience and a net worth of $5 million
        - An insider exemption for sales to officers, owners, or managers of the franchised business who have been with the franchisor for at least 2 years within 60 days of the sale
- **FTC Activities**
    - As of September 12, 2007, the Chairman said that much of the work of the FTC's Bureau of Consumer Protection has been devoted to data security and identity theft, technology risks to consumers, fraud in the marketing of health care products, financial practices, telemarketing fraud, and enforcement of the National Do Not Call Rule.
    - On May 11, 2007, Darden Restaurants Inc. (which owns restaurant chains Olive Garden, Red Lobster, Smokey Bones, and Bahama Breeze) settled Commission charges that it engaged in deceptive practices in advertising and selling its gift cards. As part of the settlement, Darden will restore fees that were deducted from consumers' gift cards and disclose fees or expiration dates in future gift card sales. This is the agency's second law enforcement action involving allegedly deceptive gift card sales. According to the FTC's complaint, Darden represented that consumers

could redeem the cards to buy goods or services at its restaurants equal to the card's monetary value, but did not disclose adequately the "dormancy fees" that would be deducted after a certain period of time. Under the settlement, Darden has to disclose any automatic fee or expiration date clearly and prominently in future advertising, at point of sale, and on the card. The settlement also requires Darden to restore to each card any dormancy fees that were assessed and publicize the restoration program on its Web sites for two years.

- **States**
  - Franchisors of restaurants may soon see an increase in the efforts of state and local governments to require the posting of nutritional information. On September 11, 2007, the United States District Court for the Southern District of New York, in *New York State Restaurant Association v. New York City Board of Health, et al.*, struck down a New York regulation concerning the posting of caloric information on menu boards and menus because the specifics of that situation caused it to be preempted by the federal Nutrition Labeling and Education Act of 1990 (NLEA). The New York State Restaurant Association (NYSRA) had challenged a regulation recently adopted by the City of New York which required New York City restaurants (which already make the calorie content information of their menu items publicly available) to post that information on their menu boards and menus "in a size and typeface at least as large as the name of the menu item or price, whichever is larger." The menu disclosure requirement was imposed only on those restaurants that already voluntarily made such disclosures elsewhere. New York City explained it had issued the regulation as part of a public-health policy initiative to stem the "obesity epidemic." The NYSRA argued that the regulation was invalid because it is expressly preempted by the NLEA and unconstitutional because it violates its members' First Amendment rights. Through an extensive and detailed analysis of the NLEA and its legislative history, the court concluded that the voluntary nature of the New York regulation led to

it being preempted by the federal statute. However, the court found that regulations that were mandatory in nature were not so preempted.

- Tax Nexus – Ready to get touched…..

COURT DECISIONS

- **Federal – Leegin Creative Leather Products, Inc. v. PSKS, Ins., dba Kay's Kloset** (U.S. Supreme Court, June 28, 2007)
  - Minimum resale pricing floors (vertical restraints) are no longer per se illegal. Instead, the "rule of reason" will be used to evaluate such pricing restrictions. Court abandoned a ban on minimum resale pricing that had been in place for 96 years.
  - The court noted the competitive benefits of pricing restrictions. Each resale pricing requirement will now be examined on a case by case basis.
  - "As courts gain experience considering the effects of these restraints by applying the rule of reason over the course of decisions, they can establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses. Courts can, for example, devise rules over time for offering proof, or even presumptions where justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote procompetitive ones."
  - Businesses should proceed with caution in the aftermath of this case. While some pricing floors may be allowed, anticompetitive restraints will not, and courts will begin by making case by case determinations.
- **Massachusetts – Cummings Properties, Inc. v. Aspeon Solutions, Inc.** (Mass. App. Div., April 30, 2007)
  - A company president, not realizing he was signing a personal guaranty to a commercial lease, succeeded on his argument that the guaranty should be set aside because he was mislead as to the contents of the document.

- Although the President handled the lease and other tasks, it was known by the company/tenant that he was considering leaving it. The president asked whether his company's counsel had reviewed the documents and whether it reflected the final outcome of negotiations. Relying on the lessor's affirmations and believing he was signing in his representative capacity, president signed the lease.
- The judge noted that no one in the president's position would have risked such large sums of his own money for the benefit of a company in which he had no stake and was thinking of leaving. Also, nothing in lease itself or in negotiations with the lender gave him any reason to believe that he would sign in a personal capacity.
- Parties should know that the statements they make during negotiations do matter. In addition, both parties should ensure that they understand the written agreement and that it accurately reflects the agreements they have reached during negotiations.

- **Massachusetts – Dunkin Donuts Franchised Restaurants LLC v. Cardillo Capital, Inc.** (D.C. Fla., July 30, 2007)
  - Franchisor argued that franchisee breached an agreement by failing to make required payments but continuing to operate its business as if still a franchisee. Franchisee did not succeed in its argument that franchisor had waived its claim by accepting electronic payment of the unpaid fees over three months after the effective date.
  - Under Massachusetts law, a party who claims another has waived a contractual provision is required to show unequivocal conduct proving that the opposing party would not request that the contractual provision be performed.
- **California – Radisson Hotels Int'l, Inc. v. Majestic Towers, Inc.** (D.C. Cal., January 24, 2007)
  - Franchisor was allowed to recover liquidated damages despite the fact that franchisor had terminated the agreement with franchisee, because

franchisee's failure to pay past due royalties may have been the proximate cause of the franchisor's lost future profits.

- A further chipping away of the *PIP v. Sealy* line of cases.
- These parties included a specific provision in their agreement that required franchisee to indemnify the franchisor's lost profits in the event that their agreement was terminated as a result of franchisee's failure to pay past royalty fees.
- This case is another illustration of the importance of carefully drafting to anticipate potential future issues. Careful drafting brings predictability.

- **California – Wagner Construction v. Pacific Mechanical.** (Cal. Sup. Ct., May 21, 2007)
  - An arbitrator should be the one to decide where a party asserted an affirmative defense that the statute of limitations had run on a claim parties had agreed to arbitrate.
  - The defense was not justifiable reason for the court to deny the party's request for arbitration, as the statute of limitations defense was within the scope of the parties' agreement to arbitrate.
  - If there is uncertainty as to what issues are arbitrable, the decision will lean in favor of arbitration.
- **Connecticut – Doctor's Associates, Inc. v. Downey.** (D.C. Conn., February 12, 2007)
  - The franchisees contended that, because an association of franchises was not a party to the franchise agreements with the arbitration clause, the franchisor was not an aggrieved party who could compel arbitration with respect to claims brought by the association.
  - The court instead held that the issues presented in the association's suit were the subject of the arbitration clause.
  - The same agreement provisions will usually limit an association suing on behalf of its members as limit those members themselves.

- **Florida – Lady of America Franchise Corp. v. Malone** (D.C. Fla., February 10, 2006)
  - Franchisee claimed to have properly relied on what it believed were intentional misrepresentations made by a franchisor in order to induce the franchisee to enter into a franchise agreement. Franchisee argued that the franchisor's statements should be admissible, because they showed that the agreement was induced by fraud.
  - The agreement had a detailed provision expressly disclaiming any representations received regarding profits or success and disclosing the risk associated with entering into the franchise. The provision also gave franchisee an opportunity to expressly list any representations given by the franchisor, which franchisee did not do.
  - Court ruled that franchisee had disclaimed any reliance on franchisor's statements.
  - Once again, addressing foreseeable contingencies with detailed provisions in the agreement will protect the parties' expectations.
- **Illinois – Ramada Worldwide, Inc. v. Homewood Hotel, Inc.** (D.C. Ill., February 5, 2007)
  - Liquidated damages provision found valid and enforceable: Hotel franchise agreement liquidation provision said the franchisor was entitled to $160,000 in liquidated damages from the franchisee for premature termination of the agreement.
  - Franchisee had successfully negotiated a lower liquidated damages amount in the franchise agreement in an informed compromise between the parties, creating a presumption of validity and shifting the burden of proof to the franchisee. The franchisee also failed to show that the liquidated damages were excessive, the court finding that the franchisor's 11-year loss of future revenues would be very difficult to determine.
- **Minnesota – Bores v. Domino's Pizza LLC** (D.C. Minn., May 31, 2007)
  - A franchisor violated its agreements with its franchisees by requiring them to install the franchisor's PULSE computer system in their restaurants but

refusing to provide the system's specifications in accordance with the agreement.

  - The parties' franchise agreement stated that the franchisor would provide the franchisees with specifications for equipment, fixtures, furniture, computer hardware and software, and decorations required to be used in franchisees' stores and that franchisees would then be free to purchase items meeting those specifications from any source.
  - Franchisor then required franchisees to purchase the PULSE computer system created for Domino's Pizza stores. PULSE hardware can only be purchased from IBM, while PULSE software can only be purchased from Domino's.
  - Franchisees argued that Domino's had mandated PULSE simply to generate additional revenue from its franchisees and insisted that Domino's provide them with PULSE's specifications so that they could purchase the components elsewhere.
  - Although the franchisor argued that its power to require the use of computer equipment justified this behavior, the court ruled against the franchisor, finding that Domino's was required to provide its franchisees with specifications for any required hardware and software.
  - The court dismissed another of franchisor's arguments, which was based on its ability to require franchisees to purchase food, packaging, and other items only from the franchisor, as computer equipment was not mentioned in that provision, thus supporting franchisee's argument.
  - This case is yet another good example of how influential drafting can be to the outcome of a dispute.

- **Texas – Townsend v. Goodyear Tire and Rubber Co.** (D.C. Tex., March 27, 2007)
  - A manufacturer was not liable for the injuries of one of its dealer's employees, after the employee was injured attempting to install tires produced by the manufacturer.

    - Manufacturer owed no duty to the employee, because the manufacturer did not have the right to control the means, methods, and details of the employee's work, and therefore did not have the necessary level of control.
    - This case involves another type of liability that is affected by the determination of the parties' relationship to one another, illustrating the importance of ensuring that the actions of the parties reflects the agreement they have reached.
- **Federal – Wine and Spirits Retailers, Inc. v. Rhode Island** (U.S. Court of Appeals, March 20, 2007)
    - 2004 amendments to the RI liquor franchises law did not unconstitutionally violate freedom of speech: The amendments prohibited the grant, renewal, or transfer of liquor store operator licenses (Class A liquor license) to or for the use of any liquor franchisor/ee and expressly prohibited such license holders from utilizing the provisions of the RI Franchise Investment Act.
    - The amendments also defined the term "chain store organization" to include licensees who engaged in certain common marketing or coordinated planning. Chain store organizations cannot sell alcoholic beverages in RI (retail).
    - The court dismissed the argument that the statute's restrictions on coordinated marketing prohibited the advertisements themselves. Instead, the court found that the statute merely prescribed the launching of advertisements resulting from pre-agreed commercial strategies. Moreover, the conduct in question was not so inherently expressive as to warrant First Amendment protection.
- **Federal – Elkhatib v. Dunkin Donuts, Inc.** (U.S. Court of Appeals, July 10, 2007)
    - The court found that a franchisor could have committed racial discrimination in violation of federal civil rights law by denying a franchisee eligibility for relocation or renewal of his franchise agreements.

- The franchisee refused to carry the franchisor's breakfast sandwiches, as handling the meat ingredients was against his religion. Although the franchise agreement required franchisees to carry the product, many other franchisees refused to carry the product without such retaliation resulting.

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