The Tripartite Relationship: Issues Following Default by a Master Franchise Holder

Terrence Dunn

Mr. Dunn

Perhaps *the* key element in any long-term contract is the language governing defaults and remedies. It is the parties' opportunity at the outset to agree to a set of procedures, remedies, and processes for how to handle breach and termination. The franchisor-franchisee relationship has its own set of considerations, many of which require special attention in the event of a default, including protection of intellectual property, such as trademarks and confidential information; possible preservation and support of a specific ongoing enterprise; and continuation of an unimpaired franchise brand, system, and the goodwill associated with it.

Franchisors often address these considerations in the franchise agreement with provisions that provide the franchisor with rights if a franchisee defaults. There is no such thing as a "standard" franchise agreement, but any competently drawn franchise agreement contains certain types of default-related terms. Those terms invariably include the franchisor reserving rights and providing remedies to protect the essence of its business model. However, for reasons discussed below, the master franchise model poses special challenges in a default scenario.

A master franchise agreement is an agreement in which a franchisor grants rights that allows a party to, among other things, sell unit franchises in a franchisor's system and enter directly into unit franchise agreements with unit franchisees. To avoid confusion, this article will refer to the potential involved parties as follows: (a) the primary franchisor as the *master franchisor*; (b) the subfranchisor as the *master franchisee*; and (c) the ultimate franchise operator as the *unit franchisee*. The paper will examine what happens when a default of a master franchise agreement occurs. It will answer questions, like what happens if the master franchisee defaults and is subsequently terminated for a failure to cure such defaults? What issues are raised that concern the master franchisor when the master franchisee defaults? What effect does the default have on the master franchisor and its relationships with each unit franchisee? (After all, each unit franchisee has various rights under

Terrence M. Dunn is a partner in the New York law firm of Einbinder & Dunn, LLP.

its franchise agreement, and the unit franchisee may now be looking to the master franchisor when enforcing those rights.)

Before reaching these questions, this article will first provide background on what a master franchise agreement is and how it differs from a normal franchisor/unit franchisee arrangement. Next, it will discuss how the federal and state regulatory regime for franchising applies in the context of a master franchise. The article will then discuss the contract and intellectual property law issues that arise when a master franchisee is terminated. Finally, the article will provide practical advice on how best to draft franchise contracts when a master franchisee is involved.

I. How Does a Master Franchise Agreement Differ from Other Forms of Franchise Agreements?

There are a variety of types of franchise relationships and accompanying agreements. The most common, and simplest, franchise relationship is the single unit franchise. For a single unit franchise, the franchisor will enter directly into a franchise agreement with the franchisee for the operation of a single location.[1] The next level is a multi-unit franchise relationship, which occurs when the franchisee plans to open and operate more than one franchise unit. The accompanying agreements often are for a predetermined number of franchise units and usually within a certain territory.[2] Typically, the franchisor and franchisee sign a multi-unit agreement that contains terms related to the sequencing and development of the multiple locations. They will, for example, often have a development schedule for the franchisee that sets out the number of units that the franchisee is required to open in an assigned territory within a certain amount of time.[3] In addition, as the multi-unit owner opens each individual franchise, the parties will sign a single unit franchise agreement that specifically governs the operation of that location.

An area development franchise agreement is somewhat similar: it allows for a franchisee to open and operate a number of units in a given area during a specific amount of time.[4] Like the multi-unit relationship, the franchisee signs a single development agreement and then a separate franchise agreement for the operation of each location. The major difference between the multi-unit franchise structure and area development structure is exclusivity. In an area development franchise agreement, the franchisee is usually granted the exclusive right to develop all franchise locations within an assigned area.[5]

1. *See* Barbara Beshel, An Introduction to Franchising 7 (2010).
2. *See id.*
3. *See* Lane Fisher & Max Staplin, *Planning Ahead: Creating and Enforcing Mandatory Development Schedules in Area Development, Area Representative, and Master Franchise Relationships*, 33 Franchise L.J. 49, 51 (2013).
4. *See International Law Group Studies Franchising, Intellectual Property Aspects*, Bus. Franchise Guide (CCH) ¶ 7301, 2015 WL 6833399 (2018) [hereinafter *Int'l Law Group*].
5. *See* Beshel, *supra* note 1, at 7.

Another franchise development vehicle is the area representative or development agent concept[6] in which the representative recruits unit franchisees and provides certain services in exchange for a fee, which is typically a portion of the initial franchise fee and ongoing royalties charged to the unit franchisees by the franchisor. However, the area representative/development agent is not required to be a franchisee (though they often own unit franchisees too) and is not a franchisor.[7]

The master franchise agreement is a significantly different arrangement from all of those just discussed. A true master franchise agreement grants the right to another person or entity, the master franchisee (also commonly referred to as a "subfranchisor"), not only to operate a franchised business, but also to recruit franchisees and sell unit franchises to other persons or entities, known as unit franchisees (also commonly referred to as "subfranchisees"), in a predetermined geographical area.[8] The terms of this arrangement are spelled out in the master franchise agreement between the master franchisor and the master franchisee. The master franchise agreement often requires the master franchisee to pay a very large initial fee to the master franchisor. Master franchise arrangements are frequently used when the master franchisor is located in a geographically remote location from the master franchisee and the market is less desirable or would otherwise be difficult to administer. For this reason, among others, master franchise arrangements are commonly used by many international master franchisors. Ideally, master franchisees will provide familiarity and knowledge about a given market area that the remote master franchisor does not have.

It is also worth noting that the term "master franchise" is often used informally to describe a number of different business arrangements that do not meet this definition. Many times, the term is used colloquially to refer to an arrangement that is described more accurately as a multi-unit or area development relationship. That is not surprising—all three structures have some similarities. The master franchisor structure also resembles an area representative or development agent arrangement because, in both, the contracting party is recruiting franchisees. But unlike any of the other arrangements, the master franchisee is both a franchisee (of the master franchisor) *and* a franchisor (to the unit franchisee).[9]

Master franchising can be an advantageous business strategy for several reasons. In utilizing master franchising, the master franchisor gains the benefit of growing a presence in a market where it may not otherwise be feasible

6. Susan Grueneberg, *Entering the U.S. Franchise Market: A Summary of Legal Considerations*, 11 Int'l J. Franchising L., 48, 50 (2013).

7. David Levaton, *Area Representatives and Developers, an Outline of Issues*, Franchise Lawyers for Franchisees (Feb. 24, 2015), https://www.franchiselegalsupport.com/Blog/2015/February/Area-Representatives-and-Developers-an-Outline-o.aspx.

8. *See Int'l Law Group*, *supra* note 4.

9. *Franchise Arrangements: Understanding the 4 Types*, Franchise & Business Law Group, http://www.franchisebusinesslawgroup.com/franchise-arrangements-understanding-the-4-types (last visited Dec. 17, 2019).

to accomplish the logistics of making local unit franchise sales or providing sufficient support to develop unit franchises or the system as a whole. Next, master franchisors can generate more upfront revenue from the larger initial fee charged to the master franchisee for the right to operate and sell franchises than it could by waiting for the sale (which could never materialize) of unit franchisees in the future. Additionally, cost savings are often associated with delegating to the master franchisee the obligations typically assumed by a franchisor. While a master franchisor may provide training and other forms of support to the master franchisee, it is typically up to the master franchisee to search for and service its own unit franchisees in its designated local market. On the one hand, in most ways, the master franchisee steps into the shoes of a franchisor, absorbing responsibilities, risk, and control, in order to properly maintain, manage, develop, and support its unit franchisees.[10] On the other hand, the master franchisee also obtains much of the upside that a master franchisor otherwise would have, including keeping the lion's share of the fees earned for selling franchises and receiving a substantial portion of the royalty revenues generated in its region.

But the model has some undesirable qualities as well. Disadvantages of a master franchising arrangement include overcoming the challenges of adapting an already established franchise system to meet the local needs—including those driven by customs, laws, regulations, and consumer preference—that could alter the way the system would usually run. While any franchise system of a certain scale faces this challenge, with the master franchising structure, a new layer of complexity is added: the master franchisor has now placed a middleman in between itself and the operating franchisees. In doing so, the master franchisor forfeits a significant portion of its control over the unit franchisees. The existence of this middleman opens the door for a disconnect between the master franchisor and the unit franchisees. This disconnect can become problematic in a number of ways, such as in communicating system standards, rules, and goals to unit operators, and in efforts to enforce those standards.

Because of the above, the master franchisor's evaluation and selection of the master franchisee is vital. The abilities and access to resources of the master franchisee may determine whether the system succeeds or fails in a particular region, notwithstanding the quality of the system or the efforts of the unit franchisees.

The selection of unit franchisees is equally crucial, but this task will be left mostly to the master franchisee. Significant and specific issues arise if a unit franchisee misbehaves. In that case, the master franchisor must rely on the master franchisee to enforce rights that may directly impact the value and integrity of the system and the brand elsewhere. This reality underscores the importance of selecting a quality master franchisee. A strong master franchisee is likely to make good unit franchisee selection decisions. A weak master

10. *See* Levaton, *supra* note 7.

franchisee is more likely to select unit franchisees that are ultimately low performing, dishonest, or otherwise problematic.

However, the divide between unit franchisees and the master franchisor is of greatest concern when the master franchisee defaults. There, the lack of a direct contractual privity between the master franchisor and the unit franchisees often creates significant issues. The master franchisor has been depending upon the master franchisee for administration, training, support, and the like for the development of the system in the territory. A default by the master franchisee can cripple development in the territory. What's more, the master franchisor may struggle to remedy the situation if the contracts between it and the master franchisee, or the master franchisee and unit franchisees, were poorly drafted or did not sufficiently anticipate the effects of a default.

Before addressing how best to prepare for and deal with this type of situation, it is necessary to understand the legal and regulatory frameworks that govern—or in some cases do not govern—the master franchisor/master franchisee relationship.

II. Master Franchises and the FTC Rule

The Federal Trade Commission's Franchise Rule, as amended in 2008 (FTC Rule), regulates what a franchisor is required to disclose to a prospective franchisee in its franchise disclosure document (FDD).[11] The FTC Rule requires that a FDD consist of twenty-three specific items of disclosure that will allow a prospective franchisee to make a fully informed decision on whether to invest in purchasing the franchise.[12] If a material change to any representation in the FDD occurs, for example a significant litigation involving the franchisor, the franchisor must update the FDD to reflect the change.[13]

These general requirements apply to an FDD involving the grant of a master franchise. Generally, the master franchisor gives a prospective master franchisee a FDD that is specific to the master-franchisee relationship.[14] Master franchisees are themselves, in turn, required to create and issue their own FDD in connection with their sale of unit franchises (often referred to as a "subfranchisor FDD" or "SFDD"). The SFDD must satisfy the same requirements under the FTC Rule that a franchisor has to satisfy.[15] Thus, the SFDD must include all twenty-three disclosure items required by the FTC Rule, as those items relate to the master franchisee. [16] What's

11. 16 C.F.R. § 436 *et seq.*
12. *See id.* § 436.5.
13. *See id.* § 436.7(b).
14. *See* Carl E. Zwisler & Beata Krakus, *Avoiding Common Mistakes in International Franchising*, 48th IFA Ann. Legal Symposium (May 3–5, 2015).
15. Lulu Chiu Gomez, *Drafting the FDD for Multiple or Otherwise Complex Offerings*, ABA 41st Ann. Forum on Franchising (W-19) 17–18, 24 (Oct. 10–12, 2018).
16. Grueneberg, *supra* note 6.

more, the SFDD must contain a number of pieces of information about the master franchisor. The more important items requiring disclosure of information for both the master franchisor and master franchisee include Items 1 (identify of franchisor and affiliates), 2 (business experience), 3 (litigation), 4 (bankruptcy), 8 (restrictions on source of products and services), 11 (franchisor's assistance, advertising, computer systems, and training), 12 (territory), 13 (trademarks), 14 (patents, copyrights, and proprietary information), and 20 (outlets).[17] For example, Item 20 of an SFDD, regarding outlets and franchisee information, must have two separate sets of charts outlining information for both the master franchisees' outlets and outlets in the master franchisor's entire system.[18] In addition, a master franchisee must disclose the financial information of any master franchisor in its SFDD.[19]

III. Registration States

Most states have not chosen to enact franchise specific legislation and are instead content to let the requirements of the FTC Rule govern the sale of franchises in their state. Thirteen states have adopted their own disclosure laws, which apply if the franchise will be located within the state. Each of the registration states also has additional criteria besides franchise location that may mandate registration. For instance, in New York, if the offer for the sale of a franchise is made within the state, accepted in the state, or the prospective franchisee is a resident of the state, state disclosure laws apply even when the franchise itself is ultimately located outside of New York.[20] These thirteen registration states are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.[21] Several other states have filing or notice requirements but do not require the registration of a franchise's FDD: Connecticut, Florida, Kentucky, Maine, Nebraska, North Carolina, South Carolina, South Dakota, Texas, and Utah.[22] None of the registration or notice states has specific rules to govern master franchise agreements other than what the FTC Rule provides, but each of the master franchisor

17. Gomez, *supra* note 15.

18. *Id.*

19. 16 C.F.R. § 436.5(u)(1)(v); *see also Amended Franchise Rule FAQ's*, Fed. Trade Comm'n (Dec. 2013), https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs#9.

20. N.Y. Gen. Bus. Law § 683.

21. *See generally* Cal. Corp. Code § 31110; Haw. Rev. Stat. Ann. § 482E-3; 815 Ill. Comp. Stat. Ann. 705/10; Ind. Code Ann. § 23-2-2.5-9; Md. Code Ann., Bus. Reg. § 14-228; Mich. Comp. Laws § 445.1508; Minn. Stat. Ann. § 80C.02; N.Y. Gen. Bus. Law § 683; N.D. Cent. Code Ann. § 51-19-03; R.I. Gen. Laws Ann. § 19-28.1-5; Va. Code Ann. § 13.1-560; Wash. Rev. Code § 19.100.020; Wis. Stat. § 553.21.

22. Conn. Gen. Stat. § 36b-62; Fla. Stat. § 559.802; Ky. Rev. Stat. Ann. § 367.805; Me. Rev. Stat. tit. 32, § 4696; Neb. Rev. St. § 59-1750; N.C. Gen. Stat. § 66-97; S.C. Code Ann. § 39-57-50; S.D. Codified Laws § 37-5B-4; Tex. Bus. & Com. Code Ann. § 51.051; Utah Code Ann. § 13-15-4.

and the master franchisee must file and complete FDD registrations for each of the master FDD and SFDD.[23]

Additionally, a number of other states, as well as Puerto Rico, have franchise relationship laws.[24] These relationship laws do not require registration, but govern certain aspects of the franchise relationship, most often termination (such as in New Jersey, where the franchisor cannot terminate a franchise without cause).[25] None of those laws sets forth requirements that are specifically or exclusively directed at the master franchisor-master franchisee relationship.[26]

In short, neither federal nor state statutes and regulations regarding the sale of franchises specifically address the differences that make the master franchise relationship distinct, such as the tripartite relationship and the lack of privity. Thus, general contract principles govern those distinctions and issues.

IV. Contract Law

When a master franchisor terminates a master franchise agreement, absent specific contractual provisions, a unit franchisee's position can be in a state of limbo. As stated above, the franchise statutes and regulations do not provide requirements or guidance on how the tripartite relationship between the master franchisor, the master franchisee, and unit franchisees should be governed. Similarly, there is a paucity of caselaw specifically addressing the nuances of the tripartite relationship that constitutes the master franchise structure. Thus, basic contract principles are the proper framework for assessing the issues that arise in the instance of a terminated master franchise agreement.

A contract analysis requires a two-step approach in determining the relative positions of the master franchisor and the unit franchisee if the master franchise agreement is terminated.

The first step is to determine if specific clauses in the relevant contracts (i.e., the master franchise agreement and the unit franchise agreement) address the respective rights of the unit franchisee and the master franchisor when a master franchise agreement terminates or expires. For example, the master franchise agreement could provide for various enforcement rights to the master franchisor in the event of the termination or expiration of the master franchise agreement. In addition, the unit franchise agreement could

23. N. Am. Secs. Admins, 2008 Franchise Registration and Disclosure Guidelines § IV.A. (2008), https://www.nasaa.org/wp-content/uploads/2011/07/2-2008UFOC.pdf.

24. Ark. Code Ann. § 4-72-202; Cal. Bus. & Prof. Code § 20001; Conn. Gen. Stat. § 42-133e; Del. Code Ann. tit. 6, § 2551; Haw. Rev. Stat. § 482E-1; 815 Ill. Comp. Stat. 705/3; Ind. Code § 23-2-2.7-1; Iowa Code § 523H.1; Mich. Comp. Laws § 445.1502; Minn. Stat. § 80C.01; Neb. Rev. Stat. § 87-401; N.J. Stat. Ann. § 56:10-3; P.R. Laws Ann. tit. 10, § 278a.

25. N.J. Stat. Ann. § 56:10-3.

26. Thomas M. Pitegoff & W. Michael Garner, Fundamentals in Franchising 187 (2008).

have terms that trigger upon termination or expiration of the master franchise agreement, such as (1) the termination of the rights of the unit franchisee to use the trademark (see the discussion of trademarks and licensing below); (2) a mandatory or optional right for the master franchisor to step into the shoes of the master franchisee to ensure the continued operation of the system; and/or (3) the right of the master franchisor to substitute another master franchisee to continue in that role in the event the initial master franchise agreement is terminated or expires, and a requirement that the unit franchisees must honor the appointment of the new master franchisee. If any potentially applicable contractual terms exist, the primary dispute will revolve around whether the terms are enforceable, as discussed below. If they are, then the outcome is clear: the contract is followed. If they are not (or there are no contractual terms to begin with), then the second step of the approach comes into play.

If there are no applicable contractual terms (either because they do not exist or are not enforceable), then the evaluation of the rights of the parties likely will depend upon generally applicable contractual doctrines, most notably privity and third-party beneficiary, that impact three-party contract arrangements.[27]

A. *Privity*

The existence of privity of contract between parties often controls whether a party can enforce rights or have a claim under a contract. “Privity of contract is that connection or relationship which exists between two or more contracting parties.”[28] It is typically created by an executed agreement to which the parties are signatories. Master franchisors and unit franchisees, however, are almost never a party to a contract that includes the other. As explained above, master franchisors contract with master franchisees, who then contract separately with unit franchisees. Given the definition of “privity” and how privity is created, it may seem like a simple solution to have a master franchisor, a master franchisee, and a unit franchisee all sign a contract or agreement creating and acknowledging privity between the three parties. However, that is not how typical master franchise arrangements work. In fact, it is often an intentional choice, and it is often beneficial to the master franchisor, for liability purposes, to not have privity with unit franchisees. However, in the event of a master franchisee default resulting in the termination of its master franchise agreement, absent specific protective contract provisions, both remaining parties may attempt to establish privity to protect itself: (1) the master franchisor to enforce rights against the unit franchisee to protect its trademark, brand, system, and goodwill through either requiring the unit franchisee to continue performance under the unit

27. It is beyond the scope of this article to address legal concepts under international law, including whether any particular country has applicable franchise relationship laws.

28. Prof’l Lens Plan, Inc. v. Polaris Leasing Corp., 675 P.2d 887, 891 (Kan. 1984) (quoting Black’s Law Dictionary 1362 (4th ed. 1968)) (emphasis and internal quotation marks omitted).

franchise agreement or to cease operations; and (2) the unit franchisee to continue its business operations. On its face, the answer seems simple: a lack of privity prevents either party from succeeding in its argument. But the reality is more nuanced.

A lack of privity can be overcome if a court finds it necessary to restrict one party's actions to protect the superior rights of another. An example is a master franchisor seeking to enforce its intellectual property and contractual rights under a master franchise agreement, especially when the rights of the unit franchisee are ultimately derived from that agreement. In *Jay Bharat Developers, Inc. v. Minidis*, the master franchisor terminated the master franchisee for breaching several contractual provisions of the master franchise agreement, including failing to pay royalty fees, allowing a state registration to lapse, and operating franchises outside of its defined territory.[29] Undeterred, the master franchisee continued to service its unit franchises and collect royalties from them, which it then withheld from the franchisor. In response, the master franchisor sought an injunction against the master franchisee and the unit franchisees.[30] The court applied contract principles to determine whether a master franchisor could be granted an injunction to prevent the master franchisee and unit franchisees from continuing to use the master franchisor's trademarks and system information. The court ultimately found that an injunction was proper:

> Under basic contract principles, when one party to a contract feels that the other contracting party has breached its agreement, the non-breaching party may either stop performance and assume the contract is avoided or continue its performance and sue for damages. Under no circumstances may the breaching party stop performance and continue to take advantage of the contract's benefits.[31]

Here, the master franchisee was taking advantage of the master franchise agreement's benefits by using the entire business system and trademark without otherwise performing on the contract. As such, the court ultimately entered an injunction in the master franchisor's favor that prevented the master franchisee from continuing to use the marks and system.[32] The court extended this injunction to the unit franchisees, despite the lack of privity between those parties, because once the master franchisor properly terminated the master franchisee's agreement, it extinguished any rights in the system that the unit franchisees had."[33] While this result is somewhat surprising at first blush, it is consistent with trademark law. As discussed below, a trademark holder's rights to protect its trademark give it the ability to enjoin the actions of parties with whom it is not in privity.

29. Jay Bharat Developers, Inc. v. Minidis, 167 Cal. App. 4th 437, 441 (Cal. Ct. App. 2008).
30. *Id.*
31. *Id.* at 443 (quoting S & R Corp. v. Jiffy Lube Int'l, Inc., 968 F.2d 371, 376 (3d Cir. 1992)) (emphasis and internal quotation marks omitted).
32. *Id*. at 437.
33. *Id.*

B. *Third-Party Beneficiary*

Third-party beneficiary is a contractual doctrine that allows a person or entity who is not a party to the particular contract at issue to assert claims pursuant to that contract. Considering that a unit franchise agreement ultimately benefits the master franchisor and vice versa, an argument exists that a unit franchisee can assert third-party beneficiary rights in a master franchise agreement against either the master franchisee or master franchisor and that a master franchisor can assert third-party beneficiary rights in a unit franchise agreement directly against the unit franchisee.

To assert third-party beneficiary rights, a party must demonstrate that there was an intent by the contracting parties for the third party to benefit from the agreement. As one court explained, "[A party that is] not a party to an express contract may bring an action on the contract if the parties to the agreement intended to benefit the non-party, provided that the benefit claimed is a direct and not merely an incidental benefit of the contract."[34]

On their face, the arguments going both ways have an intuitive appeal. Master franchise agreements grant a master franchisee the right to grant its own unit franchises. The master franchisee's primary purpose, in turn, is to recruit unit franchisees to grant to them the right to open and operate unit franchises under the master franchisor's brand. If master franchisees explicitly intend in the master franchise agreement to contract with unit franchisees and through those unit franchise agreements expand the master franchisor's brand using intellectual property originating from the master franchisor, it can be argued that the unit franchisees intend and are intended to benefit from the master franchise agreement. While this circumstance does not create privity between master franchisors and unit franchisees, it does create a connection between the two that is not expressly addressed in the master franchise agreement and could allow for application of the third-party beneficiary doctrine. Similarly, the master franchisor enters into the master franchise agreement for one purpose: to monetize its intellectual property by capturing the upfront fees paid by the master franchisee and, depending on the terms of the agreement, capture some portion of the royalties paid by the unit franchisees. Because the unit franchise agreements allow for use of the master franchisor's intellectual property and create a direct financial benefit for the master franchisor, it can be argued that the master franchisor is a third-party beneficiary of the unit franchise agreement. Of course, one solution to the issue of third-party beneficiary uncertainty is to have the master franchise agreement or unit franchise agreement explicitly provide for such rights or benefits to be granted to the master franchisor in the unit franchise agreement. Alternatively, if a master franchise agreement explicitly excludes the possibility of the unit franchisee being a third-party beneficiary of the master franchise agreement, it is unclear if courts would honor that

34. Hawkinson v. Bennett, 962 P.2d 445, 450 (Kan. 1998).

language or use the aforementioned test to protect a potential third party who believes they are an intended beneficiary.

1. Master Franchisor as Intended Beneficiary

In *Torres v. Simpatico, Inc.*, the United States District Court for the Eastern District of Missouri found that a master franchisor, Stratus Franchising LLC (Stratus Franchising), and a number of its non-signatory master franchisees were the intended third-party beneficiaries to the unit franchise agreement between a master franchisee and unit franchisee and were therefore permitted to enforce the arbitration agreement in that contract.[35] In the case, the unit franchisee sued several defendants in a putative class action asserting claims under the Racketeer Influenced and Corrupt Organizations Act (RICO).[36] Plaintiff alleged that the defendants, which included Stratus Franchising, the plaintiff's master franchisee, and master franchisees from other territories who did not have a direct relationship with the plaintiff, were part of a RICO enterprise.[37] The non-signatory master franchisees and the master franchisor sought to have the claims asserted against them by the unit franchisee sent to arbitration due to the arbitration agreement in the unit franchise agreement between the plaintiff and its direct master franchisee.[38]

The court first focused on the arbitration clause in the unit franchise agreement, which expressly stated that it is "intended to benefit and bind certain third-party non-signatories."[39] The court determined that this phrase meant that the parties intended to benefit identified non-signatories under the arbitration clause.[40] The court then explained that the unit franchise agreement required the unit franchisee to purchase insurance policies naming Stratus Franchising as an additional insured and also required indemnification of Stratus Franchising and other franchisees.[41] Relying on these references, the court determined that that both Stratus Franchising and other master franchisees were identified parties and therefore had third-party beneficiary rights in both the indemnification and arbitration language of the plaintiff's unit franchise agreement.[42] Therefore, the court compelled arbitration on dual grounds that (1) the arbitration agreement reflected the contracting parties' intent to bind some third parties, and (2) the unit franchise agreement clearly conferred benefits upon Stratus Franchising and other master franchisees, such that Stratus Franchising and other master franchisees may enforce the arbitration agreement.[43]

35. Torres v. Simpatico, Inc., 995 F. Supp. 2d 1057 (E.D. Mo. 2014).
36. *Id.* at 1057.
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.* at 1065.
42. *Id.*
43. *Id.*

In *Collins v. International Dairy Queen, Inc.*, unit franchisees who had contracted directly with a master franchisee brought claims against a master franchisor for breach of contract and violation of the antitrust law.[44] The unit franchisees argued that the master franchisor could not enforce the mandatory arbitration agreements found in each unit franchise agreement because the master franchisor was not a signatory.[45] The United States District Court for the District of Maryland rejected this argument.[46] It found that the master franchisor was a third-party beneficiary of the unit franchise agreements and could invoke the arbitration clauses therein.[47] In reaching this conclusion, the court noted several factors demonstrated an intent by the unit franchisees to benefit the master franchisor, including, inter alia, that the unit franchise agreements required the unit franchisees to operate their unit franchises according to the master franchisor's specifications, the unit franchise agreements required master franchisor approvals, and the master franchisor was given inspection rights.[48]

With respect to *Collins* and *Torres*, it should be noted that both cases result in enforcement of arbitration provisions. The United States Supreme Court recently reaffirmed in *Epic Systems Corp. v. Lewis* that the Federal Arbitration Act (FAA) clearly instructs courts to enforce arbitration agreements according to their terms.[49] Although the Supreme Court was addressing a different issue than the one at hand, the holding in *Epic Systems* again emphasized the Court's view that the FAA evinces a strong federal policy in favor of enforcing arbitration agreements. While neither *Collins* nor *Torres* references this consideration, it cannot be ruled out as a factor in any judicial determination regarding the enforcement of an arbitration provision, which could make other factors in those cases less compelling.

In *Vapor Corporation v. Welker*, the patent holder to "Flow Regulator," Welker Engineering Company (Welker), entered into an agreement referred to by the court as a franchise agreement with Vapor Corporation (Vapor), whereby Welker would receive a five percent royalty from the sale of products covered by the patent.[50] Vapor subsequently entered into a manufacturing agreement with a different party, Heeco Limited (Heeco), authorizing it to sell products based on the patent in exchange for the payment of royalties, which would be ultimately directed to Welker, based on sales.[51] When Welker then created and began selling a "Welker Jet," another version of the Flow Regulator, Vapor claimed that this product was an "improvement" to the Flow Regulator and that Vapor was entitled to sell it.[52] Welker argued

44. Collins v. Int'l Dairy Queen, Inc., 2 F. Supp. 2d 1465 (M.D. Ga. 1998).
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.* at 1469.
49. Epic Sys. Corp. v. Lewis, 138 S. Ct. 1612, 1619 (2018).
50. Vapor Corp. v. Welker, 582 S.W.2d 858, 860 (Tex. Ct. App. 1979).
51. *Id.*
52. *Id.* at 860.

that it was a different product entirely.[53] While it was not the crux of the dispute (the court ultimately found the Welker Jet was not an "improvement" to the Flow Regulator), in analyzing a counterclaim for unpaid royalties, the court determined that, although Welker was not a party to the Vapor-Heeco manufacturing agreement, the agreement specifically acknowledged royalties due under the agreement and authorized direct payment of royalties to Welker.[54] Based on this fact, the court held that Vapor and Heecco intended for royalty payments to be paid to Welker, and concluded that Welker was a third-party beneficiary of the manufacturing contract.[55]

2. Unit Franchisees as Intended Beneficiaries

But what of the rights of the unit franchisees when a master franchisee defaults? In that scenario, the unit franchisee will often need to seek injunctive relief in an effort to protect their rights when a master franchise agreement is either facing termination, or has been terminated. If a unit franchisee can obtain an injunction to maintain the status quo of its unit franchise agreement when the master franchise agreement is no long in effect, the unit franchisee can continue operations while figuring out alternative solutions or can create sufficient leverage with the master franchisor to reach an palatable settlement (at least to the unit franchisee). Whether or not an injunction is proper in this situation starts with the four familiar factors for determining injunctive relief:

1. the likelihood that the [the petitioner] will succeed on the merits;
2. the 'balance of convenience,' determined by whether greater injury would be done to the [respondent] by granting the injunction than would result from its refusal;
3. whether [the petitioner] will suffer irreparable injury unless the injunction is granted; and
4. the public interest.[56]

Proving a likelihood of success on the merits—and specifically an ability to enforce its rights under the unit franchise agreement against the master franchisor directly—will likely control the outcome of these cases.

Unit franchisees have been found to be third-party beneficiaries of master franchise agreements. In *Hawkinson v. Bennett*, a unit franchisee brought an action against the master franchisor for breach of fiduciary duty and tortious interference after the master franchisee failed to provide various support and services to the unit franchisee.[57] The court held, *inter alia*, that the unit franchisee was a third-party beneficiary of a master franchise agreement

53. *Id.*
54. *Id.* at 861.
55. *Id.* at 862.
56. DMF Leasing, Inc. v. Budget Rent-A-Car of Maryland, Inc., 871 A.2d 639, 643 (Md. Ct. Spec. App. 2005).
57. Hawkinson v. Bennett, 962 P.2d 445, 450 (Kan. 1998).

between the master franchisor and master franchisee because the master franchise agreement provided language that obligated the master franchisee to "provide administrative and marketing support . . . for those franchises that are established in the Master Franchise area."[58] In reaching its decision, the court explained that "the intent to benefit a nonparty does not need to be expressly accounted for in the master franchise agreement so long as the intent is apparent from the terms therein, the surrounding circumstances, or both."[59] As such, the court held the master franchisor liable to the unit franchisee for breach of the master franchise agreement because the unit franchisee was the intended beneficiary of that agreement.[60]

In *DMF Leasing, Inc. v. Budget Rent-A-Car of Maryland, Inc.*, a unit franchisee sought a preliminary injunction to prohibit a master franchisee and master franchisor from terminating its three rental car franchises.[61] The unit franchise agreement stated that if the master franchise agreement were to terminate, the unit franchise agreements would terminate as well.[62] In response to this provision, the unit franchisee informed its master franchisee that it did not intend to renew its unit franchise agreement at the end of its term.[63] The master franchisee, in response, threatened to terminate the unit franchise agreement, thereby triggering certain post termination obligations that would not be triggered by a nonrenewal.[64] The two parties ultimately entered into a settlement agreement that included language that led the unit franchisee to believe its risk of being terminated due to the termination of the master franchise agreement was eliminated.[65] The master franchisor then sought to terminate the master franchise agreement, and the unit franchisee was not provided sufficient assurances that its unit franchise agreement would not be terminated too.[66] This action prompted the unit franchisee to pursue a preliminary injunction against both the master franchisor and master franchisee that was denied by the trial court.[67] The appellate court reversed this decision.[68] The appellate court noted that if the master franchise agreement in question was ultimately terminated, the unit franchisee would be left "vulnerable" and that a premature termination of the unit franchise agreement would cause more harm to the unit franchisee than to the master franchisor.[69] It then instructed the lower court on remand to issue a preliminary injunction for the unit franchisee in order to maintain the status quo of the unit franchise agreement until a final determination on the

58. *Id.* at 468.
59. *Id.* at 450–51.
60. *Id.*
61. *DMF Leasing, Inc.*, 871 A.2d 639.
62. *Id.*
63. *Id.* at 645.
64. *Id.*
65. *Id.* at 642.
66. *Id.* at 646.
67. *Id.*
68. *Id.* at 653.
69. *Id.*

merits of other issues were determined.[70] The court recognized that the unit franchisee had legitimate possible third-party beneficiary rights so that its position should be preserved until the issues were resolved.[71]

V. Trademarks and Licensing

Franchise systems are typically built on trademarked brand names. A master franchisor who is seeking to regain control of its brand and who is willing to shut down the unit franchisees will argue that the unit franchisee no longer has a right to use the trademark and therefore must cease operation. The master franchisor will specifically assert that the termination of the master franchise agreement terminated all sublicenses that originate from it. The unit franchisees will claim that they obtained a sublicense to the trademark through their unit franchise agreement and that sublicense cannot be terminated absent malfeasance on their part.

No cases that specifically address the trademark law rights and obligations that form a part of the master franchise three-part relationship, but some cases address sublicensing and indirect licenses from outside the franchise universe that provide guidance about how trademark issues will be resolved in the master franchise context.

In *First Flight Associates, Inc. v. Professional Golf Co., Inc.*,[72] a manufacturer and its foreign sales representative had an informal agreement, evidenced by letters, that granted the sales representative a trademark license in exchange for the payment of royalties to the manufacturer for sales of golf-related products using the trademark. The foreign sales representative then granted trademark sublicenses to other parties without passing any royalties it received under those sublicenses onto the manufacturer.[73] In analyzing a claim for inducement of contract breach, one of the several claims and counterclaims in this suit, the United States Court of Appeals for the Sixth Circuit found that because the underlying trademark license had expired by its terms, the licensee thereafter had nothing to sublicense to the sublicensees.[74] In its analysis, the appellate court indicated that a court could find that the sublicense agreements had been concurrently terminated with the original license agreement.[75] This case certainly supports the proposition that the termination of the master franchise agreement terminates any underlying trademark licenses granted by the master franchisee, including any trademark rights granted in the unit franchise agreements.

In *E.G.L. Gem Lab Limited v. Gem Quality Institute, Inc.*, trademark owners brought an action against sublicensees for, *inter alia*, trademark infringement

70. *Id.*
71. *Id.*
72. First Flight Assocs., Inc. v. Prof'l Golf Co., Inc.,527 F.2d 931 (6th Cir. 1975).
73. *Id.* at 937.
74. *Id.*
75. *Id.* at 936.

and dilution.[76] There, the sublicensee, after disputes with the sublicensor, created its own company and trademarks to compete with the sublicensed trademarks, often comingling the marks in advertisements and promotions.[77] Though the trademark owner was not a party to the sublicense agreement between the sublicensor and sublicensee, the United States District Court for the Southern District of New York found that the trademark owner was an intended third-party beneficiary of that sublicense agreement and that under New York law, the trademark owner was entitled to enforce the sublicensor's (i.e., its direct license) contract with the sublicensee.[78] Further, the sublicensee's commingling of the sublicensed trademark with its own in connection with the operation of its business was a breach of the sublicense agreement. The court then issued an injunction in the trademark owner's favor, which prohibited the sublicensee from associating its own trademark with the sublicensed trademark.[79]

Similarly, in *Major League Baseball Promotion Corp. v. Colour-Tex, Inc.*, the copyright and trademark owner filed an infringement action against sublicensees and the sublicensees counterclaimed for, inter alia, wrongful seizure under trademark laws.[80] The license agreement at issue between the trademark owner and the direct licensee required the direct licensee to obtain the trademark owner's written approval in order to sublicense.[81] The direct licensee had not obtained that approval before entering into sublicenses.[82] Against this backdrop, the United States District Court for the District of New Jersey found that a trademark owner may enforce its trademark rights against a sublicensee where the sublicense agreement between the sublicensee and the direct licensee was invalid because the direct licensee did not obtain the contractually required prior written approval to sublicense.[83] The court went on to hold that, absent a valid and enforceable sublicense, use of the trademarks by the sublicensee amounted to infringement of the trademark.[84] The court ruled in favor of the trademark owner and entered an order allowing it to seize products bearing its trademarks and copyrights.

Conversely, the result was different in an international case in Germany regarding the rights to a copyrighted music composition, "Take Five." In that case, the court addressed whether a terminated master license resulted in the termination of all sublicenses.[85] The Federal Supreme Court of Germany,

76. E.G.L. Gem Lab Ltd. v. Gem Quality Inst., Inc., 90 F. Supp. 2d. 277 (S.D.N.Y. 2000).
77. *Id.*
78. *Id.*
79. *Id.* at 309.
80. Major League Baseball Promotion Corp. v. Colour-Tex, Inc., 729 F. Supp. 1035 (D.N.J. 1990).
81. *Id.* at 1035.
82. *Id.*
83. *Id.*
84. *Id.* at 1042.
85. Peter Bert, *"Take Five"—Sub-license Survives Expiry of the Master License*, Dispute Resolution in Germany (July 20, 2012), http://www.disputeresolutiongermany.com/2012/07/take-five-sublicense-survive-expiry-of-the-master-licence.

applying German law, protected the rights of the sublicensee in determining that the termination of the master license agreement does not necessarily terminate the sublicense agreements.[86] The decision was made, in part, by analyzing succession protections as applicable to copyright laws, and it was determined that the holder of a licensed right should be protected and able to recover its investment in said right.[87] The court also weighed the interests of both parties and found that the interests of the sublicensee outweighed the interests of the licensor.[88] On the issue of unaccounted for license fees, the court found that the licensor would not suffer a financial loss because it can assert a claim directly against the main licensee for an assignment of the main licensee's rights to receive license fees from the sublicensee.[89] While this analysis and conclusion may seem straightforward enough, it may not necessarily be applicable towards master franchise agreements in the United States. First, German law appears to take a somewhat different view of sublicense rights than United States courts. Second, master franchise agreements grant rights that go well beyond the use of a single trademark or copyrighted item like a song. Master franchise agreements outline a complete and confidential system for operating a business. As such, a court should conduct a significantly more in-depth scrutiny of the agreement arrangement and parties' rights than what appears to have been done in the cases discussed above.[90]

Accordingly, in the event of a default by a master franchisee (the underlying premise of this article), both the master franchisor and the unit franchisee could assert claims related to their positions derived from their rights as a trademark licensor and trademark sublicensee, respectively. While the "Take Five" case suggests an argument for seeking to protect rights granted to a sublicensee in good standing, the *E.G.L. Gem* and *Major League Baseball* cases suggest that a trademark owner's rights will be given primary consideration and that the sublicensee will likely lose its rights if the original license is invalidated.

VI. Practical Advice for Attorneys

A. *Advice for Master Franchisor Attorneys*

The attorney for the master franchisor should focus on providing the master franchisor with the broadest rights possible so that the master franchisor has every option available if a master franchisee defaults. The master franchisor ideally will have specific provisions in the master franchise

86. *Id.*

87. Karl Rauser & Karsten Metzlaff, *Can Sub-franchise Continue Once Master Franchise Agreement Is Revoked?*, Globe Bus. Media Group (Jan. 15, 2013), https://www.internationallawoffice.com/Newsletters/Franchising/Germany/Noerr-LLP/Can-sub-franchise-continue-once-master-franchise-agreement-is-revoked.

88. *Id.*

89. *Id.*

90. *See id.*

agreement enabling it to take specific actions, and those provisions will need to be binding upon the unit franchisee. How can that be done?

First, a master franchisor can require in its master franchise agreement that the unit franchise agreements between the master franchisee and the unit franchisee contain certain provisions. Those provisions would permit the master franchisor to assert contractual rights or take certain actions against the unit franchisee to protect the master franchisor's interests (see the discussion of privity above).

Below are some possible provisions or terms that a master franchisor may want to include:

(1) have the master franchisor actually be a party or named third-party beneficiary to each unit franchise agreement, with a list of enumerated rights that the master franchisor has in event the master franchisee is no longer in good standing;

(2) provide in the master franchise agreement that the master franchisor may, at its option, be deemed to have taken an assignment of all (or some, if it wants to be selective) of the unit franchisee agreements in the event the master franchise agreement is terminated; when taking this approach, the unit franchise agreements should also permit the master franchisee to make assignments, including by operation of law, without the consent of the unit franchisee, and require the unit franchisee to honor any such assignments.

A sample provision would be:

> Franchisor may, but shall not be obligated to, require the master franchisee, within ten (10) days of expiration or termination (regardless of the cause for termination) of the master franchise agreement, to: (1) Terminate all or any number of current unit franchisee agreement(s) that master franchisee has entered into with any and all unit franchisees, except that master franchisor, or its nominee, may, but is not obligated to, elect to enter into a unit franchise agreement with each unit franchisee for the unexpired portion of the respective term of each unit franchise agreement, in which event master franchisee shall cause each such unit franchisee to enter into such unit franchise agreement; or (2) Assign to the master franchisor, or a nominee of the master franchisor, at the sole discretion of master franchisor or its nominee, all or any number of current unit franchisee agreements that master franchisee has entered into with unit franchisees.

This kind of approach could result in the master franchisor being in contract with the unit franchisee, which may not be to the advantage of the master franchisor, particularly if the manner of the master franchisee's default has created defaults in the obligations to the unit franchisees. The master franchisor may not want to step into that situation.

Thus, a second possible approach is to have a right of assignment, but to also have the master franchisor, master franchisee, and each unit franchisee execute individual collateral assignments in favor of the master franchisor that permit the master franchisor to designate a successor assignee (a new master franchisee). This type of collateral assignment permits the assignment by the master franchisor of the master franchise agreement to a new master franchisee, with all of the same rights and obligations of the master franchisee, and provides in the unit franchise agreement that the unit franchisee will honor that assignment. In that case, if the master franchisor is able to designate a new master franchisee before invoking its right to an assignment of the unit franchise agreements, the assignments may be effectuated in a manner that binds the unit franchisees but without binding the master franchisor to the possibly disgruntled unit franchisees.

Before including a master franchisor's right to assign the master franchise agreement to itself, the master franchisor must be made aware of the assumption of risk and the added responsibility and support it would have to give the unit franchisees. If master franchisor is unsure of its actual ability to take on the added responsibility and support, consider drafting clauses that permit for reduced services in exchange for reduced fees, as an alternative to outright termination for unit franchisees as discussed above. Additionally, attorneys should advise franchisors that it is imperative to have proper liability and indemnification provisions in the master franchise agreement to protect the master franchisor from claims by unit franchisees that are terminated as a result of a master franchisee default.

Clauses that the attorney for the master franchisor can include in the master franchise agreement to address these liability issues could read such as the following, as to exposure with the unit franchisee:

> Master franchisee shall cause each and every unit franchise agreement to provide that unit franchisee waives any and all actions or claims for liability or damage ("Claims") against the master franchisor and shall indemnify and hold harmless master franchisor from any and all Claims in connection with or arising from the termination (regardless of the cause for termination) of the unit franchise agreement as a result of the termination (regardless of the cause for termination) of the master franchise agreement. Further, unit franchisee agrees and acknowledges that unit franchisee shall have no Claims whatsoever against master franchisor. Moreover, unit franchisee agrees and acknowledges that unit franchisee fully understands and accepts the risks associated with the structure of this relationship (whether or not such risks have been expressed to unit franchisee by master franchisee or master franchisor) and the underlying premise of the unit franchise agreement.

Another variation would be to address the master franchisee's indemnification obligations directly:

> Master franchisee shall indemnify and hold harmless master franchisor from any and all Claims in connection with or arising from any legal actions initiated by the unit franchisees or other third parties in connection with or arising from (1) the termination (regardless of the cause for termination) of the master franchise agreement and/or (2) the termination (regardless of the cause for termination) of a unit franchise agreement as a result of the termination (regardless of the cause for termination) of the master franchise agreement.

Some master franchisors may not want the option to assign the master franchise agreement to itself, or anyone else. This could be due to the area's remote geographic location, lack of market knowledge, or the lack of resources and local management. The attorney should alert the master franchisor to these issues. If this is the case, then another approach is for the master franchisor to require that the master franchisee include an automatic termination or notice of termination clause for the unit franchisees that is triggered by master franchisee's default.

B. *Advice for Master Franchisee Attorneys*

Attorneys representing master franchisees are in a different negotiating position than the master franchisor. They should try to draft the master franchise agreement in such a way that the master franchisee will retain as many rights as possible in the event of termination of the agreement. If a master franchisee has established unit franchisees before termination, it is possible to negotiate the right to continue operating the unit franchisees that it has established, as long as the default is not based upon any kind of egregious conduct. Stated differently, this term would allow the master franchisee to remain the master franchisee of the units already in existence, but to surrender the right to develop further unit franchises. A similar term that can be negotiated is that the master franchisee surrenders his or her master franchise rights, but is allowed to keep operating all of the unit franchises that he or she personally owns.

Additionally, and similarly to the liability provisions suggested for master franchisors, master franchisees should have unit franchisees waive potential claims against the master franchisee in the event of termination of the master franchise agreement by the master franchisors or through no fault of the master franchisee. This way, the master franchisee has some protection from liability to the unit franchisees in the event of a termination of its franchise rights for reasons outside of its control.

C. *Advice for Unit Franchisee Attorneys*

Last, attorneys representing a unit franchisee must educate their client on the nature of the derivative structure of the master franchise arrangement and the risk that their rights to operate the franchise business could be terminated by default through no fault of their own. This risk inherently comes along with being a unit franchisee subject to a master franchise agreement. An attorney's best bet is to try and negotiate the right for the unit franchisee to have the master franchisor become its direct franchisor in the event of the master franchisee's default, which, of course, is dependent on the master franchisor's ability and willingness to step into the shoes of the master franchisee.

Even if their rights to operate are preserved, unit franchisees should be alerted to the issues that will arise in the event of a master franchisee's termination: lack of management, no access to suppliers, and possible issues with vendors and landlords. If faced with these risks, the unit franchisee may want the option to close.

VII. Conclusion

The title of this paper speaks of issues that face the master franchisor in dealing with unit franchisees in the event of a master franchisee default. As discussed above, there is a three-way relationship that is complicated by variables such as (1) whether or not the master franchise agreement and unit franchise agreement address the issues arising from such a termination and, if so, how completely; and (2) what law will govern the parties in the event the agreements are silent, incomplete, or unsatisfactory to a particular party. These laws relate to arguments based on third-party beneficiary, privity, and equity. The master franchisor's issues are also defined by the master franchisor's goals. Does the master franchisor want to keep the system alive in the master franchisee's area, or is the master franchisor inclined to accept the failure and move on? Keeping the system alive raises challenges that we have discussed, including finding a new master franchisee and dealing with unit franchisee claims. The decision to walk away may not be so simple. Even in the face of language to the contrary, unit franchisees may pursue claims based upon third-party beneficiary and other theories to seek compensation for the businesses that they will have to de-identify if the system is closed. Like many things in franchising, the best approach is to have robust and properly worded contracts which address what is to be done if the master franchisee defaults.