



# The Franchise Lawyer

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## WINTER 2012



### VOL. 15, NO. 1

#### Why Have the Rule? Recent Opinion May Decrease Compliance with FPR Disclosure Requirements

By David L. Cahn

In the recent decision of *Ellering v. Sellstate Realty Systems Network, Inc.*, the court granted summary judgment in favor of the franchisor on a franchisee's claim for statutory fraud under the Minnesota Franchise Act because of a "no reliance" clause in the parties' franchise agreement. That decision, and other similar rulings nationwide, may have the unfortunate effect of implicitly encouraging franchisors to provide a financial performance representation outside of their FDD, despite a "negative disclosure" in Item 19, since they are unlikely to face civil liability even if the informal disclosures are false or misleading. Read more...

#### Inedible Arrangements: Can Arbitration Clauses And Franchisee Associations Co-Exist?

By Scott C. Kern and Allan P. Hillman

Cases balancing the rights of franchisee associations to sue for their members and the rights of franchisors to require arbitration are building toward a confrontation that could threaten the leverage of associations or the strength of ADR requirements. Read more...

#### The Growing Prominence Of Franchisee Associations In Canada

By David N. Kornhauser

While franchisees have remained relatively unorganized over the past 20 years, the enactment of franchise legislation in several Canadian provinces enshrining the right to associate has paved the way for the growth of franchisee associations. Franchisees have to varying degrees seized the opportunity presented to them and have developed, or are in the process of developing, associations to promote their interests within their respective franchise systems and in the broader economic landscape. There is little doubt that franchisee associations will continue exploit their protected status to gain power and influence going forward, and that franchisors will have to come to terms with this new reality. Read more...

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is a great opportunity for our newer members to get more involved in the Forum. Read more...

### **Avoiding State Comments: Recommended Integration Clause Language And Disclosure**

By Jordan Zucker

What integration clause language should you include in Item 17(t) of the FDD and in franchise and related agreements to avoid state comment letters? Read more...

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By Frank Robinson

What important differences should you keep in mind if you are a U.S. attorney assisting a franchisor with its expansion into Canada? Read more...

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### **Message From The Chair**

By Joseph J. Fittante

I hope you had a wonderful holiday season and your 2012 is off to a great start. During the holidays, many of us take time to reflect upon those things in our lives for which we are thankful. As I reflected on those things, I realized that many of them outside of my family are linked to the Forum on Franchising in one way or another. Read more...

### **Annual Forum Community Service Event**

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By  
David L. Cahn

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In the recent decision of *Ellering v. Sellstate Realty Systems Network, Inc.*, 2011 U.S. Dist. LEXIS 75852, Bus. Franchise Guide (CCH) ¶ 14,664 (USDC Minn., July 13, 2011) (“Ellering”), the court granted summary judgment in favor of the franchisor on a franchisee’s claim for statutory fraud under the Minnesota Franchise Act because of a “no reliance” clause in the parties’ franchise agreement. That decision, and other similar rulings nationwide, may have the unfortunate effect of implicitly encouraging franchisors to provide a financial performance representation (“FPR”) outside of their Franchise Disclosure Document (“FDD”), despite a “negative disclosure” in Item 19, since they are unlikely to face civil liability even if the informal disclosures are false or misleading.



DAVID L. CAHN

#### The FTC Franchise Rule and Item 19 FPRs

The FTC Franchise Rule applies to all franchise sales in the United States and its territories. 16 C.F.R. ¶ 436. The section of the Rule entitled “Additional Prohibitions,” 16 C.F.R. ¶ 436.9, states:

It is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any franchise seller covered by part 436 to:

(a) Make any claim or representation, orally, visually, or in writing, that contradicts the information required to be disclosed by this part.

\* \* \*

(c) Disseminate any financial performance representations to prospective franchisees unless the franchisor has a reasonable basis and written substantiation for the representation at the time the representation is made, and the representation is included in Item 19 (§ 436.5(s)) of the franchisor’s disclosure document.

The term “financial performance representation” means “any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits.” 16 C.F.R. ¶ 436.1(e).

Most state franchise disclosure laws contain similar requirements. For example, both a “prospectus” that must be provided to prospective franchisees under the Maryland Franchise Registration and Disclosure Law, Md. Code Ann. Bus. Reg. §14-216(c)(20), and a “public offering statement” that must be provided under the Minnesota Franchise Act, Minn. Stat. §80C.04(p), must contain, “A copy of any statement of estimated or projected franchisee earnings prepared for presentation to prospective franchisees, subfranchisors, or others and a statement of the information on which the

estimation or projection is based." In each state with a franchise disclosure law, no person may offer or sell a franchise "by means of any written or oral communication which includes an untrue statement of a material fact or which omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." See, e.g., Md. Code Ann. Bus. Reg. §14-229(a)(2), and Minn. Stat. §80C.13, subd. 2. Many state franchise laws also contain a broad "anti-waiver" provision providing that "a franchisor may not require a prospective franchisee to agree to a release, assignment, novation, waiver, or estoppel that would relieve a person from liability under this subtitle." Md. Code Ann. Bus. Reg. §14-226. See also Minn. Stat. §80C.21 ("Any condition, stipulation or provision . . . purporting to bind any [covered person acquiring a franchise] to waive compliance or which has the effect of waiving compliance with any provision of [the Franchise Law] or any rule or order thereunder is void.").

### ***Randall v. Lady of America Franchise Corporation: The Interplay of "No-Reliance" Contractual Provisions and Statutory Fraud Claims***

The landmark ruling of *Randall v. Lady of America Franchise Corporation*, 532 F. Supp. 2d 1071 (D. Minn. 2007) ("Randall"), involved claims brought by several former "Ladies Workout Express" franchisees, most of whom closed their franchises after finding them to be unprofitable. While the facts alleged by each plaintiff varied, several recalled attending a "Discovery Day" event at the headquarters of the defendant ("Lady of America") in which senior executives provided them with specific statements (some oral and some in a slide presentations) about the levels of revenues and, in some cases, net profits being earned by existing Ladies Workout Express businesses.

Lady of America had registered its Uniform Franchise Offering Circular ("UFOC," which today is known as the "FDD") with Minnesota and provided it to each plaintiff. Item 19 of the UFOC contained a "negative disclosure" stating, "We do not furnish or authorize [our] salespersons to furnish any oral or written information concerning the actual or potential sales, costs, income or profits of your Franchise." *Id.* at 1075.

All of the franchise agreements issued by Lady of America contained a "no reliance" provision that read, "The franchisor expressly disclaims the making of, and the franchisee acknowledges that he or she has not received, any promises or representations, express or implied, orally, in writing or otherwise of assistance, expenses, benefits, sales volumes, profits, success or any other matter except as expressly made in this agreement or the franchisor's franchise offering circular." *Id.* That sentence was succeeded by the following less common sentences: "If any promises or representations have been made, the franchisee must list them below. The franchisor is relying on the franchisee to see that all matters are included in writing in this agreement, if they are not, the franchisee will not be able to rely in any way on any promises or representations and the franchisor will not be bound by them." *Id.* The aspect of "listing the representations" is more typically seen in a "franchise disclosure questionnaire" to be completed by the prospective franchisee before completing the purchase.

The franchisees who alleged receiving an FPR claimed that some of the information provided was outright false and that other claims made were misleading because Lady of America omitted material facts. Lady of America moved for summary judgment on the plaintiffs' claims for violations of the Minnesota Franchise Act, principally on the basis that, in the face of the language in Item 19 of the UFOC and the "no reliance" contract clause, none of the plaintiffs could have justifiably relied on the claims made at Discovery Day.

Judge Schiltz held that, as a matter of Minnesota's common law of fraud, a question of fact exists as to whether each plaintiff reasonably relied on representations made outside of the written contract, in the face of specific contract provisions disclaiming reliance on such outside representations. The court acknowledged that this aspect of Minnesota law is distinct from the common law of New York and other states that broadly apply the parol-evidence rule in fraud cases. However, the court also denied the motion for summary judgment on two alternative grounds: (a) justifiable or reasonable reliance is not a required element of a civil claim under the Minnesota Franchise Act because the statute contains no such requirement; and (b) the anti-waiver provision of the statute rendered the disclaimer of reliance provision void as a defense against a statutory fraud claim. *Id.* at 1085 – 1089.

In so doing, the court emphasized that Minnesota's appellate courts "have repeatedly observed that the Minnesota Franchise Act is a remedial statute designed to favor franchisees over franchisors." *Id.* at 1087. The court stated that the effect of the anti-waiver provision was that it "voids anything in a contract that explicitly waives compliance with a provision of the Act or that has the effect of waiving compliance with a provision of the Act. One such provision that cannot be waived is §80C.13's prohibition of material false statements." *Id.* at 1088. In short, the court held that a jury had to decide whether Lady of America made the statements alleged by the franchisees, whether they were materially misleading, and whether the franchisees relied on them to their detriment.

The 2007 amendments to the FTC Franchise Rule substantially liberalized both the type of data that can be provided in a written FPR and its form of presentation. That development, when combined with decisions such as the *Randall* case, has had the salutary effect of encouraging franchisors to provide an FPR in Item 19 of the FDD. In my experience, this has occurred because the burdens presented in compiling and disseminating the FPR are outweighed by both (a) the benefit of having control over the information that franchise sales staff can credibly provide to prospective franchisees, and (b) the perception that a failed franchisee will not be able to credibly claim having received and relied on an informal FPR that was substantially more "optimistic" than the Item 19 presentation.

However, this risk calculus may change if written or oral statements made by franchise sellers that go beyond or contradict the FDD are not binding on the franchisor, or subject these individuals to

personal liability.

### **Ellering: A Disincentive to Make FPRs?**

The plaintiffs in *Ellering* are a husband and wife who purchased the master franchise rights of a real estate brokerage concept for the entire state of Minnesota. Prior to purchase, the couple received a UFOC containing a negative disclosure in Item 19, after which they had their first in-person meeting with Sellstate Realty's officers. The plaintiffs claimed that at that meeting, Sellstate's *President* told them, "(i) they could earn \$37,000 per month as Sellstate franchisees, *as confirmed in handwritten notes he provided to them*, and (ii) he had recently earned \$250,000 in one month." 2011 U.S. Dist. LEXIS 75852, at \*4 (emphasis added).

The area representative agreement and franchise agreement between the parties each contained the following "no reliance" clause:

You acknowledge that neither [Sellstate] nor any other party has guaranteed to you or warranted that you will succeed in the operation of the Area Representative business nor provided any sales or income projections, forecasts or earnings claim of any kind to you. You have not relied upon any guarantee, warranty, projection, forecast or earnings claim, whether express, implied, purported or alleged, in entering into this Agreement.

*Id.* at \*5.

In their own real estate brokerage franchise, the plaintiffs did not achieve nearly the level of income claimed by Sellstate's President, and they also were unable to sell any Sellstate franchises. When they asserted a claim for statutory fraud under the Minnesota Franchise Act, the court granted summary judgment on the claim, holding that the plaintiffs "could not, as a matter of law, justifiably rely" on the representations of the franchisor's President, *because of* the "no reliance" clause in the Franchise Agreement. *Id.* at \*30 - \*31. In so doing, the court asserted that the *Randall* holding regarding the anti-waiver provision of the Franchise Act solely concerned whether a negative disclosure in Item 19 could be used to defeat a claim for misrepresentation. *Id.* at \*28 - \*29. The *Ellering* court simply ignored the question of whether the "no reliance clause" had the effect of waiving the franchisees' rights under the anti-fraud provisions of the Franchise Act.

The *Ellering* decision follows the majority view of courts in the United States, as most reported decisions have held that a franchisee cannot pursue a misrepresentation claim under a state franchise law concerning an FPR made outside of the FDD. *See, e.g., California Bagel Company 18, LLC v. American Bagel Company*, 2000 U.S. Dist. LEXIS 22898, Bus. Franchise Guide (CCH) ¶ 11,880 (C.D. Cal. 2000), following *Cook v. Little Caesar Enterprises, Ltd.*, 210 F.3d 653, 659 (6th Cir. 2000); *Motor City Bagels, L.L.C. v. American Bagel Co.*, 50 F. Supp. 2d 460, 472 (D. Md. 1999); *Bonfield v. AAMCO Transmissions, Inc.*, 708 F. Supp. 867, 876 (N.D. Ill. 1989); *Rosenberg v. Pillsbury Co.*, 718 F. Supp. 1146, 1153-52 (S.D.N.Y. 1989); *MasteAbrasives Corp. v. Williams*, 469 N.E.2d 1196, 1201 (Ind. App. 1984); and *Travelodge Int'l, Inc. v. Eastern Inns, Inc.*, 382 So.2d 789, 791 (Fla. App. 1980).

However, there are notable exceptions. In *Emfore v. Blimpie Associates, Ltd.*, 51 A.D.3d 434, 860 N.Y.S.2d 12, Bus. Franchise Guide (CCH) ¶ 13,889 (N.Y. App. Div., 1st Dept. 2008), the court held that a "franchise disclosure questionnaire" completed at the time of the franchise sale, in which the franchisee did not identify any earnings information that the franchisor provided outside of the FDD, could not be used to bar the franchisee from pursuing claims under the anti-fraud provisions of the New York Franchises Law. More recently, in *Cousins Subs Systems, Inc. v. Better Subs Development, Inc.*, 2011 U.S. Dist. LEXIS 112903, Bus. Franchise Guide (CCH) ¶ 14,705 (E.D. Wis., Sept. 30, 2011), the court held that a "no reliance" clause in the franchise agreement could not be used to bar claims under the anti-fraud provisions of the Wisconsin Franchise Investment Law and the Indiana Franchise Disclosure Act.

### **Conclusion**

As the *Cousins Subs Systems* court wrote, "Ingenious wrongdoers cannot immunize their wrongdoing from the law with a single [contract] clause." 2011 U.S. Dist. LEXIS 112903, at \*24. On the other hand, as emphasized in the FTC's process of revising its Franchise Rule, there are justifiable policy reasons to permit "no reliance" clauses to be enforced with regard to truly unauthorized earnings claims made by a "rogue" salesperson. *See, e.g.,* Statement of Basis and Purpose for the Amended FTC Franchise Rule, 72 FR 15444, Bus. Franchise Guide (CCH) ¶ 6066, G. (commentary on 16 C.F.R. ¶ 436.9(h), which prohibits franchise sellers from disclaiming or requiring "a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments.").

However, in my opinion such policy justifications are untenable when the provider of the alleged FPR is a senior executive officer of the franchisor, such as its President, Chief Executive Officer, Chief Financial Officer or General Counsel, who made or had significant influence over the making of the franchisor's decision not to provide a written FPR. In such situations, the courts should allow the fact-finders to decide whether a franchise sale was procured by the provision of misleading financial performance information, despite a "negative disclosure" in Item 19 of the FDD. Otherwise, courts are defeating the purpose of requiring that franchisors' financial performance representations be in writing and are putting franchisors that provide written FPRs at an unfair disadvantage.



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## Inedible Arrangements: Can Arbitration Clauses and Franchisee Associations Co-Exist?

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### Inedible Arrangements: Can Arbitration Clauses and Franchisee Associations Co-Exist?

Vol. 15, No. 1

By  
 Scott C. Kern and Allan P. Hillman

Kern & Hillman LLC

#### I. The Case

Even though the members of plaintiff EA Independent Franchisee Association LLC (the "Association") had binding arbitration clauses in their franchise agreements (the "Franchise Agreements"), on July 19, 2011, the United States District Court for the District of Connecticut declined to dismiss *EA Independent Franchise Association LLC v. Edible Arrangements Int'l, Inc., et al.*, Bus. Franchise Guide (CCH) ¶ 14,650 (D.Ct. 2011). On September 11, 2011, the Court reaffirmed its decision on reconsideration. Case No. 3:10-cw1489(WWE), 2011 U.S. Dist. LEXIS 78008. The Court ruled that, while it reserved the right to reconsider the Association's standing later in the litigation, the Association could now sue in court for declaratory relief. Further, on reconsideration, it ruled that the defendants simultaneously could seek to compel individual arbitration.



ALLAN P. HILLMAN



SCOTT C. KERN

The Association, a Michigan entity, represents more than 170 franchisees of Edible Arrangements International, Inc. ("Edible"), a Connecticut corporation that has several Connecticut corporate affiliates, including EA Connect, Netsolace and Dipped Fruit. The Association alleges that: (i) Edible violated the FTC Franchise Rule by failing to disclose its relationships with its affiliates while requiring its franchisees to do business with them; (ii) Edible failed to disclose fees associated with franchisees' mandatory use of an online ordering system provided by EA Connect and computer software provided by Netsolace; (iii) Edible improperly imposed *new* rules requiring longer franchise hours of operation and the purchase of supplies from only certain vendors; (iv) Edible sanctioned franchisees who do not comply with the new rules by imposing special costs and barring them from filling orders placed via the Edible website; (v) Edible used money that franchisees paid for national advertising for the benefit of itself and Dipped Fruit, which operates a website selling products similar to those of Edible; and (vi) Edible unfairly allows only selected franchisees to fill orders for Dipped Fruit.

The Association seeks a declaratory judgment that defendants breached the Franchise Agreements, violated the implied covenant of good faith and fair dealing, and violated the Connecticut Unfair Trade Practices Act (CUTPA), Conn. Gen. Stat. § 42-110a et seq. Because an ascertainment of damages suffered by each franchisee would require the participation of each franchisee, but the principles of associational standing forbid such individual participation, *see, infra*, the declaratory judgment action was the proper vehicle.

#### II. The Issues: Associational Standing to Sue in Court and the Effect of Arbitration Clauses

The standing issue presented is: Can the franchisees, through an association, make an alleged "end

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run” around an arbitration clause in their franchise agreements that permits litigation for injunctive (but not declaratory) relief, where the association is not required to and cannot be forced to arbitrate? Leaving aside the nice drafting distinction between injunctive and declaratory relief, ignored by the Court in its rulings, the broader issue is what effect franchisees’ arbitration clauses have—and should have—on the ability of their association to seek relief for them. Could a very carefully drafted arbitration clause (more exacting than in the Edible Franchise Agreement) eviscerate the ability of an association to pursue litigation for its members, making the association a toothless tiger?

### III. The Complaint

In the Complaint, the Association (“EAIFA” in the Complaint) alleges the following concerning standing:

The EAIFA has standing to maintain this action. At least one of its members (indeed, all of its members) will suffer injury in fact by the real and immediate threatened harm, from Defendants’ conduct.

Further, the interests sought to be protected by this action are germane to the EAIFA’s purpose.

The interests sought to be protected are the rights of [Edible’s] franchisees to prevent [Edible] from unfairly and unilaterally modifying the terms of the franchise agreement and the relationship of the parties and to change system standards in the manner so as to render the terms of the parties’ franchise contracts commercially impracticable.

Pursuant to Article II of the EAIFA’s bylaws . . . . “The purpose of the EAIFA bylaws are: . . . . (3) *To protect and promote the rights of EA franchise owners (“Members”) in their EA franchised business (“Store”) . . . . (8) To promote fairness in the franchise relationship between it Members and the Franchisor . . . .”*

Finally, neither the claim asserted nor the relief requested requires the participation of individual members of EAIFA (i.e. the franchisees) since the EAIFA can prove its allegations of [Edible’s] breach of the duty of good faith and fair dealing, which is both contractual and implied by law, and other franchisee abuses through [Edible’s] own internal documents and data, and through expert testimony. The claim for relief involves issues that are common to all members of the EAIFA and do not require determination on an individual basis. The claim is for declaratory relief only and does not involve any potentially differing claims for monetary compensation.

Complaint, ¶¶ 21-25 (emphasis in original).

### IV. The Principles of Associational Standing

Franchisees who belong to an association and who are contemplating litigation relating to their franchises turn naturally to their association as the vehicle for their suit. From their viewpoint an association is the ideal plaintiff; it can amass a litigation war chest through member contributions, and it can provide a conveniently anonymous plaintiff in the event that a total rupture with the franchisor is not contemplated.

A franchisee association, like other plaintiff associations, must surmount a challenge based on standing. While state law may permit associations to sue and be sued, the association is not allowed to proceed with a claim for damages unless it can show some injury to *itself*. If its only claim is *for damages* to its members, it will be dismissed in a summary proceeding. But it may seek *equitable* relief for them.

The oft-cited case that addresses this issue is *Warth v. Seldin*, 422 U.S. 507, 95 S. Ct. 2197 (1975). In that case, the Supreme Court stated:

Even in the absence of injury to itself, an association may have standing solely as the representative of its members. [Citation omitted.] The possibility of such representational standing, however, does not eliminate or attenuate the constitutional requirement of a case or controversy. [Citation omitted.] The association must allege that its members, or anyone of them, are suffering immediate or threatened injury as a result of the challenged action of the sort that would make out a justiciable case had the members themselves brought suit. [Citation omitted.] So long as this can be established, and so long as the nature of the claim and of the relief sought does not make the individual participation of each injured party indispensable to proper resolution of the cause, the association may be an appropriate representative of its members, entitled to invoke the court’s jurisdiction.

95 S. Ct at 2211-12.

This theme was elaborated in *Hunt v. Washington State Apple Advertising Commission*, 432 U.S. 333 (1977), in which a state agency that represented Washington apple growers, although without “members” as such, was held to have standing to pursue a claim on behalf of the growers. The Court held that an association has standing to bring suit on its members’ behalf when:

(a) its members would otherwise have standing to sue in their own right; (b) the

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interests it seeks to protect are germane to the organization's purpose; and (c) neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit.

*Id.* at 343. The three *Hunt* elements are those evaluated in resolving associational standing issues.

## V. An Evaluation of the District Court's Application of the Principles

As to the first element, the District Court found the plaintiffs could have standing individually, while not focusing on the arbitration clause as a possible bar. It ruled they would have no trouble showing concrete actual or imminent injury traceable to defendants' conduct, and capable of redress by the Court. The second *Hunt* prong was not placed in issue.

The battle was joined over the third prong. In that regard, the Franchise Agreements all contain mandatory arbitration clauses for all claims, but with a carve-out allowing the parties "to seek temporary restraining orders and temporary preliminary injunctive relief from a court of competent jurisdiction, provided, however, that they must contemporaneously submit their dispute for arbitration on the merits . . . ." (Franchise Agreements, ¶ 20(F)). Interestingly, as noted above, the litigation carve-out is not for equitable relief in general, and by its terms does not include the relief sought by the Association: declaratory relief.

The defendants argued that individual members would be required to participate in the suit, and that the Association was evading the arbitration requirement by forming the Association and seeking to use it to bring litigation.

Defendants did not focus on the carve-out in the arbitration clause even though it arguably precludes franchisees from bringing declaratory judgment actions in court, perhaps logically assuming the Court would not split hairs. The Association did not focus on the possible dichotomy between injunctive relief and declaratory relief in the carve-out, logically leery of the subject.

The Association opposed defendants' "individual participation" argument by pointing out the Association had no right or obligation to arbitrate for the franchisees, and the Court ruled in its initial opinion on *that* basis that the individual arbitration clauses did not deny the Association standing. The Court also accepted the Association's argument that, while there are several types of Franchise Agreements and FDDs, and arguably several franchisee witnesses would be required, that was insufficient to bar standing, especially as the basic issues were common to all the Franchise Agreements. The Court pointed out that damages to the franchisees were not sought and could not be the subject of the Association's suit. Finally, it accepted the argument of the Association, at this early stage, that it would prove its case without calling franchisee witnesses, but instead through experts and documents.

On reconsideration, defendants re-argued the point that the Court was allowing the franchisees to circumvent the arbitration clause, a reprise of defendants' initial argument, hence a tenuous ground for reconsideration. *Edible*, which had not sought to compel arbitration as yet, argued that the case should be dismissed immediately and individual arbitrations instituted. The Court adhered to its prior provisional ruling, however, and in the face of no "controlling decisions" adverse to it, noted that defendants' authorities were from decisions invoking motions to compel arbitration, not to dismiss for lack of standing—alas, a distinction without a difference. *See In re Managed Care Litigation*, 2003 WL 22410373 (S.D. Fla. Sept. 15, 2003).

Defendants had argued from the start of the case, and restated on reconsideration, that the Association members had attempted to skirt their obligation to arbitrate by advancing claims through the Association, a "blatant misuse of the associational standing doctrine [that] flies in the face of the strong federal policy favoring enforcement of agreements to arbitrate." Defendant's Memorandum in Support of Their Motion to Dismiss for Lack of Standing, at 22. They relied principally on *Conn. St. Med. Soc. v. Oxford Health Plans (CT), Inc.*, 272 Conn. 469, 480, 863 A.2d 645, 651 (2005), where the Connecticut Supreme Court refused to allow an association to sue when its members were parties to arbitration agreements; *Penn. Chiropractic v. Blue Cross Blue Shield*, 713 F. Supp. 2d 734, 744 (N.D. Ill. 2010) (holding the need for individual members to testify so as to determine whether their claims were arbitrable mitigated against associational standing); and *In re Managed Care Litigation*, *supra*, at \*9, observing that "[a]ssociations suing in a representative capacity are generally bound by the same limitations and obligations as the members they represent." Defendant's Memorandum, *supra*, at 22-23).

While the *Penn. Chiropractic* case is beside the point (there was no serious dispute that the substantive claims were subject to the arbitration), the Connecticut Supreme Court decision is on point philosophically, as is the Florida decision.

Considering the issue frontally on reconsideration, the District Court relied instead on *Penn. Psychiatric Soc'y v. Green Spring Health Serv., Inc.*, 280 F.3d 278, 286-87 (3d Cir. 2002), cited by the Association. There, the Third Circuit ruled that, where the individual association members were subject to an arbitration clause, but the association represented it did not require more than "limited individual participation," the case should not be dismissed even where the association had a questionable chance of success. The Court in *Edible* therefore allowed the case to proceed, while not expressly precluding the franchisor from seeking to compel individual arbitration (presumably as to the damage aspects of the claims). 2011 U.S. Dist. LEXIS 78008 at \*7 It has now moved to do so while also seeking certification of the standing question for immediate appeal under 28 U.S.C. 1292.

*Penn. Psychiatric Soc'y*, the Third Circuit decision on which the *Edible* Court relied, is of little relevance here. In that case, the Appellate Court actually affirmed the denial of standing for an

association to advance claims of the member *patients*, on grounds of lack of direct injury, and it did not hold the association had standing to pursue the claims of its doctor-members. It merely remanded to the District Court to determine the effect of the arbitration clauses in the contracts of doctors who were association members. Therefore, it did not dismiss that association's case, pending further review.

## VI. Conclusion

The Court in *Edible* also decided not to "bite the bullet" yet, and it signaled it may well revisit the standing issue later in the case. With respect, that is not sound judicial policy because, unlike the case on which it relies, here there is no doubt that the substantive claims for damages are arbitrable. Hence, the parties may spend more time and legal fees, and the District Court could be faced again with the same issues: (1) is the Association end-running the arbitration clauses of the individuals; (2) how material is it that the individuals can seek injunctive relief in court but perhaps not declaratory relief in court (an arbitrator certainly *can* declare rights); and (3) what is and ought to be the relationship between the preeminence of arbitration, the important rights advanced by associations, and the ability of parties to draft in such a way as to make associational standing highly problematic?

Stay tuned.



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# The Franchise Lawyer

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## The Growing Prominence of Franchisee Associations in Canada

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### The Growing Prominence of Franchisee Associations in Canada

Vol. 15, No. 1

By

David N. Kornhauser

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#### Overview

It is trite to state that franchised businesses are prominent players in the Canadian marketplace. Franchise systems have become increasingly sophisticated over the last 20 years, particularly in the retail food and apparel sectors. While franchisees remained relatively unorganized through this period, the enactment of franchise legislation in several Canadian provinces enshrining the right to associate has paved the way for the growth of truly independent and active franchisee associations.

The post-legislation era of franchisor-franchisee relations is, however, still in its infancy and the content of the right to associate has not yet been fully articulated. Nonetheless, the franchise statutes and associated regulations have leveled the playing field to a certain extent. Franchisees have to varying degrees seized the opportunity presented to them and have developed, or are in the process of developing, equally sophisticated associations capable of promoting their interests within their respective franchise systems and in the broader economic landscape. There is little doubt that franchisee associations will continue to exploit their protected status to gain power and influence going forward.



DAVID N. KORNSHAUSER

#### The Right to Associate

To date, five common law provinces have enacted franchise-specific legislation: Ontario – the *Arthur Wishart Act (Franchise Disclosure)*, 2000, S.O. 2000, c. 3 (the “Wishart Act”); Alberta – the *Franchises Act*, RSA 2000, c. F-23 (the “Alberta Act”); Prince Edward Island – the *Franchises Act*, R.S.P.E.I. 1988, c. F-14.1 (the “PEI Act”); New Brunswick – the *Franchises Act*, S.N.B. 2007, c. F-23.5 (the “New Brunswick Act”); and Manitoba – *The Franchises Act*, C.C.S.M. c. F156 (the “Manitoba Bill”). Those laws are in force in four of the provinces. Manitoba has passed franchise legislation, but it will not come into force until a date to be fixed by proclamation. Regulations are expected to be passed in Cabinet by the end of February 2012, which would indicate a coming into force date of September 1, 2012. However, any delay in the regulation approval process could push that date further into the future.

Each of these statutes is of general application. That is, they apply to all franchisor-franchisee relationships regardless of industry or sector. The definition of franchise is inclusive rather than exclusive, encompassing relationships not traditionally considered as franchisor-franchisee. The statutes are remedial in nature and are given a liberal interpretation to redress the imbalance of power inherent in the franchise relationship and to protect and promote the interests of franchisees.

One of the most important aspects of franchise legislation is the protection of the right of franchisees to associate. Section 4 of the Wishart Act establishes the right of franchisees to associate with other franchisees or to form or join a franchisee association. Subsections 4(2) and 4(3) of the Wishart Act expressly prohibit franchisors or their associates from penalizing or attempting or threatening to penalize franchisees that form or join an association or otherwise exercise that right. Furthermore, a

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provision in a franchise agreement or other relevant agreement that purports to interfere with, prohibit or restrict the right to associate is void. Perhaps most significantly, subsection 4(5) of the Wishart Act grants franchisees a right of action for damages against franchisors and their associates that contravene any section 4 rights. These rights are mirrored in identical language in section 4 of the PEI Act, the New Brunswick Act and the Manitoba Bill. Subsection 8(1) of the Alberta Act prohibits franchisors and their associates from restricting or prohibiting franchisees from forming organizations of franchisees or from associating with other franchisees in organizations of franchisees, while subsection 8(2) provides that franchisors and their associates must not directly or indirectly penalize franchisees that engage in such activities. Section 11 of the Alberta Act establishes a right of action in favor of franchisees for any breach of their section 8 rights.

Since there have been very few court decisions involving franchisee rights to associate, the scope of this right has yet to be judicially determined. There has been some indication from the courts that the interpretation of the right will involve the application of principles similar to those developed in relation to freedom of association under subsection 2(d) of the *Canadian Charter of Rights and Freedoms*, Part I of the *Constitution Act, 1982*, being Schedule B of the *Canada Act 1982* (U.K.), c.11, 1982, which protects, among other things, the basic right of union members to meet.

The Supreme Court of Canada has recently extended constitutional protection to collective bargaining, an important union activity. *Health Serv. & Support – Facilities Subsector Bargaining Assn. v. B.C.*, [2007] 2 S.C.R. 391, 2007 SCC 27 (Can.). The majority was careful to limit the ambit of protection to collective bargaining, which it described as a right to a process. *Id.* at para. 135. It remains to be seen whether this type of analysis will be applied to construe franchisees' statutory right to associate. However, restricting it to a mere right to meet would not advance the interests of franchisees. Extending the protection to the affairs and activities of an association would appear be more in keeping with the intention of the legislature.

### **Damages for a Breach of the Right to Associate**

The law relating to damages for a breach of the right to associate is similarly underdeveloped. The statutes are silent on the criteria for awarding damages and on their quantification. The scope of those damages will no doubt be defined over time. Guidance about where the law will go on this issue might be taken from the courts' interpretation of another aspect of Canadian franchise legislation.

Each of the provincial statutes referred to above states that a franchise agreement imposes on each party a duty of fair dealing in the performance and enforcement of those agreements (subsection 3(1) of the Wishart, PEI and New Brunswick Acts and the Manitoba Bill, and section 7 of the Alberta Act). In all but the Alberta statute, the duty of fair dealing includes the duty to act in good faith and in accordance with reasonable commercial standards (subsection 3(3) of the Wishart, PEI and New Brunswick Acts and the Manitoba Bill). Each of the statutes, other than the Alberta Act, also provides a right of action in damages for breach of that duty (subsection 3(2) of the Wishart, PEI and New Brunswick Acts and the Manitoba Bill). As is the case with respect to the right to associate, the legislation does not establish parameters for an award of damages for a breach of the duty of fair dealing. However, the Ontario Court of Appeal recently addressed this issue in *Salah v. Timothy's Coffees of the World Inc.*, [2010] O.J. No. 4336 (Can. Ont. C.A.).

In *Timothy's*, the trial court held that the franchisor breached the duty of fair dealing by failing to provide key information to the franchisee despite repeated requests, keeping the franchisee in the dark regarding the status of negotiations between the franchisor and the landlord of the business premises that bore directly on the future of the franchise and inaccurately stating that it would take a payment of \$350,000 to allow the franchisee to take up a new location at the shopping center in question. *Salah v. Timothy's Coffees of the World, Inc.*, [2009] O.J. No. 4444 (Can. Ont. S.C.J.). Damages on a combined basis in the amount of \$50,000 were awarded at trial for breach of the statutory duty of fair dealing, with a small component included for mental distress. *Id.* at para. 156. The award was upheld by the Ontario Court of Appeal. Significantly, the Court of Appeal stated that damages for breach of the duty of fair dealing are not limited to compensatory damages for pecuniary loss and noted that to so limit them would be contrary to the policy initiative that franchise legislation represents. *Id.* at para. 26. It may be that similar principles will inform the award of damages for breach of the right to associate, but that remains to be seen.

The remedies available for a breach of the right to associate do not appear to be limited to damages. The Ontario Court of Appeal, in another recent decision (*405341 Ontario Ltd. v. Midas Canada Inc.*, [2010] O.J. No. 2845 (Can. Ont. C.A.)), considered a provision in a franchise agreement requiring a franchisee to execute a release as a condition of renewal. The release would have estopped signing franchisees from participating in a class proceeding against the franchisor. The court determined that the requirement to sign a release breached those franchisees' right to associate pursuant to section 4 of the Wishart Act (*Id.* at para. 39) and declared the provision void under section 11 of that statute (*Id.* at para 31). That section, which renders void any contractual waiver or release of a right given under the legislation, represents a significant restriction on freedom of contract, one that clearly inures to the benefit of franchisees. Similar provisions are contained in the Alberta Act (section 18), the PEI Act (section 12), the New Brunswick Act (section 12) and the Manitoba Bill (section 11).

### **Extra-provincial Application**

Many franchise systems have an inter-provincial or national presence. However, none of the other common law provinces (Newfoundland and Labrador, Nova Scotia, Saskatchewan, British Columbia and Quebec) or territories has enacted franchise-specific legislation, raising the specter of unequal treatment of franchisees depending on location. The existing statutes attempt to ameliorate this

concern by providing that the legislation applies to franchises that are operated wholly or partly within the province in question. In addition, in the *Midas* decision, the Ontario Court of Appeal also held that the Wishart Act applied to franchises operating outside of Ontario where the franchise agreement expressly stated that the law of Ontario was the governing law of the contract. Still, a franchise operated wholly within a non-franchise jurisdiction province whose agreement is expressly governed by its laws arguably may not yet benefit from the protections granted to franchisees in provinces that have enacted franchise legislation. Although I am not aware of any decisions in provinces that do not have franchise legislation that protect the rights of franchisees to associate, I believe that the right to associate would likely also be protected by the courts in those provinces as being consistent with a franchisor's common law duty of good faith.

Further, the Uniform Law Conference has recommended the implementation of a *Uniform Franchises Act*. However, that recommendation has not been acted upon. Until further action is taken, the risk of unequal protection will continue to exist. Although the *Uniform Franchises Act* is only a recommendation and does not carry the force of law, it is strong indication from an important national advisory body that the relationship between franchisors and franchisees should be regulated in a consistent manner and that the right to associate should be enshrined in the law across all of Canada.

### Class Proceedings

The Canadian experience since the advent of franchise legislation has already shown that franchisee associations have a significant role to play in disputes between franchisors and franchisees. While an association generally lacks standing to participate directly in franchisor-franchisee litigation, well-funded franchisee associations can and do lend their often substantial financial resources in support of actions brought by or against franchisees. This is particularly evident in class proceedings in which matters of interest to a large percentage of franchisees are at issue or in resource intensive and complex litigation involving, for example, anti-competition claims under the federal *Competition Act*, R.S.C. 1985, c. C-34. Such support is crucial to franchisees that might not otherwise be able to afford to pursue meritorious claims against franchisors.

### Conclusion

The protection of the right to associate in existing Canadian franchise legislation provides a substantial incentive to form or join a franchisee association. Franchisors can no longer prevent franchisees, contractually or otherwise, from leveraging their resources to effect changes within the system. Franchisees, for their part, are now free to associate with each other without fear of retaliation. The stage has been set for a rise in the influence of franchisee associations, particularly in those provinces that have franchise statutes on their books. Manitoba will soon be added to the list and others may well follow. What that will mean for franchise systems in Canada is not yet clear. However, franchisors will have to come to terms with this new reality. Given such clear statutory protection, franchisors would be well served by reaching out to franchisee associations from the outset. The interests of both sides are more likely to be advanced through cooperative engagement than otherwise. While this might not always be possible, franchisors that fail to recognize the new paradigm could lose a vital opportunity to influence the direction taken by increasingly emboldened franchisees and the mandate of the associations they form.



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# The Franchise Lawyer

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## Pointers and Pitfalls

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## Pointers and Pitfalls (NEW SECTION!)

Vol. 15, No. 1

At the suggestion of Joe Fittante, the current Forum Chair, we have added this new "Pointers and Pitfalls" section. The plan is to include one to three entries per issue on practical "Pointers" (tips or best practices) and "Pitfalls" (traps or missteps to be avoided) that attorneys come across in their practices. They could be on franchise transactional topics (like a quirky state registration requirement or an unexpected comment from an examiner) or on litigation topics (like a unique filing requirement or particular way to bring or defend a claim). Entries should be 100 to 200 words, with limited internal citations and no footnotes. If you are interested in submitting a proposed entry to this new section, please email it to Max Schott, II, the Editor-in-Chief of *The Franchise Lawyer*, at [max.schott@gpmlaw.com](mailto:max.schott@gpmlaw.com). Based on the current release schedule, entries need to be received by the 15th of November, February, May or August (or shortly thereafter) for consideration in the next issue. While open to all, this is a great opportunity for our newer members to get more involved in the Forum.

*Submit Your Proposed Entry*

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## Avoiding State Comments: Recommended Integration Clause Language and Disclosure

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### Avoiding State Comments: Recommended Integration Clause Language and Disclosure

Vol. 15, No. 1

By  
Jordan Zucker

DLA Piper LLP (US)

Transactional practitioners undoubtedly are familiar with the annual task of responding to FDD application comments from state examiners. Given the changes to applicable franchising law and regulatory guidance at both the federal and state levels in recent years, even the most experienced drafters have encountered new criticism or unique interpretations of disclosure requirements from state agencies in comment letters. Recently, a particularly high-mileage target of examiner comments has been the contractual language and disclosures surrounding a franchisor’s integration clause.



JORDAN ZUCKER

The amended FTC Franchise Rule prohibits franchise sellers from “disclaiming or requiring a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments.” According to the FTC Compliance Guide, this prohibition is designed to combat potential deception by a franchisor who might otherwise use its integration clause to disclaim representations made to prospects via FDD Items. This prohibition has been the subject of many state examiner comments, whether in the context of an Item 17 disclosure or in the specific language found in the franchise agreement or other FDD-related contract. By way of example, some Item 17 disclosures have been deemed insufficient when they do not match exactly the *sample* wording provided in the FTC Compliance Guide (including striking additional “franchisee-friendly” text that went beyond the *sample* wording). In other instances, the non-waiver proviso built into a franchise agreement’s integration clause did not reference “any related agreements” beyond the franchise agreement, and a related contract’s incorporation by reference of the franchise agreement’s integration clause was unacceptable. Accordingly, the following wording is recommended for use in franchise program documents to avoid comments or delays in the FDD registration process:

Section in Franchise Program Document:	Language Generally Approved by State Examiners:
Item 17(t) disclosure in FDD	Only the terms of the [agreement] are binding (subject to state law). Any representations or promises outside of the disclosure document and [agreement] may not be enforceable.
Franchise Agreement’s integration clause	“ . . . nothing in this Agreement <i>or in any related agreement</i> shall disclaim or require Franchisee to waive reliance. . . .”
Additional contract’s	[Copy wording of Franchise Agreement’s integration clause in

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integration clause

each related contract included in FDD.]

Based on these experiences, hopefully you can reduce the volume of comments you receive during the upcoming FDD renewal season and expedite the registration process.



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## Canadian Expansion: A U.S. Attorney's Cheat Sheet

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## Canadian Expansion: A U.S. Attorney's Cheat Sheet

Vol. 15, No. 1

By  
Frank Robinson

Cassels Brock & Blackwell LLP

Canada has long been a favored destination for U.S. franchisors eyeing international growth. Similarities in culture, business practices and law make northern expansion particularly attractive. At the same time, however, there are important differences that U.S. attorneys should recognize and make known to their clients before they head northward.

Here is my cheat sheet for U.S. franchise attorneys:



FRANK ROBINSON

- 1. Go Local** – Assemble the right team, consisting of legal, accounting and business advisors who are experienced in the Canadian market. Reputable professionals can be found through referral sources, or trade organizations like the ABA Forum on Franchising or the Canadian Franchise Association.
- 2. Mark Your Spot** – In Canada, protection of trademarks is a matter of federal jurisdiction and should be considered a first priority. Searches should be done to determine availability. Registration provides rights to exclusive use in Canada.
- 3. Structure** – The structuring of franchise expansion (i.e., whether the franchisor will be a U.S. entity or a Canadian subsidiary, and whether expansion will be through single unit franchising, master franchising, area development, area representation or some hybrid method) is largely driven by tax considerations. So, get tax and accounting advice from the outset, and then grow.
- 4. Canadian Content** – A U.S. franchisor likely will have existing forms of documentation, including a franchise agreement. Such documents, and approaches to their use, need to be “Canadianized” to account for local law and custom. The franchisor also may need to prepare new documentation if the program is to be significantly modified for Canada or if local law requires.
- 5. Disclosure** – Whether an existing form of U.S. disclosure document can be modified for use in Canada will depend on each case, but because of differences in disclosure requirements and emerging trends in Canadian case law, it is best to invest resources upfront to produce a sound form of Canadian FDD, while relying on information from U.S. forms.
- 6. The First Franchise** – Providing deal-specific disclosure and executing documents for the first few times can be challenging for a franchisor accustomed to U.S. practices. You should rely on local advisors to help work through growing pains.

Franchising into Canada can provide great opportunity for growing systems. Making sure it is done right from the beginning will help transform opportunity into success.

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# The Franchise Lawyer

American Bar Association • Forum on Franchising

## Message From The Chair

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## Message From the Chair

Vol. 15, No. 1

By  
Joseph J. Fittante

Forum Chair

I hope you had a wonderful holiday season and your 2012 is off to a great start. During the holidays, many of us take time to reflect upon those things in our lives for which we are thankful. Maybe this is because we are likely surrounded by friends and family, or because we are turning the page on the past year and moving into the new year, where hope springs eternal.

In any event, as I watched my daughters open their gifts from Santa this year, I could not help but think about all of the things in my life for which I am thankful. As I reflected on those things, I realized that many of them outside of my family are linked to the Forum on Franchising in one way or another. Whether it is the education I have received, the friends I have made, or the mentoring that has been provided to me on how to be a lawyer, I realized that this organization and its members have had and continue to have a profound impact on my personal and professional development. This got me thinking about all of the things related to this organization for which I am thankful. In no particular order, I have listed some of them below. Although this is my list, I am sure that many of you would have a number of these same items on your lists. So without further ado, I am thankful for:



JOSEPH FITTANTE

- The Forum's approximately 2,000 members, whose passion for what they do is evidenced by their attendance at the Annual Meeting in near record levels, even in a tough economy;
- An organization where competitors knowingly spend time educating each other on the finer points of franchise law;
- An organization where adversaries check their differences at the door of the Annual Meeting and respectfully exchange views on various topics on which they may vehemently disagree;
- Those Forum members who speak their minds about ways to improve the Forum and its programming, even though sometimes it may be hard for leadership to hear;
- Those Forum members who generously give of their time and knowledge to answer questions on the Forum's ListServ or write scholarly articles for publication in *The Franchise Lawyer* and the *Franchise Law Journal*;
- Those Forum members who may never have been involved in formal Forum leadership, but who have nonetheless contributed to the success of the Forum in various ways, including mentorship of its new members;
- The Forum's past leaders, who have for the last thirty plus years guided the organization on a steady course of growth;
- The Forum's current Governing Committee members and Senior Leadership who give selflessly of their time and talent, many times without public acknowledgment;
- The Forum's youngest members who are truly the future of the organization; and
- Last but not least – Kelly Rodenberg and Kim Nelson, our "ABA Angels." Without their help, we would all be in deep, deep trouble.

Here is to another successful year for the Forum and to all of its members in their practices.

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## The Franchise Lawyer

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### Annual Forum Community Service Event

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### Annual Forum Community Service Event

Vol. 15, No. 1

This year's community service event was a great success, thanks to the more than 30 forum attendees, friends and family members who generously donated their time and/or money. The Moveable Feast is a Baltimore-based non-profit organization that prepares and delivers meals to homebound clients living with HIV/AIDS, breast cancer and other life-challenging conditions. The crew performed a variety of tasks, from plating sour kraut to organizing and packing already frozen meals so that Moveable Feast could distribute them to clients. The Forum's Women's Caucus, Diversity Caucus, and Corporate Counsel Division committees appreciate the generosity of those persons who contributed to make the community service event a great success.

**EVERYONE IS SUSCEPTIBLE TO DATA BREACH.**

Take an in-depth look at the issue of escalating data breaches and their legal ramifications for you and your clients.

DATA BREACH AND ENCRYPTION HANDBOOK  
Lucy Thomson, Editor

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60 Years of Antitrust  
Section of Antitrust Law  
Spring Meeting  
March 28-30, 2012



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## Save the Date! – 35th Annual Forum on Franchising

Vol. 15, No. 1

Save the Date!

**35th Annual Forum on Franchising**

**Franchising — Your Backstage Pass**

October 3-5, 2012

JW Marriott at L.A. Live

Los Angeles, CA

60th Antitrust Law  
Spring Meeting  
March 28-30, 2012

JW Marriott and  
National Press Club  
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## New Books from the Forum On Franchising: Franchise Law Compliance Manual, Second Edition

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### New Books From the Forum: Franchise Law Compliance Manual, Second Edition

Vol. 15, No. 1

Editor

Jeffrey A. Brimer

#### NEW: Franchise Law Compliance Manual, Second Edition

Jeffrey A. Brimer, Editor

Designed as a working tool for both corporate franchise lawyers and outside counsel, the *Franchise Law Compliance Manual* is a practical, comprehensive guide to establishing and maintaining a successful corporate compliance program. From intellectual property to termination, this updated and expanded guide covers every aspect of franchise law and will help you protect the franchisor's property, limit liability, and prepare for and limit the inevitable tensions of a franchise system. Includes CD-ROM of checklists and forms.

<http://apps.americanbar.org/abastore/productpage/5620137>

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