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The Right Law for the Lawsuit

By Matthew Liebson

Disputes over choice of law in litigation are common among suppliers or principals and their terminated distributors or sales representatives. Such disputes typically center on a contractual choice-of-law clause versus the distributor's or agent's preferred choice of law. Distributors and agents frequently try to invoke state statutes that offer additional protections, many of which also include provisions that attempt to void contractual choice-of-law clauses that would apply the law of a different state. When a distributor's or agent's territory encompasses multiple states – or even multiple countries – the challenge of identifying the correct law to apply is greater.

Recent Developments

A recent decision from Ohio's Second Appellate District sheds light on how these choice-of-law matters are resolved in Ohio and reveals that a state statute purporting to void contrary choice-of-law clauses is not an affirmative declaration of choice of law. The case, *EnQuip Technologies Group Incorporated v. Tycon Technoglass S.r.l,* 2012 Ohio 6181, 986 N.E.2d 469 (Montgomery Cty. 2012), was brought by a Florida-based sales representative (EnQuip) that had been terminated from representing the Italy-based defendant's (Tycon) line of glass-lined steel chemical reactor vessels across a territory spanning the United States, Canada, Mexico and the Bahamas.

The suit was brought in Ohio because the defendant's ultimate corporate parent was located there. Although the parties' contract specified Italian law, and the bulk of EnQuip's claims were brought and heard under Italian law, EnQuip also sought punitive damages under Ohio Revised Code §1335.11, a sales representative statute that specifies an award of up to three times actual damages if a principal fails to pay commissions due and payable upon termination within 30 days, or subsequently earned commissions within 13 days, and if the representative proves the failure was "willful, wanton, or reckless misconduct or bad faith" on the principal's part. The trial court granted Tycon's motion for a directed verdict on the statutory claim at trial.

For more details on any of the topics covered in this *Franchise & Distribution News,* please contact the authors via the links at the beginning of each article.

Verdict Appealed

On appeal, EnQuip argued that R.C. 1335.11(F) voided the choice of Italian law as to the statutory damages claim. The Court of Appeals agreed that the choice-of-law provision "does not apply" to the statutory claim but, importantly, concluded, "[b]ut this does not mean that Ohio law applies to determine these damages." ¶45. The court noted several reasons why the potential application of Ohio law to the relationship at issue was troublesome:

- The parties selected Italian law.
- The contract was negotiated outside Ohio "between an Italian manufacturer and a Florida-based sales representative."
- Only minimal relevant sales occurred in Ohio.
- Several other states have sales representative statutes with provisions purporting to void any contrary choice-of-law clause. ¶46.

On this last point, the court observed that "[t]he convoluted mess that could be created in trying to determine which state's laws should apply in a multi-state contract must be avoided." *Id.* The court determined that "Ohio's choice-of-law rules ultimately determine the applicable law." ¶47.

The existence of statutory provisions purportedly voiding choice-of-law or forum clauses does not foreclose actual choice-of-law analysis or independently dictate a choice of law, at least in Ohio.

The Most Significant Relationship Test

Referring to Section 145 of the Restatement of the Law 2d, Conflict of Laws (Restatement) and treating the exemplary damages claim as a tort issue, the court ultimately used the familiar "most significant relationship" test of Section 6 of the Restatement to make its choice-of-law determination. It ultimately concluded that, of the three potentially most relevant choices (Ohio as the forum, Florida as the agent's home state, and Italy as the supplier's location and the contractual choice of law), Ohio had the least substantial interest in the matter. ¶50. The court also found considerable significance in the fact that EnQuip's territory was national (indeed, international), but only a single small commission had been earned in Ohio. *Id.* Having resolved the issue before it by concluding that Ohio law did not apply, ¶52, and with the knowledge that neither Florida nor Italian law provided for exemplary damages similar to R.C. 1335.11, the court did not reach a final conclusion as to applicable law. ¶53.

Reconsidering the Appeal

EnQuip subsequently moved for reconsideration of the appellate court's decision. In a July 18, 2013 *per curiam* decision and entry, the court indicated that "Ohio law does not apply because Ohio bears no relationship to the parties and little relationship to the claim." It further explained its understanding of R.C. 1335.11, stating that "[W]e do not think that the General Assembly intended R.C. 1335.11 to apply to cases like the present one" and observing that the underlying claim in the case involved a Florida resident, an Italian company and only minimal connection to Ohio.

As an additional matter, the court rejected EnQuip's contention that R.C. 1335.11(F) – the provision voiding contrary choice-of-law clauses – was a "statutory directive" on choice of law, instead concluding that the provision is not "expressly directed" to choice of law and that it "does not affirmatively direct the application of Ohio law."

Conclusion

This last concept is the most important lesson to be taken from the *EnQuip* decision. The existence of statutory provisions purportedly voiding choice-of-law or forum clauses does not foreclose actual choice-of-law analysis or independently dictate a choice of law, at least in Ohio. The significance of the relationship between the forum state and another whose law is sought to be applied may well ultimately determine whether that law might actually apply.

When testing significance, the extent of the territory and the locations of actual sales at issue matter, as do the locations of the parties themselves. The forum state's interest may well be limited if the parties' actual connections to the forum are attenuated. Manufacturers, suppliers and principals should keep these principles in mind when considering the choice of forum and law in their arrangements with distributors and agents.

When a Franchisee Files Bankruptcy

By Jennifer Maffett

Would you know what to do if you learned that one of your franchisees had filed for bankruptcy? Perhaps more importantly, would you know what *not* to do? While each circumstance and franchise agreement is different, there is a general framework for dealing with a franchisee in bankruptcy. Here we'll introduce some of the issues you are likely to encounter throughout the bankruptcy process.

The Automatic Stay

One of the most important and valuable benefits for any individual or company filing bankruptcy is the automatic stay. Immediately upon the filing of a bankruptcy petition, the Bankruptcy Code provides the debtor with "breathing space" and promotes fairness among creditors by prohibiting creditors from taking any action, formal or informal, against the debtor or its assets to collect money owed or to enforce contractual obligations. As a result, the automatic stay stops a creditor (including a franchisor) in its tracks, and it cannot take any actions to enforce its rights unless and until allowed by an order from the bankruptcy court.

This means that even if the franchisee is in default under the franchise agreement, whether because of nonpayment of amounts owed or because of noncompliance with obligations under the franchise agreement, a franchisor is prohibited from taking any action to collect those amounts or to terminate the franchise agreement without the prior approval of the bankruptcy court. This includes informal actions like placing phone calls, writing letters and sending emails, as well as formal actions like filing litigation. While the franchisor can communicate with the franchisee regarding ongoing business operations, the franchisor must be careful that its actions are not perceived to be efforts to collect amounts owed or enforce default provisions. The stay does not generally prohibit actions against nondebtor parties, such as a personal guarantor (assuming the guarantor has not filed bankruptcy).

Consequences of Violating the Stay

Violating the stay, particularly when the actions taken are intentional, with full knowledge of the bankruptcy filing, can expose a franchisor to liability. The complexities are many, so when you learn that a franchisee is in bankruptcy,

it is wise to contact legal counsel for help in determining your options.

What About the Franchise Agreement?

Not only does the automatic stay provide the debtor franchisee some breathing space, but the debtor will also likely be given time to determine whether to continue with the franchise agreement or not. A franchise agreement is likely to be considered an *executory contract,* a contract in which both parties still have continuing obligations as of the time of the bankruptcy filing. If the franchise agreement is an executory contract, the franchisor is likely going to be required to continue to perform its obligations after the filing even if the franchisee had defaulted prior to filing. This is true even if the franchise agreement contains a provision that expressly provides that the franchisor is excused from further performance if the franchisee files bankruptcy, because these terms are generally not enforceable in a bankruptcy context. If the franchisee is not complying with its obligations under the agreement after the bankruptcy is filed, the franchisor may be able to seek relief from the bankruptcy court, including the right to terminate the agreement.

During the bankruptcy, the debtor franchisee will have the option of choosing to either assume the franchise agreement, meaning it will continue to operate under the franchise agreement, or to reject it, meaning it no longer will be bound by the agreement nor entitled to its benefits. Before the debtor can assume the agreement, it generally must cure any defaults unless the franchisor agrees otherwise.

As Time Goes By

Unless the franchisee immediately ceases operation, it can often be months, sometimes a year or longer, before the franchisee must make the assumption/rejection decision, during which time it will remain under the protection of the bankruptcy court. While this can be a frustrating process for the franchisor, you are not without rights, and good counsel can provide valuable advice to protect and enforce those rights and obtain the best possible results under less-than-ideal circumstances.

Using Regional Agreements in International Distribution


By Paul Allaer & Barry Block

Manufacturers should have written agreements with agents and distributors they use to sell outside their home country, whether the home country is the United States or another jurisdiction. Written agreements help communicate expectations at the beginning of a relationship, and, if drafted properly, should help protect the manufacturer's rights during and at the end of the relationship.

An agreement for international sales can be similar to, but will have important differences from, manufacturer and agent agreements for domestic sales. For instance, international contracts generally should specify:

- The definitive language for interpreting the contract (especially if it is translated)
- The language in which the parties will communicate with each other
- Governing law
- How disputes will be settled (including arbitration and location for any litigation)
- The currency in which the manufacturer will be paid
- Shipping terms (including who pays freight and who is responsible for import and export documentation, taxes and risk of loss)
- Responsibility for translation of advertising materials, technical manuals and other documents
- Compliance with applicable law (including U.S. antiboycott laws and the anticorruption laws of the United States and other applicable jurisdictions)

Dealer Protection Laws & Other Local Requirements

Many jurisdictions also limit when a contract with an agent or distributor can be terminated or require indemnity payments on termination. The international contract should seek to eliminate, or at least limit, these restrictions and indemnity payments.

Of course, each jurisdiction will have its own legal requirements. Even if a manufacturer has internationalized its contracts, there are often specific requirements in particular jurisdictions and subtle variations in the laws of each jurisdiction that should be covered by the international contract. Customizing the international contract to each jurisdiction is the best solution to deal with these requirements and variations. However, that can be prohibitively expensive.

Two Suggestions

First, while a manufacturer might not want to customize its international contract for all jurisdictions, it could particularize the contract for the jurisdictions most important to its business.

Second, the manufacturer should consider regional contracts that have specific provisions for different regions of the world. Regional contracts will not handle every issue perfectly in every jurisdiction, but this approach comes closer than just one form of international contract. Regional distribution agreements covering the Americas, EMEA (Europe, Middle East, Africa) and Asia-Pacific are typical for multinational companies.

Helpful Examples

- An international distributor for a U.S. manufacturer might not be comfortable agreeing to governing law in the United States, arbitration by the American Arbitration Association in the United States or a location for litigation in the United States. A U.S. manufacturer with plants or significant locations outside the United States might want to consider governing law and location for arbitration and litigation in the area of its international plant or office. For

instance, a Chinese distributor may feel more comfortable designating that arbitration takes place at the Singapore International Arbitration Centre, rather than in Ohio or New York.

- Some resale restrictions that may be allowed under U.S. law could violate the laws of other countries. For instance, strict territorial limits on sales and solicitations by distributors will generally be permissible in the United States depending on the circumstances, such as the manufacturer's market power. However, under EU rules the manufacturer might be able to limit where the distributor may solicit sales but, under EU competition laws, could not limit where sales may actually be made.
- Another example is how warranty disclaimers are handled. In the United States, a manufacturer is likely to give some warranty on its products, but might want to limit its scope and the remedies available to the buyer if the warranty is violated. In the United States this would be worded as a waiver of implied warranties, which should be spelled out in a conspicuous language (e.g., all bold-faced capital letters). The U.S. manufacturer might also want to limit the remedies to repair or replacement and require a local distributor to waive any claims for punitive or consequential damages (such as lost profits). In other regions of the world, the use of "conspicuous typeface" would not be necessary, and the waivers may need to be reworded to clarify their meaning in other jurisdictions.

Written agreements help communicate expectations at the beginning of a relationship, and, if drafted properly, should help protect the manufacturer's rights during and at the end of the relationship.

- Finally, most manufacturers will want their distributors to carry insurance to cover any damages that may arise from the distributor's actions and the distribution of the product. However, the dollar amount of the insurance requirements in the United States would generally be expected to be higher than in other jurisdictions. Seeking to impose the same insurance requirements in other regions would likely be prohibitively expensive for a local distributor. Insurance requirements in international contracts need to be tailored to the appropriate jurisdiction or country.

In Sum

How a manufacturer regionalizes its distributor and agent agreements will vary with the circumstances of the manufacturing business. It is one alternative, however, for dealing with the variety of laws and complexities of international distribution.

International Franchise Business Expansion: Tax Considerations


By James Koenig & Kevin Tabor

If you've been thinking of expanding your franchise network beyond U.S. borders, you are well aware of the many business, financial and legal hurdles you must address. But you will also need to consider taxes other countries may impose on your business. This article focuses on withholding taxes a foreign country may impose on various streams of income the foreign franchisee will pay to the U.S. franchisor (U.S. Franchisor) pursuant to the franchise arrangement.

One of the simplest ways to expand your franchise network internationally is to enter into a franchise agreement with a franchisee located in a foreign country. Many terms of the franchise agreement will be similar to that of a standard U.S. franchise agreement. Among other things, it will specify a territory and provide for payments for use of intellectual property, rental of equipment, sale of property, training and the like. A master franchise agreement, which is a form often used in international transactions, may also provide for many or most of these same types of payments.

Royalties, Rents, Service Fees & Interest

Some or all of the payments the U.S. Franchisor receives may be subject to withholding tax imposed by the foreign country, including royalties, rents, service fees and interest. If we assume, for example, that under the terms of the franchise agreement the foreign country franchisee (FC Franchisee) were to pay a $100 royalty to the U.S. Franchisor, and the foreign country imposes a 20 percent withholding tax on royalties, the U.S. Franchisor would receive only $80 of the $100 royalty payment, with the remaining $20 withheld by the FC Franchisee and paid to the foreign country.

In certain circumstances the U.S. Franchisor may realize U.S. income tax savings that would offset part or all of the $20 in lost revenue. In any event, to protect the U.S. Franchisor, the franchise agreement should include a term requiring the FC Franchisee to be responsible for all taxes imposed by the foreign country on any payment to the U.S. Franchisor. This contract term is often referred to as a gross-up provision because the payment is to be grossed up to cover any foreign country taxes. In our example, the purpose of the gross-up provision is to ensure the U.S. Franchisor will receive the full $100 royalty payment.

Shifting the Burden

Shifting the burden of the foreign country withholding tax to the FC Franchisee, however, makes the franchise arrangement much less beneficial to the FC Franchisee. In our example, the FC Franchisee will end up paying a total of $125 ($100 to the U.S. Franchisor and $25 in withholding tax). The full $125 will be subject to the withholding tax and 20 percent of $125 is $25. If the FC Franchisee paid $120, 20 percent of that (that is, $24) would go to the withholding tax and the U.S. Franchisor would receive only $96, not $100 as intended. The FC Franchisee may realize income tax savings as a result of the payment of the extra $25; however, that would offset only part of this additional $25 cost. So that neither the U.S. Franchisor nor the FC Franchisee is severely harmed by the foreign country withholding tax, the goal should be to eliminate as much of that tax as possible. For example, there may be tax saving opportunities available to parties who structure a franchise arrangement to take advantage of tax treaty relief provisions.

Tax Treaties

The United States has entered into tax treaties with more than 50 countries. One of the purposes of a tax treaty is to reduce or eliminate withholding taxes. Understanding the types of payments that are exempted from withholding tax under a tax treaty (or under the foreign country's tax laws) and structuring a franchise arrangement accordingly can lead to significant tax savings. For instance, depending on the FC Franchisee's country, withholding tax savings often can be realized if the U.S. Franchisor sells (rather than leases) equipment to the FC Franchisee or if the U.S. Franchisor performs services in the United States rather than in the FC Franchisee's country.

In addition to withholding taxes, other countries may impose sales-and-use or value-added taxes on payments for goods and services or rental payments made by a FC Franchisee. These taxes also need to be considered.

Conclusion

So, when contemplating expansion of your franchise network to another country:

- Consider including a gross-up provision to shift the burden of any foreign taxes to the franchisee.
- Obtain advice on minimizing foreign country and U.S. taxes.

Can a Franchisor Control Franchisee Pricing?

By Barry Block

Franchisors can often control pricing by their U.S. franchisees within certain limits if the circumstances are right and if the franchisors proceed in the proper manner.

Antitrust Considerations

Historically, the U.S. antitrust laws have been a major concern for franchisors seeking to control franchisee pricing. This still is true for franchisors who want to limit the minimum prices that franchisees may charge, but the antitrust laws are of less concern for franchisors who want to limit maximum prices.

Before 1997, it was illegal per se for a franchisor and a franchisee to agree on the maximum or minimum prices that could be charged by franchisees. Illegal per se means illegal without any need to show harm to competition. In 1997, the U.S. Supreme Court ruled that an agreement on maximum resale price was not illegal per se but that legality would be determined by the rule of reason. The rule of reason determines the legality of a practice by weighing all of the circumstances to determine whether a restrictive practice should be prohibited because it imposes an unreasonable restraint on competition.

In 2007, the Supreme Court ruled that minimum resale price agreements would also not be illegal per se, but would be judged under the rule of reason. However, minimum price agreements remain highly risky. They remain illegal per se under some state laws (regardless of the Supreme Court's interpretation of federal law), and some states have taken enforcement actions against such conduct.

Interpreting Franchise Agreements

In recent years, there have been at least two well-publicized disputes between a franchisor and its franchisees over maximum price agreements.

Burger King Prevails on Ambiguous Contract Language
In 2009, Burger King began requiring its franchisees to charge no more than $1 for its double cheeseburger, even though the franchisees had twice rejected this proposal when Burger King asked for a vote of support. The franchisees also claimed that their cost to produce the double cheeseburger was more than $1.

The Burger King franchisee association brought suit in Florida challenging the $1 price as a breach of contract, but it did not make an antitrust claim.

In 2010, the Florida District Court found that Burger King was not breaching the franchise agreements. Section 5A of the franchise agreement provided that the franchisee agreed that changes in the franchise standards and specifications may become necessary from time to time and agreed to comply with modifications to the operations manual that Burger King in good faith believes are reasonably necessary. The District Court found this provision sufficient to allow Burger King to amend its manual to require franchisees to adhere to maximum pricing when required by Burger King as part of its value menu. It also found that Burger King had this authority even though Section 5A had been drafted before 1997 (i.e., when maximum resale pricing was still illegal per se) and even as to agreements entered into before 1997.

Even though the complaining franchisees lost in court, in 2010 Burger King took the double cheeseburger off its $1 value menu and raised the suggested price for that product.

Steak n Shake Loses on Ambiguous Contract Language
More recent litigation arose when in June 2010 Steak n Shake adopted a policy requiring that its franchisees follow the company's menu pricing and promotions, including a requirement that franchisees offer $4 meals. The $4 pricing was challenged by numerous franchisees.

The first challenge was brought by a longtime Illinois franchisee with five restaurants that refused to implement the $4 pricing. When Steak n Shake threatened to terminate the franchise, the franchisee brought a declaratory judgment action seeking a determination that Steak n Shake did not have the contractual power to impose the $4 pricing.

In 2012 the District Court in Illinois hearing the matter found Steak n Shake did not have the contractual right to impose the $4 pricing. The various franchise agreements between the Illinois franchisee and Steak n Shake provided that the franchisee was required to comply with the franchise "System," which the franchisor could change from time to time. The System was defined as "a unique restaurant concept, including … standardized methods of preparing and serving certain food products and beverages…." Also, the franchisee acknowledged the importance of "maintaining uniformity in every component of the operation of the System … including a designated menu…."

The District Court held this language was ambiguous as to whether the franchisor had the contractual right to impose maximum prices. When considering extrinsic evidence, it found the franchisor had no right to impose these maximum prices in light of various factors, such as the past course of dealing (where the franchisee had been allowed to set its own prices), the language of the franchise disclosure document (which also allowed the franchisee to set its own prices) and other factors.

Steak n Shake Prevails on Clear Contract Language

Even though the Illinois decision was issued in 2012, it interpreted the language of prior contracts entered between 1995 and 2006. In contrast, a 2013 case in Colorado interpreted more recent contract language.

When two franchisees in Colorado violated the $4 pricing requirement, Steak n Shake terminated their franchise agreements. The franchisees continued to operate, and Steak n Shake brought an action to enjoin them from doing so. In September 2013 the District Court in Colorado hearing the matter issued a preliminary injunction requiring the franchisees to cease operating the restaurants and cease using any Steak n Shake trademarks.

The two franchisees had entered into franchise agreements in 2012. The agreements, which had been updated from the agreements considered in the Illinois case, provided that the franchisee acknowledged the importance of maintaining uniformity in every component of the operation of the System "including a designated menu (including maximum, minimum and other prices the Franchisor specifies for menu items and mandatory promotions)." This clear authority for Steak n Shake to establish maximum prices enabled the District Court to grant the preliminary injunction.

A franchisor's ability to control maximum pricing depends heavily on the contractual language of the franchise agreement.

Lessons

These cases offer several lessons:

- Franchisors can control the maximum pricing of franchisees in some circumstances.
- A franchisor's ability to control maximum pricing depends heavily on the contractual language of the franchise agreement.
- Antitrust challenges to maximum or minimum pricing remain viable theoretically, but, as in the cases described above, may not always be used by franchisee counsel to challenge franchisor pricing practices.

Our Lawyers: Recent Activities & Honors

Tom Collin, leader of the firm's Antitrust, Competition & Distribution practice, was named one of the leading franchising lawyers in the United States and a leader in antitrust litigation in Ohio in the 2013 edition of *Chambers USA.*

Matt Ridings and **Jennifer Roach** presented "Practical Tips to Avoid Legal Pitfalls in Pricing, Distributing, and Selling Products and Services" at the Ohio State Bar Association's Annual Convention on May 8, 2013. Matt was selected for inclusion in *Rising Stars* by *Ohio Super Lawyers®* magazine (2013-2014) and listed in *The Best Lawyers in America®.* Jennifer was selected for inclusion in *Rising Stars* by *Ohio Super Lawyers* (2010-2014).

Thompson Hine sponsors, and **Barry Block** moderates, the International Franchise Association's Franchise Business Network meetings in Cincinnati and Dayton where franchisors, franchisees and suppliers exchange ideas and share business strategies.

Paul Allaer was listed in *The Best Lawyers in America* (2006-2014) and selected as a Leading Lawyer in the International practice area in *Cincy Business Magazine* (2004-2013).

James Koenig was listed in *The Best Lawyers in America* and selected for inclusion in *Ohio Super Lawyers* (2005-2014).

Matthew Liebson, who serves as chair of the Antitrust Section of the Ohio State Bar Association, was selected for inclusion in *Rising Stars* by *Ohio Super Lawyers* (2013-2014).

Jennifer Maffett was selected for inclusion in *Rising Stars* by *Ohio Super Lawyers* (2010-2014), selected for the Dayton Chamber of Commerce's 2012 Leadership Dayton and recognized as a member of the *Dayton Business Journal's* 40 Under Forty Class of 2012.