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MSBA Franchise and Distribution Law Committee Presentation

Re: Rescission of Franchise Agreements under Maryland law

This presentation based on a break-out session in 2015 ABA Forum on Franchising, "Rescission: the Annulment of a Franchise Marriage," and paper by Rochelle Spandorf, Julianne Lusthaus, and Theresa Koller.

CONTEXT

After they have launched a franchised business and learned the franchisor's operating methods, some franchisees find that they would rather be free of franchise restrictions and royalties.

Perhaps they determine that the franchisor's methods and brand aren't helpful.

Maybe they even have learned that the franchisor hid important information during the sales process.

BOTTOM LINE: THE FRANCHISEE WANTS OUT, AND TO BE FREE TO OPERATE INDEPENDENTLY.

Is the remedy of rescission available to the franchisee?

RESCISSION AT COMMON LAW

Rescission of a contract is available in common law, as an equitable remedy, for agreements induced by fraud, duress, or a material mutual mistake, or in the event of a "serious" breach of contract.

Misrepresentation that induces contract can be innocently or negligently made, doesn't have to be made with knowledge of falsity. *See, e.g., Shulton, Inc. v. Rubin*, 239 Md. 669 (1965).

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Duress = if threatened with a sudden termination unless sign a release of claims and pay additional fees, Franchisee might have grounds to undo the release if it acts promptly. *See, e.g., Simko, Inc. v. Graymar Co.*, 55 Md. App. 561, cert. denied 298 Md. 244 (1983) (employee with pregnant wife, threatened with termination if he didn't sign non-compete, may have had right to undo non-compete if he acted promptly to find new job and quit).

If a party takes advantage of economic leverage to extract benefits that it is not entitled to under the parties' contract, then the agreement extracted is vulnerable to rescission if asserted promptly.

Mutual mistake means factual mistake, such as wrong piece of property identified in sales contract.

"Serious breach of contract" = the breach or breaches must destroy the essential object of the contract. In other words, the breach or breaches must significantly deprive the rescinding party of the benefit it reasonably expected under the contract. See, e.g., *Manpower, Inc. v. Mason*, 405 F.Supp.2d 959, 970 (E.D. Wis. 2005) (franchisee's repeated breach of obligation to refrain from placing employees in the territories of other franchisees, and other material refusals to follow system standards, justified rescission of the agreement by the franchisor and enjoining franchisee from further use of the Marks).

BUT THE PARTY ASSERTING RESCISSION MUST:

- Promptly notify the other party of the claim (more on this below)
- Tender back the benefits received -- but the extent of this requirement depends on the circumstances and the relative fault of the parties
- Have no adequate remedy – meaning a damages case will not be as prompt, complete and certain in all respects as that available in equity.

How long can a party wait before seeking rescission?

- That depends on the circumstances, but many courts in franchise sales cases have said two years is too long. *See, e.g., Albarqawi v. 7-Eleven, Inc.*, Civil Action No. 12-3506, 2014 WL 616975 (E.D. Pa. Feb. 18, 2014); *Holiday Hospitality Franchising, Inc. v. 174 West Street Corp.*, Case No. 1:05-CV-1419-TWT, 2006 WL 2466819 (N.D. Ga. Aug. 22 2006).

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MARYLAND FRANCHISE REGISTRATION AND DISCLOSURE LAW, Sect. 14-227

(a) Grounds. --

(1) A person who sells or grants a franchise is civilly liable to the person who buys or is granted a franchise if the person who sells or grants a franchise offers to sell or sells a franchise:

(i) without the offer of the franchise being registered under this subtitle; or

(ii) by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, if the person who buys or is granted a franchise does not know of the untruth or omission.

(2) In determining liability under this subsection, the person who sells or grants a franchise has the burden of proving that the person who sells or grants a franchise did not know and, in the exercise of reasonable care, could not have known of the untruth or omission.

(b) Action to recover damages. -- The person who buys or is granted a franchise may sue under this section to recover damages sustained by the grant of the franchise.

(c) Action by court. -- A court may order the person who sells or grants a franchise to:

(i) rescind the franchise; and

(ii) pay restitution.

SO UNDER WHAT CIRCUMSTANCES CAN A MARYLAND FRANCHISEE RESCIND?

No = *Bagel Enterprises, Inc. v. Baskin & Sears*, 56 Md. App. 184 (1983), *cert. denied*, 299 Md. 136 (1984). During the first year after passage of the Maryland Franchise Act, Bagel Nosh, Inc. proceeds with a sub-franchise agreement and single unit agreement with Bagel Enterprises, Inc., a Maryland corporation formed by Arnold Mallinger and Rita Mallinger.

Two months after signing the agreements, Bagel Nosh learned of the Maryland Franchise Act and advised Bagel Enterprises that it would have to prepare a UFOC and register.

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When Bagel Enterprises applied for registration three months later, David Bortz, who was the "State Franchise Administrator" as of 1978, advised them that it would demand Bagel Nosh offer rescission, comply with the registration requirement and then allow Bagel Enterprises to decide whether to move forward.

Within weeks thereafter, Bagel Enterprises learned that various people involved with Bagel Nosh "had been linked to organized crime." Bagel Nosh's president admitted his recent personal bankruptcy and said that there were cases pending against Bagel Nosh "all over." Bagel Enterprises advised David Bortz of these issues, and he talked of filing suit against Bagel Nosh, but Bagel Enterprises asked for time to negotiate with Bagel Nosh.

Bagel Enterprises tried to force Bagel Nosh to give it a much larger development area. In response, Bagel Nosh offered to rescind the sub-franchise agreement and return the $120,000 initial fee (in 1978 dollars). Bagel Enterprises refused the offer.

They eventually signed a lease for their single unit and pursued financing, even while continuing negotiations with Bagel Nosh for rescission.

Bagel Enterprises filed a court action for rescission in April 1979. Jury found that Bagel Nosh violated the Maryland Franchise Act, but that Bagel Enterprises waived its right to rescind through its actions, and the appeals court affirmed.

Yes: *Shulton, Inc. v. Rubin*, 239 Md. 669 (1965) – solicitor of investor misrepresented the price per share of certain stock supposedly being transferred "at cost," as well as other aspects of the business being transferred. Buyer immediately demanded rescission after learning of the false representations, and when the seller refused to give rescission buyer immediately sued for rescission under the anti-fraud provisions of the Maryland Securities Act (same as Franchise Act). Rescission granted, with pre-judgment interest and attorneys' fees.

No – *U-Bake Rochester, LLC v. Utecht*, No. 12-1739 ADM/SER, 2014 WL 223439 (D. Minn., Jan 21, 2014). After operating almost 2 years under a Trademark License Agreement, and seeing their business decline and fail, licensee filed for rescission claiming that it bought an unregistered franchise. Court held licensee was equitably estopped from pursuing the claim because:

(1) plaintiffs, through their attorney (who had suggested revisions that were ultimately incorporated into the agreement and who understood the requirements for a franchise) were aware of the type of business arrangement that constitutes a franchise at the time of execution of the agreement;

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(2) during the process of reviewing and revising the agreement, plaintiffs never expressed a belief that the terms created a franchise and they left intact the provision expressly disclaiming that the agreement constituted a franchise;

(3) plaintiffs engaged in affirmative conduct consistent with the position that the arrangement was not a franchise, including touting the non-franchise relationship as a benefit when seeking an SBA loan; and

(4) the plaintiffs only asserted that the agreement constituted a franchise after their sales declined in their second year of operation.

As is often the case, the court was unwilling to allow a failing franchisee to "use the franchise laws as an escape hatch to undo a business decision they now regret."

Similar logic in *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, No. 12-CV-1117-KBJ, 2014 WL 4852095, at *14-15 (D.D.C. Sept. 30, 2014) (holding that the franchisee, who filed suit approximately three years after execution of the franchise agreement, would not be allowed to rescind the franchise agreement based on a failure to register violation of the Maryland Franchise Law).

Aside: ***A Love of Food is more controversial in granting MSJ on claim for damages for franchisee's claim for losses due to purchasing a franchise that was not registered as required by MD law.***

Yes: In *Final Cut, LLC v. Sharkey*, No. X05CV085007365S, 2012 WL 310752 (Conn. Super. Ct. Jan. 3, 2012), the court found that a franchisor fraudulently induced a franchisee into purchasing three different company-owned children's hair cut shops. In that situation, the court determined that requiring the franchisor to pay the franchisees the full amount of their investment in three hair salon franchises was necessary to undo the harm caused by the franchisor's fraud and unfair trade practices under the Connecticut Unfair Trade Practices Act – even though one of the locations had been closed and could not be returned to the franchisor. In addition to awarding the franchisees a refund of all fees paid to the franchisor, the court required the franchisor to pay to the franchisees the amounts paid to third parties such as rent and the costs and expenses of litigation, including attorneys' fees.

Conclusion: Rescission is an equitable remedy, so if your client had a claim for an unlawful franchise sale, misleading FDD or other representation, or severe breach of contract, act quickly and decisively!

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