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FRANCHISE DISCLOSURE IN CANADA: HOW FRANCHISE LEGISLATION PROTECTS FRANCHISEES’ RIGHTS IN THE CONTEXT OF FRANCHISORS’ DUTY OF DISCLOSURE

Kamaal R. Zaidi†

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I. INTRODUCTION

Franchise law is a growing area in the Canadian marketplace, and the legal issue of franchise disclosure is becoming prominent in the context of the franchisor-franchisee business relationship. Franchise disclosure is a request by a franchisee investor to the franchisor to provide detailed background documents about the franchise.¹ This disclosure is meant to provide accurate, timely, and verified information to enable a prospective franchisee investor to make informed decisions about investing in the franchise, while also ensuring that the franchisor is both accountable and transparent about his business to the franchisee.² In Canada, franchise legislation prescribes specific technical criteria regarding what constitutes “adequate disclosure” on the part of the franchisor.³ There are five provinces with franchise legislation: Alberta, Ontario, Prince Edward Island, New Brunswick, and Manitoba.⁴ More specifically, the rule is that franchise disclosure must have form and content with sufficient particularity.⁵ If franchise disclosure documents are given to a franchisee following this legislative criteria, then a franchisor has fulfilled adequate disclosure.⁶ If not, a franchisee has a statutory right to seek a claim of rescission and damages with respect to the alleged inadequate disclosure or non-disclosure relating to the franchised business.⁷ Thus, franchise legislation adds a layer of legal protection which favors the franchisee, in a relationship often dominated by one-sided franchise agreements where, in many instances, the franchisee holds an unequal bargaining position with a franchisor offering its established business model.

The purpose of this paper is to review case law that describes how franchise legislation in Canada protects franchisees’ rights with respect to a franchisor's duty of disclosure, particularly when franchisees experience financial losses in the operation of the franchise. This paper argues that Canadian courts strictly enforce franchise disclosure provisions against franchisors, and in this way are protecting franchisees’ rights with respect to disclosure when experiencing financial losses.

² See id.
⁴ Id.
⁵ Id.
⁶ Id.
⁷ Id.
primarily financial losses in the franchised business. This enforcement complies with the legislative intent of requiring adequate disclosure to provide accurate, updated, verified, and comprehensive disclosure documents to prospective franchisees so that they can make reasonably informed decisions about investing in the franchise, thereby creating a more stable franchisor-franchisee relationship.8

Part II of the paper introduces the basic concept of franchise law, as well as the current franchise legislation in Canada that outlines the ground rules of what constitutes adequate franchise disclosure. Part III describes key provisions in Canadian franchise legislation that are routinely applied by courts when interpreting such provisions in legal disputes between franchisees and franchisors. Part IV focuses on modern Canadian case law and how courts apply such franchise provisions in various circumstances. By examining franchise case law, one can appreciate the author’s position that franchise legislation protects franchisees from being given disclosure documents that may be incomplete, untimely, and often misleading, thereby preventing one from making an uninformed decision to invest and operate a franchise.

II. FRANCHISE LAW—WHAT IS IT?

A franchise is a business relationship between a franchisor and a franchisee, where the franchisor has an established business model within a particular industry, and offers an opportunity to purchase and operate this business to prospective investors (franchisees) for profit. The franchisee is an investor who normally meets a franchisor representative at a trade show, or responds to an advertisement posted by the franchisor.9 Alberta’s Franchises Act defines a franchise as

[A] right to engage in a business in which goods and services are sold or distributed under a marketing or business plan prescribed mostly by the franchisor or its associate, that is substantially associated with a trademark . . . and that involves a continuing financial obligation to the franchisor . . . by the franchisee and significant continuing operational controls by the franchisor . . .

There are several types of franchised businesses (such as fast-food restaurants, convenience stores, and mechanic shops), and this

8 See id. (explaining the reasoning behind the remedies implemented by franchise legislation).
9 See generally Franchises Act, R.S.A. 2000, c F-23 (Can.) (defining franchisee and franchisor).
10 Id.
commercial relationship becomes part of a broader “franchise system” that is dominated by various legal elements, including:

- agreements (examples include franchise agreements, lease and subleases, purchase and sale agreements)
  - set obligations of franchisors and franchisees
- franchise disclosure documents
  - franchise marketing and business plans
  - financial statements
  - location(s)
  - uses of a franchise's trademark, trade name, advertising, and goodwill

A. The Franchise Model

Initially, preliminary information is given to the franchisee (normally as an informational circular), and later, when the franchisee has made a serious commitment to purchase the right to operate a franchise, the franchisee will request franchise disclosure documents under the franchise model. The franchise model is the business and marketing plans of the franchise, and is presented to prospective franchisees in order to attract their investment. The franchise model is essentially a guide for how the franchisee can make a profit, using the franchise’s advertising, goods and services, inventory, and known distribution of suppliers. However, the franchise model is able to best serve the franchisee when the franchisee has had an opportunity to investigate the franchise disclosure documents that provide the overall background of the franchise system. Upon an agreement to invest, a franchisee pays the franchise fee to purchase its right to operate the business.

The relative success of the franchise model depends on a franchisee’s reliance on the franchise disclosure documents that

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11 See id.
12 See Doing Business in Canada, supra note 3 (discussing the protection disclosure documents offer under the franchise system); see also Franchises Act, R.S.A. 2000, c F-23 (Can.) (defining business plan, which specifies how a business must be conducted under the Act).
13 See generally Dennis L. Monroe, Sales Tactics, FRANCHISE TIMES (Oct. 2012), http://www.franchisetimess.com/October-2012/Sales-Tactics/ (providing the strategy about how to attract franchisees, an example of “franchise model” as defined).
14 See Doing Business in Canada, supra note 3.
outline how a person can achieve success with that franchise. This is why disclosure document provisions were introduced under the rubric of franchise legislation – a legal requirement that must be fulfilled by a franchisor to provide “material facts” to a prospective franchisee.\(^\text{15}\) Material facts include all relevant information about the franchise business, including its operations, capital, degree of franchisor control, and other aspects of the franchise system, all of which may ultimately convince a prospective franchisee to invest in the franchise.\(^\text{16}\)

**B. Franchise Legislation in Canada**

Franchise legislation consists of various provisions and regulations in governing jurisdictions. In Canada, it is a series of provincial laws because Section 92(13) of the Constitution Act of 1867 grants exclusive power to provinces over “property and civil rights.”\(^\text{17}\) Franchise legislation describes the legal terms, principles and procedures for the franchisor and franchisee, while franchise regulations serve as an enforcement tool of the statute. Some regulations govern taxes, packaging and labeling, privacy, foreign investment, intellectual property (such as trademarks), and competition law. Currently, five jurisdictions in Canada have franchise legislation – Alberta, Ontario, New Brunswick, Prince Edward Island, and Manitoba.\(^\text{18}\) The first jurisdiction to adopt franchise legislation was Alberta in 1972 via the enactment of its *Franchises Act*.\(^\text{19}\) The second province was Prince Edward Island with its own *Franchises Act* in 1988.\(^\text{20}\) Ontario became the third province in Canada to introduce franchise law with its *Arthur Wishart Act (Franchise Disclosure)*\(^\text{21}\) in 2000, and the fourth province was New Brunswick, which also introduced its own *Franchises Act*\(^\text{22}\) in

\(^{15}\) Id.

\(^{16}\) Id.


\(^{21}\) See Mochrie & Zaid, *supra* note 19.

\(^{22}\) *Franchises Act*, S.N.B. 2007, c. F-23.5 (Can.) (providing the assented date).
2007. The most recent franchise legislation was introduced by Manitoba in 2012 with its *The Franchises Act*.\(^{23}\)

Disclosure documents prepared by a franchisor in a province with franchise legislation can be used in other provinces without formal franchise legislation. In this situation, a franchisor would typically prepares a “wrap-around” document that can be forwarded to the franchisee.\(^{24}\) Perfect disclosure is not a legal requirement—technical irregularities in a franchisor’s disclosure documents are allowed under franchise legislation. Rather, a franchisor must give “substantial compliance” with disclosure requirements.\(^{25}\)

One major purpose of franchise legislation is to protect the franchisee when a franchisor provides little or no information relevant to the franchised business. If there is a breach of disclosure provisions, the disclosure legislation gives the franchisee the right to seek rescission and damages against the franchisor.\(^{26}\) Adequate disclosure and statutory remedies are outlined in section 2 of Alberta’s *Franchises Act*, which indicates three purposes:

(1) assists prospective franchisees in making informed investment decisions by requiring the timely disclosure;

(2) provide civil remedies dealing with breaches; and

(3) to guide franchisors and franchisees to govern themselves and promote fair dealing among themselves.\(^{27}\)

The statutory language implies that franchisees can make an informed decision to invest in a franchise. If a franchisor breaches its duty to provide adequate disclosure documents to a franchisee, a franchisee can seek legal remedies as rescission and damages under the remedial portions of franchise legislation. In principle, the law expects that there be fair dealing between a franchisor and franchisee. With respect to adequate disclosure, current franchise legislation in Canada requires four major things:

- adequate disclosure in one document, including key documents such as:

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\(^{23}\) Franchises Act, C.C.S.M. 2012, c. F-156 (Can.) (providing the effective date).


\(^{26}\) *Id.* §§ 6(1), 7(1).

\(^{27}\) Franchises Act, R.S.A. 2000, c. F-23, § 2 (Can.).
franchise agreements
- financial statements
- other agreements (including leases, subleases, purchase and sale agreements);
- timely delivery of disclosure (within fourteen days prior to signing any agreement);
- delivery of documents personally, by registered mail, or “any other prescribed method,” such as fax, courier, or electronic means; and
- provision of “material facts” about the franchise.28

Additional obligations under franchise legislation include timely disclosure, notice of material change, and financial statements. First, a franchisor is required to deliver disclosure documents “at least 14 days” before the signing of any agreement or payment of consideration by the prospective franchisee.29 This gives time for the franchisee to absorb the materials at hand and determine whether it is in his best interests to pursue the franchise opportunity. Second, franchisors are expected to give notice of any “material change” in its disclosure, which includes any change in the business, operations, capital, franchise system, or degree of franchisor control, all of which must be communicated to the franchisee as soon as practicable after the change has occurred.30 Material change, of course, relates to “material facts.” The assumption is that in order for a franchisee to make an informed investment decision, he must rely upon the most updated information that reflects the business direction and potential of the franchise. Is the franchise expanding to other cities, or is it experiencing financial losses?

Third, a franchisor is required to provide financial statements (balance sheets, income statements, statement of retained earnings, and statement of cash flows), for the most recently completed fiscal year, along with audited financial statements, both of which must be prepared in accordance with generally accepted auditing standards or generally accepted accounting principles equivalent to the Canadian Institute of Chartered Accountants Handbook.31 A financial statement for the previous fiscal year may be submitted by a franchisor, provided that 180 days have not passed since the end of the most recent fiscal

28 See, e.g., Franchises Act, R.S.M., 2010, c. F-156, § 5 (Can.).
29 Franchises Act, R.S.A. 2000, c. F-23, § 4(2) (Can.).
30 Id. at § 4.
31 See Franchises Regulation, Alta. Reg. 240/1995, § 3 (Can.).
year. Exemptions to the financial statement disclosure rule occur where a franchisor self-assesses itself, its recent net worth is at least C$5 million, it has continuously engaged in the franchise business for at least five years, has at least twenty five franchisees, and has had no lawsuits against it for the last five years.

III. Franchise Disclosure Case Law in Canada

Canadian jurisprudence has case law relating to disclosure requirements under franchise legislation, and how courts interpret such provisions to protect franchisees’ rights. Typically, legal disputes arise when a franchisee experiences financial losses after signing a franchise agreement with a franchisor. In that scenario, the franchisee files suit against the franchisor on the basis of receiving inadequate disclosure which prevented the franchisee from making informed investment decisions about the franchise. As will be shown, remedial provisions of franchise legislation allow a franchisee to seek rescission of a franchise agreement (and other compensatory and punitive damages) by serving the franchisor with a “notice of

32 Id. at § 3(5).
33 Arthur Wishart Act, O. Reg. 581/00, § 11 (Can.). Realize that there are exemptions to the franchise disclosure documents. All of these exemptions are found under section 5(7) of Ontario’s Arthur Wishart Act. Statutory exemptions exist for franchise disclosure documents. The first exemption relates to an executor (person appointed in a will), administrator, trustee, sheriff receiver, or guardian is not required to provide disclosure documents with a grant of a franchise. A second exemption is where there is a grant of franchise by a franchisee who is not the franchisor, the grant of the franchise is for the franchisee’s own account, and the grant of the franchise is not effected through the franchisor. A third exemption is for a grant of a franchise to a person to sell goods or services within a business, as long as the sales arising out of that business do not exceed twenty percent of the total sales of the business. A fourth exemption is where there is a grant of franchise to a prospective franchisee who is investing over $5 million in one year in the purchase and operation of the franchise (known as the sophisticated franchisee exemption). A fifth exemption is where there is a grant of franchise, but the prospective franchisee makes a total annual investment to buy and operate the franchise not exceeding $5,000.00, the franchise agreement is valid for one year or less (for a short-term franchisee), or the franchisor is governed by section 55 of the federal Competition Act. A sixth exemption is where there is a renewal or extension of a franchise agreement, and where there has been no interruption of the business operations by the franchisee, and no material change since the franchise agreement was signed. The burden of proof lies with the franchisor claiming such disclosure exemptions.
35 Id.
36 See, e.g., Arthur Wishart Act (Franchise Disclosure), O. Reg. 581/00 §§ 6–7 (Can.).
rescission.” The basis of the rescission claim is that the franchisor gave inadequate disclosure, which lacked form and content. Form refers to the nature of documents that are delivered to the franchisee, including whether disclosure draft documents or originally executed documents were verified by franchise representatives. Content refers to pertinent information (including terms and conditions, financial statements, and location) relied upon by a franchisee which substantially reveal the true nature of the franchise business, and help make an informed investment decision in the franchise. In the following case law, one can appreciate how the technical nature of the disclosure requirements plays a large role in protecting franchisees’ claims against franchisors.

A. Inadequate Disclosure

In 2005, Walden v. 887985 Alberta Ltd. saw the Ontario Superior Court of Justice consider the issue of whether a franchisor failed to provide adequate franchise disclosure documents to the franchisee. In this matter, the franchisee, Walden, entered into a franchise agreement with the franchisor, AG Connexions, a franchise business which operated a purchasing network for member farmers who could then purchase agricultural products for discounts or benefits. The franchisor sold rights to dealerships within a specific geographical region of Canada that allowed franchisees to sign up customers in the agricultural community. Franchisees would be then be compensated for the memberships they attracted to the franchise business. The franchisor was incorporated in Alberta, but in this case was offering a franchise opportunity in the region around Blyth, Ontario. The franchisee responded, met with the franchisor, and later received a brochure and a draft franchise agreement. The franchisee made a partial payment of C$45,000.00 for the franchise fee, and attended a

37 Id.
39 Arthur Wishart Act (Franchise Disclosure), O. Reg. 581/00 (Can.).
40 Walden v. 887985 Alberta Ltd, 2005 CanLII 1503 (ON SC).
41 Id. at paras. 3–37.
42 Id. at paras. 5–6.
43 Id. at para. 6.
44 Id. at para. 3.
45 Id.
46 Id. at paras. 8–9.
training seminar offered by AG Connexions. Later, Walden received a disclosure document from the franchisor, along with a “Receipt of Documentation,” which confirmed that the franchisee received the franchise agreement and disclosure document for the purchase of the franchise in Bruce County, Ontario.

Despite the franchisee’s desire to change the territory defined in the franchise agreement to move it closer to his residence, and a second franchise agreement being executed on that basis, Walden did not receive any further disclosure documents, prompting his counsel to send a letter to the franchisor requesting a full refund of the franchise fee of C$45,000.00 paid to AG Connexions. The franchisor refused to return his money. Later, Walden rescinded the second franchise agreement, and claimed damages for C$46,323.20 (including the franchise fee) under section 6 of Ontario’s *Arthur Wishart Act*. At trial, one of the issues was whether there was proper and adequate disclosure by the franchisor, AG Connexions, to the franchisee, Walden, in compliance with Ontario's *Arthur Wishart Act*, when the parties entered into agreement to operate the franchise at a different location. The franchisor filed three exhibits with the court: Exhibit A as the “Franchise Agreement”; Exhibit B as the “Opening Balance Sheet”; and Exhibit C as a “List of Franchisees” (showing territory, residence, and telephone numbers). The franchise disclosure document was not signed by the franchisor’s representative, and no financial documents or list of franchisees were attached. The franchisor argued that the proper disclosure documents were given, and that it was exempt from the disclosure requirement because the second franchise agreement was only an amendment to the first agreement, and there was no material change.

The Ontario Superior Court (trial court) interpreted two sections of Ontario’s *Arthur Wishart Act*—sections 5 and 6. Section 5 of the Act states:

> A franchisor shall provide a prospective franchisee

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47 Id. at paras. 12–13.
48 Id. at para. 27.
49 Id. at paras. 28–45.
50 Id. at paras. 43–44.
51 Id. at para. 45.
52 See id. at paras. 57–71 (analyzing the issue of whether there was proper disclosure under the *Arthur Wishart Act*).
53 See id. at para. 62 (ON SC) (detailing the “Franchise Disclosure Document at Tab 8” which details the contents of Exhibits A, B and C).
54 Id. at paras. 60–62, 66.
55 Id. at para. 67.
56 Id. at paras. 57–58.
with a disclosure document and the prospective franchisee shall receive the disclosure document not less than 14 days before the earlier of, (a) the signing by the prospective franchisee of the franchise agreement or any other agreement relating to the franchise . . .  

Section 6 states: “The franchisee may rescind the franchise agreement, without penalty or obligation, no later than 60 days after receiving the document, if the franchisor failed to provide the disclosure document or a statement of material change . . .” Relying on these provisions, and reviewing the documentary evidence submitted by the franchisor, the court held that the franchisor failed to provide adequate disclosure to the franchisee, and awarded the franchisee C$45,000.00 in compensation for expenses incurred in setting up the franchise operation.

Walden illustrates how inadequate franchise disclosure can lead to a franchisee’s right to rescind the franchise agreement. In particular, the franchisor was penalized for failing to provide proper financial statements (balance sheets), a list of franchisees, and a signed disclosure document — information that would have led the franchisee to reasonably rely upon transparent and updated information relating to the franchise business. The franchisor also failed to deal with a “material change” in that the franchisee wanted to operate the franchise outside of Alberta, and in Ontario. The relocation of the franchise was a “material fact” that considerably...

57 Arthur Wishart Act (Franchise Disclosure), O. Reg. 581/00 (Can.).
58 Id.
59 See Walden, CanLII at paras. 57–71, 74, 76, 79–90 (outlining the two sections of the law, and then applying the law to the facts of the case).
60 See id. at paras. 79–90 (applying the facts of the case to the law).
61 See id. at para. 91 (stating that the disclosure documents the franchisors provided were “seriously deficient.”).
62 Id. at para. 94.
63 See id. at para. 45 (explaining that the cost of setting up the franchise was $45,000).
64 See id. at paras. 60–62, 66, 91, 93 (detailing the problems with the disclosure documents, and then ruling that it was because of these deficiencies that the agreement was rescinded).
65 See id. at paras. 29–32, 67, 91 (detailing the two agreements, the franchisor’s argument that there was no material change, and the court’s conclusion that the franchisor’s second agreement did not qualify as an amendment and therefore was not exempt under the Arthur Wishart Act.) Implicit in the court’s argument that the second agreement was not an amendment of the first is the fact that there were material changes in the second agreement. See id. at paras. 67, 91.
66 See id. at paras. 82–83 (detailing what the court considers to be the two... continued...
influenced the franchisee’s decision to invest with the franchise initially. The court expressed concern that franchisees should be given the opportunity to properly evaluate the disclosure prior to operating a franchise. Implicit in its reasoning is that a franchisor should maintain communication with the franchisee, especially when new agreements are made to change the location of the franchise.\(^\text{67}\) If AG Connexions gave adequate disclosure with sufficient particularity to Walden that met the “substantial compliance” requirement, and maintained active communication, the court may have held in favour of the franchisor. That is, the franchisor could have successfully defended itself if it had shown its disclosure “substantially complied” with franchise legislation, even though it was not perfect disclosure.

In 2005, the Ontario Court of Appeal considered another matter at the appellate level, where the broad issue was whether adequate disclosure was provided by a franchisor to a franchisee in *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.* (“Dig This Garden”).\(^\text{68}\) The narrower issue related to whether the trial judge correctly interpreted franchise legislation in awarding rescission and damages to the franchisee based on alleged non-disclosure by the franchisor.\(^\text{69}\) The facts were that a franchisee was interested in purchasing a franchised business in the retail gardening and gifts industry.\(^\text{70}\) The franchisors disclosed many disclosure documents, “but they did so in a piecemeal fashion.”\(^\text{71}\) The franchisee claimed that the franchisor failed to provide proper disclosure documents under section 5 of Ontario’s *Arthur Wishart Act*, and was therefore entitled to rescission and damages for incurring expenses in establishing the franchise under section 6 of the Act.\(^\text{72}\) The trial judge in the Ontario Superior Court of Justice held in favour of the franchisee, and ordered that the franchisor, along with its two officers and directors, were jointly and severally liable for failing to provide adequate disclosure documents to the franchisee.\(^\text{73}\)

\(^{67}\) See *id.* at para. 90 (arguing that the franchisors needed to have provided a new disclosure when the territory covered by, and price of the franchise agreement were changed).

\(^{68}\) *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.*, 2005 CanLII 25181 (Can. Ont. C.A.).

\(^{69}\) *Id.* at para. 14.

\(^{70}\) *Id.* at paras. 4–5.

\(^{71}\) *Id.* at para. 2.

\(^{72}\) *Id.*

\(^{73}\) *Id.* at para. 3.
The Ontario Court of Appeal upheld the trial court’s decision, and based its reasoning on the form and content of the franchisor’s disclosure documents. In its disclosure, the franchisor provided two things: (1) pro forma statements of projected income and estimated expenses for franchise stores with different square footages; and (2) a draft franchise agreement. The franchise agreement gave essential information about the franchisor’s address, minimum levels of inventory, and royalty fees. The franchisor representative went even further by going to the franchisee’s lawyer’s office to answer questions about the franchise. The franchisee later attended a training session about the Dig This Garden franchise, received a buying plan, and was introduced to two suppliers in the franchise system. Eventually, the franchise agreement was executed, and a copy was provided to the franchisee, along with copies of amendments to the agreement.

At some point, the franchisee opened the store, but it experienced financial losses. Her lawyer then filed a “notice of rescission” to the franchisor, claiming that inadequate disclosure was given. On appeal, the Ontario Court of Appeal held in favour of the franchisee, reasoning that full disclosure made in one document and delivered at one time was essential in fulfilling the legislative requirement for providing adequate disclosure documents to the franchisee. The franchisor conceded that it provided only seventy percent of the disclosure, something that the court ruled would not allow a franchisee to make an informed decision about investing with the franchise. In fact, the franchisee paid her franchise fee of C$30,000.00 and assumed the risk of opening a franchise store. An interesting provision—section 5(4)(d) of the Arthur Wishart Act—states: “statements as prescribed for the purposes of assisting the prospective franchisee in making informed investment decisions.” This provision is relevant because of the oral discussions made between the franchisor's representative and the franchisee's lawyer.

74 See id. at paras. 15–19 (detailing the court’s reasoning, whereby the court relied on the contents of the various disclosures the franchisees received).
75 Id. at para. 7.
76 Id.
77 Id. at para. 8.
78 Id. at para. 9.
79 Id. at para. 10.
80 Id. at para. 11.
81 Id.
82 Id. at para. 11.
83 Id.
84 Arthur Wishart Act (Franchise Disclosure), O. Reg. 581/00 (Can.).
*Dig This Garden* is noteworthy because it shows that although a franchisor may go to great lengths to provide accurate and updated information to the franchisee, doing so in a piecemeal fashion will make the disclosure insufficient. That is, the franchisor should have provided the disclosure documents in one document and delivered it once to the franchisee. Unlike *Walden*, the franchisor in *Dig This Garden* showed its commitment to the deal by sending its representative to the franchisee’s lawyer’s office. But this personal meeting was external to the legislative requirement of providing accurate and timely disclosure with specific details that is not just preliminary in nature, but is extensive enough to make it “substantially comply” with franchise disclosure requirements under legislation. Despite the franchisor providing its projected income, estimated expenses, and contents of the franchise agreement, it admitted that only seventy percent of its disclosure was given to the franchisee.

The court suggested that this level of disclosure was not enough for a franchisee to review all the facts and figures to make an informed investment decision in the future of that franchise. In fact, the franchisee’s financial losses were a direct result of what appeared to be substantial disclosure, but nevertheless incomplete disclosure. *Dig This Garden* is compelling because it shows how a court can go beyond the legislative “substantial compliance” requirement in that a franchisor needs only to show substantial disclosure, not perfect disclosure. Regardless, in this case, the seventy percent level of franchise disclosure was insufficient, and the court set a higher standard for a franchisor to provide more accurate disclosure. Indeed, the franchisor demonstrated its good faith and effort to strike a deal with the franchisee, but its disclosures lacked critical information that would enable a reasonable franchisee to make informed investment decisions.

In 2012, the Ontario Superior Court of Justice considered the issue of whether a franchisor fitness business provided adequate disclosure documents to a franchisee in *Burnett v. Cuts*. Here, a franchisee sought rescission of a master franchise agreement against a franchisor, Cuts Fitness for Men, an incorporated business from the State of New Jersey. Initially, a Letter of Intent (LOI) and an Ontario Master Development Agent Agreement were entered into between the franchisor and franchisee. The LOI included terms related to the

85 Dig this Garden Retailers Ltd., 2005 CanLII 25181 at para. 17.
86 Id. at para. 18.
88 Id at paras. 1, 7.
89 Id. at para. 7.
franchisee’s right to operate in Ontario and franchisee fee payments.\textsuperscript{90} Moreover, a Uniform Franchise Offering Circular (“UFOC”) was given to the franchisee for informational purposes only.\textsuperscript{91} The franchisee sought a master license to operate in Ontario, and other provinces.\textsuperscript{92} By doing so, the franchisee was promised payment to successfully locate franchise units for sale in Canada.

Early in the business relationship, the franchisor sent disclosure documents (including a draft franchise agreement) to the franchisee.\textsuperscript{93} However, the Ontario Master Development Agent Agreement was not signed by both of the parties because the franchisee never received the final draft.\textsuperscript{94} The franchisee wrote to the franchisor’s representative to get paid for listing the franchise sales opportunities in Canada.\textsuperscript{95} One month later, however, the franchisee received inadequate disclosure documents; they were inadequate because they were delivered more than fourteen days after the signing of the Letter of Intent, thereby violating the fourteen-day statutory period.\textsuperscript{96} Thereafter, the franchisee sought rescission of the franchise agreement.\textsuperscript{97} The court held that the franchisor’s disclosure was inadequate and awarded damages to the franchisee for over C$200,000.00.\textsuperscript{98} The court reasoned that disclosure was inadequate because it:

- failed to meet the fourteen-day time limit for sending disclosure to a franchisee;
- was not delivered as one document;
- did not have any financial statements;
- did not have copies of all proposed franchise agreements (and other agreements);
- did not include the Ontario Master Development Agent Agreement (which included a guarantee, a confidentiality agreement, and non-competition agreement);
- was not certified (signed or dated) by the franchisor’s representative;

\textsuperscript{90} Id. at para. 18.
\textsuperscript{91} Id. at para. 10.
\textsuperscript{92} Id. at para. 15.
\textsuperscript{93} Id. at para. 16.
\textsuperscript{94} Id. at para. 23.
\textsuperscript{95} Id. at para. 22.
\textsuperscript{96} Id. at paras. 25–26.
\textsuperscript{97} Id. at para. 30.
\textsuperscript{98} Id. at para. 70.
• did not contain a list of all franchisees that were terminated, cancelled, or not renewed.\textsuperscript{99}

In this case there were multiple breaches of Ontario’s statutory disclosure requirements. In finding inadequate disclosure, the court also held that the franchisor failed to communicate with the franchisee, particularly after the franchisee sought payment of fees after successfully locating Canadian franchise units for the franchisor.\textsuperscript{100}

After certain inquiries were made, the franchisee discovered that the franchisor was dealing with a rapid decline in sales in the United States, and was changing direction by branding for Cuts Fitness for Women. The court made reference to the Ontario Court of Appeal in \textit{MDG Kingston Inc. v. MDG Computers Canada Inc.}, where it stated:

\begin{quote}
The [Act] was passed by the legislature of Ontario in 2000 to level the legal playing field between franchisees and franchisors by protecting franchisees when they enter into franchise agreements. The Act provides a drastic remedy against franchisors who do not provide prior disclosure, in the required disclosure document, of all the relevant information that franchisees may need before deciding whether to enter into a franchise arrangement and to sign the franchise agreement.\textsuperscript{101}
\end{quote}

The court further upheld the protection of franchisees’ rights by quoting from another Ontario Court of Appeal matter in \textit{6792341 Canada Inc. v. Dollar It Ltd.}, where it said: “The purpose of the legislation is to protect franchisees and the mechanism for so doing is the imposition of rigorous disclosure requirements and strict penalties for non-compliance. The legislation must be considered and interpreted in light of this purpose.”\textsuperscript{102} \textit{Burnett} illustrates how Canadian courts strictly apply the technical requirements of franchise legislation for disclosure documents, but it also stresses the importance of keeping open communication with the franchisee (particularly when payment is due). By failing to provide adequate disclosure documents

\textsuperscript{99} Id. at para. 26.
\textsuperscript{100} Id. at para. 21.
\textsuperscript{101} Id. at para. 34.
\textsuperscript{102} Id.
(such as financing statements, copies of executed agreements, having no representatives’ signatures, and no list of franchisees being terminated), the franchisee had no opportunity to discover. By enforcing a rigorous standard using the statutory criteria, the court fulfilled the legislative intent of requiring substantial and timely disclosure. The idea is that substantial, accurate, and timely disclosure enables a franchisee to weigh the risks and benefits of a franchise prior to entering into agreement with a franchisor.

In 2013, *Apblouin Imports Ltd. v. Global Diaper Services Inc.*"Apblouin"") saw the Superior Court of Justice consider the issue of whether a franchisor baby diaper business adequately disclosed a franchise document to a prospective franchisee in compliance with section 5 of Ontario’s *Arthur Wishart Act*. The franchisee entered into a franchise agreement with the franchisor, an Alberta-based corporation, to operate a business that supplied and washed baby cloth diapers in Ontario (Mississauga, Oakville, and Burlington). The franchisee sought over C$200,000.00 in damages pursuant to the remedial clause of the *Arthur Wishart Act* under section 6(6). During their first meeting, the franchisor representatives gave various materials to the franchisee about diaper services, and addressed questions about the franchise business model. Financial documentation was also provided to the franchisee. However, the documents received by the franchisee were not bound in a single document, but rather, were prepared in piecemeal fashion (as in *Dig This Garden*). The franchisee became frustrated in his dealings with the franchisor and later served a notice of rescission with respect to the franchise agreement.

After filing suit against the franchisor for inadequate disclosure, the franchisee found errors in the disclosure itself, and that no copy of a franchise agreement, despite being signed by the franchisee, was given in the disclosure. The franchisor responded that the franchisee was already a sophisticated businessman who had experience in franchising, and, on that basis, should have understood the nature of the franchise disclosure documents given to him. As

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104 *Id.* at paras. 7-9.
105 *Id.* at para. 1.
106 *Id.* at para. 8.
107 *Id.*
108 *Id.* at para. 14.
109 *Id.* at para. 9.
110 *Id.* at paras. 17, 20, 24.
111 *Id.* at paras. 8, 17.
such, according to the franchisor, there was no reason for the
franchisee to complain about the deficiencies in the franchise
disclosure itself.\textsuperscript{\textcircled{112}} The Ontario Superior Court of Justice rejected this
argument, \textsuperscript{\textcircled{113}} concluding that the degree of sophistication of a
franchisee had nothing to do with the accuracy and timing of
disclosure, as mandated by legislation.\textsuperscript{\textcircled{114}}

Rather, the court confirmed three requirements constituting
adequate disclosure from \textit{Dig This Garden}: (1) only one disclosure
document is required; (2) information contained in the disclosure
should be accurate, clear, and concise; and (3) the disclosure should be
delivered at one time.\textsuperscript{\textcircled{115}} Applying these rules, the court found that the
franchisor provided insufficient information about the franchisor’s
history and corporate structure of shareholders.\textsuperscript{\textcircled{116}} The court stressed
how a franchisee should have an opportunity to review a single
document at one time, so that an informed decision can be made as to
whether or not to invest in the franchised business.\textsuperscript{\textcircled{117}} This legislative
requirement was echoed by Madam Justice MacFarland in \textit{Dig This
Garden}, where she stated:

\begin{quote}
The requirement that disclosure occur in the form of
a single document is not an empty formal requirement. The
department clearly envisioned that the purpose of
the legislation . . . would be best fulfilled by giving
prospective franchisees the opportunity to review a
single document or documents, so that all the
information is before them at the same time. It is
simple common sense that people have more difficulty
processing and assessing information given at different
times, some of it orally, than they do information
provided in a single, written document.\textsuperscript{\textcircled{118}}
\end{quote}

According to the court, it was clear that the legislature’s intent was
to impose strict technical requirements of both form and content upon
a franchisor, and that these requirements superseded the business
experience of a prospective franchisee, something that is more of a
franchisor’s subjective assessment and not a legal requirement. The
court reasoned that any subjective requirement imposed on a

\textsuperscript{\textcircled{112}} Id. at para. 17.
\textsuperscript{\textcircled{113}} Id. at para. 18.
\textsuperscript{\textcircled{114}} Id.
\textsuperscript{\textcircled{115}} Id. at para. 14.
\textsuperscript{\textcircled{116}} Id.
\textsuperscript{\textcircled{117}} Id.
\textsuperscript{\textcircled{118}} \textit{Dig This Garden Retailers Ltd.}, 2005 CanLII 25181 at para. 18.
franchisee would distort the plain meaning of the legislative intent by placing an unnecessary burden on a franchisee to become sophisticated enough in reviewing disclosure documents to make informed investment decisions on that basis.\textsuperscript{119} If this were the case, very few franchisees would qualify to forge business relations with any franchisor, as many prospective franchisees are new to the franchise business. The subjective criteria of business sophistication would hinder business and the freedom to contract.

Another important aspect of \textit{Apblouin} was the court’s focus on financial statements. The court held that the franchisor failed to provide two sources of financial statements: (1) audited financial statements for the most recent fiscal year; and (2) financial statements prepared with “generally accepted accounting principles”—two requirements that fall under section 3(1)(a) and (b) of Ontario’s \textit{Arthur Wishart Act}.\textsuperscript{120} The court held that the franchisor only provided QuickBooks statements to the franchisee, documents from an accounting software program that are not prepared in accordance with generally accepted accounting principles.\textsuperscript{121} This failure to provide financial statements in compliance with acceptable accounting standards prevented the franchisee from making financial projections based on the financial history of the franchise. Because the franchisor’s disclosure was deficient in so many ways, the court held that the disclosure did not qualify as a “disclosure document,” and that the plaintiff franchisee may exercise a right of rescission under section 6(2) of the \textit{Arthur Wishart Act}.\textsuperscript{122}

\textbf{B. Franchisor Representatives’ Signatures—Avoiding Misrepresentation}

Adequate disclosure also includes the franchisor’s verification of the form and content by way of providing signatures of its directors or officers. The seminal case for the requirement of signatures is \textit{Hi Hotel Ltd. Partnership v. Holiday Hospitality Franchising Inc.},\textsuperscript{123}

\textsuperscript{119} Interestingly, the defendant franchisor admitted to the errors in the franchise disclosure documents given to the plaintiff franchisee. \textit{Apblouin Imports Ltd.}, 2013 CanLII 2592 at para. 22.

\textsuperscript{120} S. 3(1) of the \textit{Arthur Wishart Act} states the following: “Every disclosure document shall include, (a) an audited financial statement for the most recently completed fiscal year of the franchisor’s operations; (b) a financial statement for the most recently completed year of the franchisor’s operations, prepared in accordance with generally accepted accounting principles . . .”

\textsuperscript{121} \textit{Apblouin Imports Ltd.}, 2013 CanLII 2592 at paras. 36–37.

\textsuperscript{122} \textit{Id.} at para. 45.

\textsuperscript{123} \textit{Hi Hotel Ltd. Partnership v. Holiday Hospitality Franchising Inc.}, 2008 continued . . .
where the Alberta Court of Appeal considered the issue of whether a franchisee had the right to rescind a franchise agreement when the franchisor provided no signatures in its disclosure documents. The facts were that a franchisee was interested in purchasing a Holiday Inn franchise.\textsuperscript{124} The franchisor provided an Ontario disclosure document, along with an Alberta addendum.\textsuperscript{125} However, the franchisor did not provide any signed certificates by their representatives.\textsuperscript{126} The franchisee admitted that the signatures component of the disclosure document was not a factor in deciding whether or not to participate in the franchise.\textsuperscript{127}

At trial, the Alberta Court of Queen's Bench (trial court) held that the franchisee was entitled to seek rescission of the franchise agreement, along with damages.\textsuperscript{128} Although the Alberta Franchises \textit{Act} requires a franchisee to provide a Notice of Rescission within sixty days of receiving a disclosure document, the franchisee gave notice eleven months after the franchise agreement was signed.\textsuperscript{129} On this basis, the franchisor appealed to the Alberta Court of Appeal by arguing that the franchisee was not entitled to rescission due to the timing requirement breach.\textsuperscript{130} The Alberta Court of Appeal held that the franchisor failed to provide adequate disclosure because there was an absence of signatures and dates on the certificates, which was equivalent to having no disclosure at all.\textsuperscript{131} The court pointed to serious deficiencies in Holiday Inn’s franchise disclosure document.\textsuperscript{132} First, the franchisor never actually had copies of its disclosure document, and only generic copies were on file at Holiday Inn’s head office in the United States.\textsuperscript{133} Second, there was no cover letter to accompany the disclosure document.\textsuperscript{134}

Third, the receipts were missing the date of the disclosure document.\textsuperscript{135} Fourth, the certificate forms had no signatures—only the typed name for Holiday Inn and the franchisor’s representative, along with the word “per” below it.\textsuperscript{136} The Court of Appeals then compared

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{124} Id. at para. 277.
\item \textsuperscript{125} Id. at para. 4.
\item \textsuperscript{126} Id. at para. 124.
\item \textsuperscript{127} Id. at para. 47.
\item \textsuperscript{128} Id. at para. 300.
\item \textsuperscript{129} Id. at para. 299.
\item \textsuperscript{130} Id.
\item \textsuperscript{131} Id. at para. 135.
\item \textsuperscript{132} Id. at para. 300.
\item \textsuperscript{133} Id. at para. 79.
\item \textsuperscript{134} Id. at para. 5.
\item \textsuperscript{135} Id. at para. 4.
\item \textsuperscript{136} Id. at para. 36.
\end{itemize}
\end{footnotesize}
manual signatures versus typed names standing alone by reviewing Alberta's Commissioner for Oaths Act,\textsuperscript{137} holding that typed names have no signatory effect as opposed to manual signatures.\textsuperscript{138} The Court of Appeal ruled against the franchisor, as well as its directors and officers, both being held jointly and severally liable for failing to disclose signed certificates.\textsuperscript{139} Hi Hotel is compelling in terms of having a franchisor verify its own form and content of disclosure given to franchisees in that:

\begin{quote}
The purpose of a certificate ‘signed’ by an official ‘is personally to authenticate a document and implies knowledge and approval of it contents’ . . . A certificate involves checking facts and confirming to the outside world that one has checked. . . . Without a certificate, the franchisee has just some random statements and pieces of paper, but nothing to tie them together or even to say that they are true.\textsuperscript{140}
\end{quote}

Following this statement, which was drawn from the reasoning in Dig This Garden, the Alberta Court of Appeal further commented on how signatures relate to personal liability of the franchisor when they fail to provide adequate disclosure. It stated:

\begin{quote}
A person who signs the certificate has a personal duty to conduct an investigation sufficient to provide reasonable grounds for believing that the facts stated are accurate, and that all facts to be disclosed were disclosed. Personal liability enforces that. If no one signs, no one has that duty. . . So a signed certificate is not a question of form. It governs who has huge monetary liability, and who has the duty of investigation and disclosure.\textsuperscript{141}
\end{quote}

The court's opinion speaks to the essence of franchise disclosure—to provide authentic documents that have been verified by franchisor representatives, and to give a chance to franchisee investors to later make informed investment decisions based on the truth or veracity of such documents. The Court of Appeal stressed the importance of disclosure in administrative and criminal cases, where disclosure gives an opportunity for one to review the record at hand, make informed

\begin{footnotes}
\item[137] RSA 2000, c. C-20, s.12 (Can.).
\item[138] Hi Hotel Ltd. Partnership, 2008 CanLII 276, at para. 36.
\item[139] Id. at para. 117.
\item[140] Id. at paras. 53, 55, 59.
\item[141] Id. at paras. 73-75.
\end{footnotes}
decisions on that record, and to challenge the opposing party on key issues. Keeping with this principle of disclosure, franchisees should be capable of reviewing and verifying background franchise documents that would ultimately affect their ability to make an informed business decision. The more detailed the disclosure (such as including history of the franchise, corporate structure, goods and services, and financial statements), the more it influences a franchisee to invest using their personal savings and/or borrowed funds to enter into agreement with a franchisor.

In Hi Hotel, the franchisor’s disclosure document was missing two signatures from its directors or officers, something that breached Section 13 of Alberta's Franchises Act, which requires disclosure that is in “substantial compliance” with legislation.142 The franchisor argued that the franchisee did not rely on the representations contained in the disclosure document, and that this led to no cause of action.143 The court disagreed.144 It held that what mattered most was whether the disclosure document was “substantially complete or not,” and that a breach occurred when the franchisor failed to provide two signatures.145 When a franchisor provides two signatures, they are confirming the accuracy of “material facts” that may be relied upon by a prospective franchisee when deciding whether or not to invest in a franchise. This type of detrimental reliance gives rise to a statutory right of rescission.

Although the legislative intent gives flexibility to franchisors by requiring disclosure to be “substantially complete” (and not perfect disclosure), lacking two signatures does not fulfill this requirement in form. The two signatures show accountability and transparency in the franchisor’s preparation of documents, so that if there is a misrepresentation of material facts, the franchisee at least has the opportunity to seek damages on that basis.146 The HiHotel ruling balances the franchisor-franchisee relationship, as it imposes strict legal requirements upon the franchisor (who is usually in a superior bargaining position) to give the best chance to a prospective franchisee to thoroughly review key franchise documents. It also affords protection to franchisees while doing so.

Thus, when a franchisor provides no signatures in its disclosure document, a franchisee may likely succeed in rescinding a franchise agreement. So, what happens when there is only one signature in the

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142 Id. at para. 136.
143 Id. at para. 48.
144 Id. at para. 49.
145 Id. at para. 100.
146 Id. at para. 69.
disclosure document? In 1448244 Alberta Inc. v. Asian Concepts Franchising Corporation\textsuperscript{147} ("Asian Concepts"), the Court of Queen's Bench of Alberta considered the issue of whether a franchisee may rescind a franchise agreement under the "substantial compliance" provision (Section 13 of the Alberta Franchises Act) when a franchisor provides disclosure lacking two signatures. The facts were that the franchisee alleged that the defendant franchisor had provided "deficient" documents, particularly where there was a lack of two signatures of the franchisor’s representatives, and that this was not "substantially complete."\textsuperscript{148} The franchisor provided some documentation, but only one signature was made by the franchisor’s representative.\textsuperscript{149} The court held that the franchisor failed to provide adequate disclosure because the disclosure document had only one signature of a representative, and not two signatures.\textsuperscript{150} The court followed the rule established in Emerald Developments Ltd. v. 768158 Alberta Ltd.,\textsuperscript{151} where the Court of Queen’s Bench of Alberta held that one signature provided in a franchisor's disclosure document was a serious deficiency in its disclosure, which amounted to inadequate disclosure.\textsuperscript{152}

Three rules were highlighted in Asian Concepts. First, if proper disclosure is not made, a franchisee may rescind the franchise agreement and recover net losses incurred in acquiring, creating and operating the franchised business.\textsuperscript{153} Second, under Regulation 2(3) of Alberta Franchises Regulation, a disclosure document must include a certificate signed by at least 2 officers or directors.\textsuperscript{154} Third, section 9 of Alberta's Franchises Act states that if a franchisee suffers any loss from misrepresentation contained in a disclosure document, a franchisee has a right to seek damages against the franchisor (and anyone signing the disclosure document).\textsuperscript{155} Thus, the second signature was important not only because it breached the "two

\textsuperscript{148} Id. at para. 17.
\textsuperscript{149} Id. at para. 8.
\textsuperscript{150} Id. at para. 23.
\textsuperscript{151} Emerald Devs. Ltd. v. 768158 Alberta Ltd., 2001 CanLII 143 (Can. Alta. Q.B.).
\textsuperscript{152} Id. at para. 29.
\textsuperscript{153} Franchises Act, R.S.A. 2000, c F-23 (Can.).
\textsuperscript{154} Franchises Regulation, Alta. Reg. 240/1995 ("A disclosure document, including any material changes made in respect of a disclosure document, must include a certificate set out in Schedule 2 that must be dated and must be signed (a) by at least 2 officers or directors of the franchisor, or a combination of them totaling at least 2, if the franchisor has 2 or more directors or officers.").
\textsuperscript{155} Franchises Act, R.S.A. 2000, c F-23 (Can.).
signatures” requirement, but also because it prevented the franchisee from seeking damages against a second signatory. That is, the franchisor limited its personal liability of two signatories when making disclosure to the franchisee with only one signatory. Interestingly, like Hi Hotel, the franchisee in Asian Concepts downplayed the prospect of misrepresentation in disclosure, admitting that parts of the disclosure document were not misrepresented to him. 156 Regardless, the court held against the franchisor on the basis that any minor deviation from legislative disclosure requirements were not permitted. 157

C. Failure to Provide “Material Facts” and Misrepresentation

Other cases reveal how a franchisor’s failure to provide “material facts” in a series of disclosure documents may amount to an actionable claim for misrepresentation, in which a franchisee detrimentally relies upon such disclosure when investing in the franchise, and later experiences financial losses. 158 As shown, franchise legislation in Canada creates a statutory right of rescission for a franchisee when there is proof that “material facts” were not given to a franchisee or franchisor. In Melnychuk v. Blitz Limited 159 (“Melnychuk”), the Ontario Superior Court of Justice considered the issue of whether “material facts” were omitted from a franchisor’s disclosure documents to have them make a properly informed decision about whether or not to invest in the franchise. The facts were that a franchisee, an incorporated business in Ontario by Melnychuk, entered into a franchise agreement with the franchisor, Dollar Blitz Store. 160 Various disclosure documents were provided by the franchisor’s representative to Melnychuk, after which he signed a receipt acknowledging the documents, including a franchise agreement, general security agreement, lease and sublease, a purchase and sale agreement, and financial statements. 161

The court found deficiencies in the disclosure documents. First, the financial statements contained a notice which stated: “We have compiled the balance sheet . . . We have not audited, reviewed or otherwise attempted to verify the accuracy or completeness of such information. Readers are cautioned that these statements may not be

157 Id. at para. 136.
160 Id. at para. 1.
161 Id. at para. 7.
appropriate for their purposes.”162 Given that Ontario’s Arthur Wishart Act required accurate, updated financial statements that should be verified by auditing and generally accepted accounting principles, the franchisor failed in this respect.163 Clearly, the franchisor admitted in its own notice that the financial statements were incomplete and were not verified.164 The issue is whether a reasonable franchisee investor would rely upon such disclosure when making a serious financial commitment to a franchise.

Second, the location of the franchised business was missing from the franchise agreement.165 This was left blank, and the location was given to the franchisee much later in time. Third, there was no disclosure as to the purchase price, franchise fee, deposits, or closing date (for the purchase and sale agreement).166 This breached the legislative requirement under section 5(4)(a) of the Arthur Wishart Act, which requires a list of all franchisee’s costs to establish the franchise. Third, no lease or sublease was included with the disclosure document, with the consequence being that Melnychuk was not given sufficient notice for the term of the lease or its calculated rent, which placed Melnychuk as an “indemnifier” to indemnify the franchisor against any loss or damages arising out of the sublease.167 This failure to provide relevant contents of the sublease exposed the franchisee’s personal liability for the indemnification portion of the sublease. Without the sublease information, how would the franchisee be aware of his obligations against any loss or damage arising from the sublease?168 Fourth, the general security agreement was incomplete in that the last five pages of the document were missing.169 Given these disclosure defects, Melnychuk moved to rescind the franchise agreement under section 6(2) of Ontario’s Arthur Wishart Act on the ground that the disclosure document failed to provide “material facts,” thereby resulting in no disclosure.170

The court agreed that multiple deficiencies in the franchisor’s disclosure documents prevented the franchisee from making an informed decision, and that the franchisee was entitled to rescind the

162 Id. at para. 11.
163 Id.; Arthur Wishart Act (Franchise Disclosure), O. Reg. 581/00 (Can.).
164 Melnychuk, 2010 CanLII 566 at para 11.
165 Id.
166 Id.
167 Id. at paras. 7-8.
168 Id. at para. 8. The issue of omitting material facts from a franchise sublease was also considered in 6792341 Canada Inc. v. Dollar It Ltd., 2009 CanLII 385 (Can. Ont. C.A.).
170 Id. at para.10.
franchise agreement, general security agreement, and indemnity agreement, along with the sublease.¹⁷¹ The franchisee was awarded damages of C$266,690.00 relating to the costs of establishing and maintaining the franchised business, including the franchise fee, cost of a business plan, legal and accounting expenses, rent deposit, payment for goodwill, right to sublet, chattels, furniture, fixtures, equipment, and inventory.¹⁷² Melnychuk is instructive because it shows how a franchisor’s partial disclosure would lead a franchisee to rely to their detriment on incomplete and inaccurate information that, under the legislative scheme, amounts to inadequate franchise disclosure. The franchisee was seriously concerned with the lack of completeness in the disclosure documents, particularly with the material fact of the remaining term of the lease. The deficient disclosure hindered the franchisee’s ability to determine how long he could operate the franchise on the premises.

The issue of omitting a material fact of a lease renewal in one’s disclosure document reappeared in 2012 in Sirianni. v. Country Style (“Country Style”).¹⁷³ In this case, the Ontario Superior Court considered the issue of whether a franchisor deliberately concealed disclosure about the term of a sublease.¹⁷⁴ In this case, a franchisee entered into an agreement with the franchisor (Country Style) in 1995, and developed a solid ten-year business relationship in selling coffee, donuts, and sandwiches.¹⁷⁵ Upon the renewal of the franchise agreement, part of which included a sublease on the premises of where the store was located, there was a renewal of the franchise agreement for an additional five years.¹⁷⁶ However, the franchisee argued that inadequate disclosure was provided to them during the renewal period, and that “material facts” were deliberately omitted by the franchisor.¹⁷⁷ What was missing was a sublease that would have revealed that the lease for the premises was expiring soon. In fact, the franchisor agreed with the landlord of the commercial premises to set an early termination date, but failed to disclose this material fact to the franchisee.¹⁷⁸

¹⁷¹ Id. at para 15.
¹⁷² Id. at para 16. The court in Melnychuk also considered damages for loss of income, emotional distress, and punitive damages, but left this assessment of damages until after the discovery phase of litigation. Id. at paras. 16–17.
¹⁷⁴ Id. at para. 21.
¹⁷⁵ Id. at para. 2-3.
¹⁷⁶ Id. at para. 2.
¹⁷⁷ Id.
¹⁷⁸ Id. at para.10.
On this basis, the franchisee sought rescission of the renewed franchise agreement. The court held that the franchisor deliberately withheld showing the renewal terms of the sublease on the commercial premises because they feared the franchisee would leave the premises, and the franchisor would become responsible for paying the rent on the sublease. In essence, the omission of material facts relating to the sublease’s renewal terms prevented the franchisees from planning ahead, while exposing him to personal liability as an indemnifier. The court was mindful of these points and protected the franchisee from this type of misrepresentation by awarding damages in their favour. Thus, it became clear that the rule for adequate franchise disclosure was that a franchisor is required to submit material facts, including those facts that may potentially lead an investor to personal liability, even on the renewal terms of a sublease.

D. Method of Delivery for a Disclosure Document

An important rule in franchise law is that a franchisor must deliver franchise disclosure documents either personally or by registered mail. This rule is based on legislative requirements set under franchise legislation. One question that remains is whether e-mail alone fulfills the method of delivery for franchise disclosure documents. In 2012, the Ontario Superior Court of Justice considered this issue in Vijh et al v. Mediterranean Franchise Inc. et al, a franchise selling Mediterranean foods. Despite the franchisor fully complying with its form and content of disclosure, and despite the franchisee agreeing to receive the disclosure by e-mail, the issue of the delivery method of disclosure was in question because the franchisee sued for rescission and damages.

The court held that the franchisee could not recover damages and rescind the franchise agreement. It reasoned that notwithstanding the missing statutory language in franchise legislation for including e-mails as a method of delivering disclosure documents, the franchisor

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179 Id. at para. 69.
180 Id. at para. 123.
181 Id. at para. 131.
182 See e.g., Arthur Wishart Act (Franchise Disclosure), O. Reg. 581/00 (Can.) (describing, among others requirements, the need to ensure delivery of franchise disclosure documents either personally or by registered mail).
184 Id. at para. 2.
185 Id. at para. 3.
did provide the necessary form and content of disclosure. Drawing from another case on point in 4287975 Canada Inc. v. Imvescor Restaurants Inc., the Ontario Superior Court of Justice held that not every breach under franchise legislation justifies a franchisee’s right to rescission. The rule for rescission is that it is permitted within two years after entering the franchise agreement if “no disclosure document” or a “material deficient disclosure” was made by a franchisor. The right of rescission within the two-year period is only available to a franchisee where it is shown that a franchisor provided no disclosure at all. Here, the franchisor provided complete disclosure, and although it delivered it by e-mail (rather than personally or by registered mail), it was not a material breach under statute. Thus, minor technical breaches of franchise legislation with respect to method of delivery does not necessarily justify a claim for rescinding a franchise agreement, particularly when almost two years had elapsed after the signing of the franchise agreement.

As shown, franchise case law describe how courts protect franchisees' rights for franchise disclosure documents. It is no longer enough for a franchisor to give a bare minimum of documents (particularly those without executed signatures), and later assume that a franchisee may rely upon such disclosure to make an informed decision on investing in the franchised business. Rather, the courts look to the content and form of the disclosure provided by franchisors to determine whether or not compliance is met under the technical criteria of franchise legislation. The courts recognize the growing presence of franchises in the Canadian marketplace, and that a stable franchisor-franchisee relationship is best achieved.

IV. SUMMARY OF RULES FOR ADEQUATE FRANCHISE DISCLOSURE

From a practical viewpoint, a franchisor can meet their legislative duty of disclosure to prospective franchisees, and avoid a franchisee’s rescission claims by following some tips:

• provide “one document” at one point in time, and avoid giving disclosure in a piecemeal fashion;

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186 Id. at para. 6.
188 Id. at para. 22.
189 Id.
- provide accurate and updated financial statements, which meet auditing and generally accepted accounting principles standards;
- have signatures from at least two franchise representatives;
- provide copies of supplementary documents, including a franchise agreement, general security agreement, lease or sublease, or purchase and sale agreement;
- avoid omitting “material facts” in the disclosure documents (such as location, fees, lease terms);
- maintain regular communication with franchisee when they request information;
- deliver the franchise disclosure document within fourteen days prior to signing any agreement, and by way of personal service, registered mail, or e-mail.

V. CONCLUSION

Franchises are becoming a popular means of doing business in Canada for prospective investors. As such, the franchisor-franchisee relationship becomes important from a legal perspective when prospective franchisees request disclosure documents from the franchisor and rely upon such documents. Recent case law has revealed how inadequate disclosure can adversely affect a franchisee’s ability to use that information and make an informed decision to invest in the franchised business. In response, franchise remedial legislation was introduced to spell out with precision what a franchisor must provide in its disclosure documents to a franchisee. The courts have strictly enforced this technical criteria as to the form and content of disclosure. Legislative provisions thus provide a strong layer of legal protection for the franchisees against franchisors failing to meet this requirement.

The technical requirements discourage generic disclosure, poor record-keeping, and distributing disclosure documents in a piecemeal fashion. In addition, prescribing proper accounting standards enhances transparency and accountability of the franchisor. What can be gleaned from the case law is that courts recognize the major risk undertaken by franchisees when they invest in a franchise. Pursuing a franchise requires serious financial resources and commitment on the part of the franchisee, and because of the relatively unequal bargaining positions between franchisors and franchisees (where one-sided terms and conditions are found in franchise agreements), the courts have enforced the remedial portions of franchise legislation to protect
franchisees from possible future financial losses when relying on incomplete disclosure. The remedial provisions of legislative disclosure requirements demands high quality in the form and content of disclosure, by which a franchisee can make reasonable investment decisions. In this way, franchise legislation protects franchisees’ rights, disciplines the behavior of franchisors, and fosters a more stable business relationship in the franchise sector.
FRANCHISES AS MORAL RIGHTS

Robert W. Emerson†

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I. Introduction

Imagine living the American dream of owning a small business, such as a franchise. Now imagine what it takes to keep that dream alive—the everyday operations of this fictional franchise location. There are inventory, customers, employees, products, and of course the franchisor to consider. At the end of the day, with all crises averted, the franchise becomes profitable. In fact, the business is a local sensation. The website also draws thousands of hits each week. Yet, upon the close of the franchise agreement term, the franchisor refuses to renew the contract. Suddenly, the brand name can no longer be associated with your business. Meanwhile, the franchisor has opened near your store a new franchise location where many of your once-loyal customers now flock. You receive a cease-and-desist letter regarding the use of the brand name on your website. It seems as if all of the work put into making the franchise location a success has been undone.

Conversely, imagine heading a company that spent years and millions of dollars to stake out a brand name. You seek to expand the brand name by franchising. However, one franchisee is frequently late paying royalties, and is only consistent in its disregard for quality standards. You decide that discontinuing the franchise relationship would be in the company’s best interest. Yet the former franchisee continues to use the brand name on its own website, ignoring a cease-and-desist letter. You fear the former franchisee could harm the brand’s reputation by association and thus feel compelled to take action through the court system.

These two stories are the backdrop of a typically unaddressed issue in U.S. franchise and intellectual property rights law: who owns the “intangibles,” such as goodwill and reputation? In this article, the nature of that inquiry leads to a proposal respecting law and theory while conforming to practical concerns: moral rights.

A. Contracts and Torts

There are two scenarios in which one may witness moral rights in action: torts and contracts.¹ In the tort scenario, there is a conflict

¹ See U.S. Copyright Office, Waiver of Moral Rights in Visual Artworks (2003), available at http://www.copyright.gov/reports/exsum.html ("Nations that provide their authors and artists with protection in the nature of moral rights protection do so using various approaches. Some use statutory law to balance the interests of artists and their creations with the interests of copyright owners and other users of works. The statutes may be categorized as laws of copyright, design rights, passing-off, unfair competition, tort, or contract. In other countries, the continued . . ."
between an artist and an unauthorized user. Tort litigation can arise regarding the moral rights of disclosure, attribution, and integrity. In the contract scenario, an artist may exercise her moral rights against authorized users of her work, i.e., licensees or copyright holders. A copyright infringement action typically cannot be brought against a licensed holder; thus, artists must rely on moral rights to prevail.

These two scenarios concerning intellectual property in torts and contracts can be analogized to issues in franchise law. The question of who owns the goodwill and work product of the franchise network, be that the franchisor or franchisee, may be assessed using moral rights. The ownership of goodwill is sometimes divided between goodwill developed by the franchise as a whole or by a particular franchise location. Who owns the goodwill becomes important, for example, in the context of contract clauses against competition, when a “franchisor's contribution to local goodwill is deemed to support the enforcement of a noncompete covenant.” Of course, “[i]f an ex-franchisee continues to operate a store under a different name in the terminated location, many consumers will understand that it is essentially the same store; [a]ccordingly, the ex-franchisee would be free riding on the franchise system's goodwill.” On the other hand, if a franchisee is responsible for the goodwill of the franchise, then ownership of the goodwill may negate a non-compete agreement. A franchisee may lose its investment in goodwill at a particular location if a non-compete agreement is enforced.

personal rights of attribution, paternity, and integrity have been defined and shaped by the courts.”).  

2 Id.; see generally Laura A. Heymann, The Law of Reputation and the Interest of the Audience, 52 B.C. L. REV. 1341, 1341–64 (2011) (discussing the torts that protect reputation, such as misappropriation).


4 See U.S. COPYRIGHT OFFICE, supra note 1.

5 Rigamonti, supra note 3, at 372.


8 Id. See also Robert Emerson, Franchising Covenants Against Competition, 80 IOWA L. REV. 1049, 1049–1107 (1995).

9 Tillack & Ashton, supra note 7.

10 Id.

11 Id.
Similarly, the owner of a franchise’s goodwill must consider the possible negative impacts on reputation that can decrease the value of the franchise trademark or brand. By analogy, an artist’s reputational interests are threatened by prejudicial alterations, treatments, and uses of her work because “each of an artist's works is an advertisement for all of the others.”\textsuperscript{12} This negative impact on the artist’s reputation will adversely affect the value of the artist’s other existing and future works.\textsuperscript{13} Just as a franchisor is keen to impose strong quality standards on its franchisees, “an artist has an interest in preventing the reputation of his work in general from being depreciated by the opportunistic adulteration of individual works.”\textsuperscript{14} An artist’s name, like the signaling mechanism of a franchise bearing the name “McDonald’s,” will for the public serve as a ready indicator of quality and status in the contemporary art market.\textsuperscript{15} Whether to determine the ownership of goodwill or protect the reputation of a brand, there is broad economic justification for moral rights in the context of franchise law.

B. Roadmap of Article

This article seeks to discuss the origins and current application of moral rights and later introduce them to the world of franchise law. It begins by defining moral rights and how the concept of moral rights has been used thus far, particularly in Europe, regarding intellectual property. This discussion also considers to what extent, if any, moral rights are employed in U.S. intellectual property law, and to what effect.

This article then shifts to the world of franchise law, detailing current issues both parties of the franchise relationship face. The article discusses broad topics, such as the current franchise business model favoring franchisors and the problems inherent in trademark litigation of a franchise brand. Then the article addresses specific franchise problems, such as fraud in franchise contracting, encroachment into a party’s territory, abuses by franchisors, retaliatory or simply unfounded termination, and lack of franchisee collective


\textsuperscript{13} Id.

\textsuperscript{14} Id. Of course, opportunism is a recurring and troubling aspect of, or at least prospect in, franchising. \textit{See generally} Antony W. Dnes, \textit{Franchise Contracts, Opportunism and the Quality of Law}, 3 ENTREPRENEURIAL BUS. L. J. 257 (2009); infra Parts II, II.A, II.A.1, II.A.1.a.

action. As remedies for these problems, this article refers to state legislation and then highlights current practices on franchise websites, discusses attribution and moral rights in franchising, and deals with what this may mean in the long term for franchise relationships.

This article concludes by combining a discussion of moral rights in intellectual property law and the issues of franchise law. The article argues that the problems plaguing franchise law, particularly the ownership of a franchise brand’s goodwill, can be relieved, if not resolved, by federal legislation that employs moral rights. That is, a cohesive set of laws regarding the intangible but invaluable aspects of franchise ownership should be set in place to protect franchisees and franchisors alike.

II. MORAL RIGHTS

A. Introduction to Moral Rights

The term “moral rights” encompasses three concepts: the moral right of disclosure, of paternity, and of integrity. The moral right of disclosure allows an artist to decide the form of a work and timing of the work’s display. The moral right of paternity prevents a person from claiming to be the creator of another person’s work. Lastly, the moral right of integrity allows an artist to prevent her work from being displayed in an altered, distorted, or mutilated form.

Meanwhile, there are three legal approaches that address artists’ rights. First, the French doctrine of *droit moral*, or moral right, was adopted by many civil law countries. *Droit moral* is the most protective of these approaches because an artist’s moral rights are viewed as perpetual, inalienable, and non-waivable. Second, the Berne Convention set a minimum standard for artists’ literary and artistic rights, including moral rights. In the 1971 revision of the

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17 Hughes, supra note 16, at 659.
18 Hansmann & Santilli, supra note 16, at 96.
19 Hughes, supra note 16.
20 See Jacqueline D. Lipton, Copyright's Twilight Zone: Digital Copyright Lessons from The Vampire Blogosphere, 70 Md. L. Rev. 1, 19 n.133 (2010) (mentioning that thirty-five non-European nations have adopted moral rights).
22 See Hughes supra note 16; see also Hansmann & Santilli, supra note 16, at
Berne Convention for the Protection of Literary and Artistic Works, a moral rights provision was adopted.\textsuperscript{23} Article 6bis recognizes the right of paternity and a limited right of integrity.\textsuperscript{24} Thus far, France provides the greatest protection under the Convention, with Germany and Italy close behind.\textsuperscript{25} However, several nations not a part of the Berne Convention provide extensive protection for moral rights as part of their copyright laws.\textsuperscript{26} For example, Ecuador protects an author’s right of paternity, disclosure, integrity, and withdrawal.\textsuperscript{27} Third, an artist’s economic rights, but not moral rights, are protected under United States law.\textsuperscript{28} This is the least protective legal approach to artists’ rights, which perhaps stems from a difference in the origination of these laws.\textsuperscript{29} Continental European copyright law, for instance, is “informed to a greater degree by natural rights and a concern to protect the personality interests of the author.”\textsuperscript{30}

B. Foundation for Moral Rights: Disclosure, Withdrawal, Attribution, and Integrity

Moral rights were established in France at the end of the nineteenth century, well after economic rights were in place.\textsuperscript{31} The moral rights established in France at this time included the rights of disclosure and withdrawal.\textsuperscript{32} The right of disclosure entitles an author to decide when her work is complete, i.e., ready for publication and commercialization.\textsuperscript{33} The right of withdrawal empowers an author to


\textsuperscript{25} See Hansmann & Santilli, supra note 16, at 99; see also Hansmann & Santilli, supra note 16, at 99 n.19.


\textsuperscript{27} Id.


\textsuperscript{29} Id. at 631.

\textsuperscript{30} See Hughes, supra note 16, at 662.

\textsuperscript{31} Id. at 663 (“In 1976, Professor John Henry Merryman noted that the ‘moral right of the artist [is] still comparatively young even in the nation of its origin’ and that it probably ‘has not reached anything like its full development.’”).

\textsuperscript{32} Id.

\textsuperscript{33} Hansmann & Santilli, supra note 16, at 96.
retract the economic rights that she may have assigned or licensed to a third party in order to enable that third party to exploit the work.\textsuperscript{34}

Two other moral rights that developed during this time include the rights of attribution and integrity.\textsuperscript{35} The right of attribution gives an author the right to claim authorship in her work, including the right to determine whether and how the author’s name shall be affixed to the work.\textsuperscript{36} Specifically, the author has the right to relief against anyone who falsely claims to be the author of the work, omits the author’s name from a specific work, or falsely attributes the author’s work to a third party.\textsuperscript{37} Thus, the right of attribution gives the author a right to publish anonymously, stop her name from being attached to another’s work, and stop another’s name from being attached to her works.\textsuperscript{38} For example, in Gilliam v. ABC, Inc., the comedy troupe Monty Python prevailed in a trademark infringement action based on a misattribution claim against ABC, Inc.\textsuperscript{39} The Gilliam court’s reasoning is respected, if not controlling, in some jurisdictions.\textsuperscript{40} In the franchising context, a preliminary injunction is typically awarded to a licensor bringing a trademark claim because there is a presumption that if a licensor cannot control its trademark, consumers may associate their opinions of the licensee with the marks, thus irreparably harming the licensor’s reputation.\textsuperscript{41}

Meanwhile, the moral right of integrity is the author’s right “to object to any distortion, mutilation or other modification of, or another derogatory action in relation to, [the author’s or artist’s] work, which would be prejudicial to [the author’s or artist’s] honor or reputation.”\textsuperscript{42}

\textsuperscript{34} Rigamonti, supra note 3, at 362.
\textsuperscript{35} Hansmann & Santilli, supra note 16, at 130.
\textsuperscript{36} Id. at 130–34.
\textsuperscript{37} Id.
\textsuperscript{38} Id.
\textsuperscript{39} Id. at 113 n.54; see generally Gilliam v. ABC, Inc., 538 F.2d 14 (2d. Cir. 1976) (finding that the BBC originally owned the rights to the Monty Python comedy show, which it licensed to Time-Life, an American network. Under the agreement between the Monty Python team of writers-performers and the BBC, the shows were to remain largely original and only slightly edited. However, Time-Life substantially edited the shows, against Monty Python’s wishes and the rights under the Lanham Act.).
\textsuperscript{40} See Gilliam, supra note 39; see also Nat'l Bank of Commerce v. Shaklee Corp., 503 F. Supp. 533, 544 (W.D. Tex. 1980) (citing Gilliam for the proposition that “an author should have control over the context and manner in which his or her work is presented”).
\textsuperscript{41} Tillack & Ashton, supra note 7, at 90. The Gilliam case may be more about misattribution, even though the footnote reads as if the case illustrates the moral right of integrity (i.e., substantial editing equals infringement of the right to prohibit modification).
\textsuperscript{42} Hughes, supra note 16, at 663.
The right of integrity is perhaps the most important moral right in fine arts and literature because it provides an author with a right to prohibit modifications of her work without her consent, regardless of whether the modification would negatively or positively impact the work.\textsuperscript{43} For example, in 1993, a French court held that changing the interior design of a building was an infringement of an architect’s right of integrity.\textsuperscript{44} The court reasoned that the changes were significant, and the owner made these changes without first approaching the architect, despite a contractual provision reiterating the owner’s duty to safeguard the architect’s moral rights.\textsuperscript{45}

The value of the right of integrity lies in the ability to offer some form of protection to the artist against a non-economic type of harm to her “personality” interest when an undesired alteration is made to the work in question.\textsuperscript{46} Artists are thus empowered with the ability to control the actions of others who have proprietary titles over a work of art and generally control the artistic “voice.”\textsuperscript{47} Lastly, the right of integrity incentivizes the artist because “creative efforts are encouraged and the wider community benefits from the increased availability of artworks. With respect to works of particular cultural significance to the wider community, the instrumental value of integrity rights may also be reflected in their ability to preserve the cultural heritage of that community.”\textsuperscript{48}

In summary, the rights of disclosure, withdrawal, attribution, and integrity are the moral rights given to authors of works under French law. These rights remain with the author, but can be transferred upon the author’s death.\textsuperscript{49} However, even these far-reaching rights have

\textsuperscript{43} Rigamonti, supra note 3, at 364.
\textsuperscript{44} T.G.I. Paris, 3e ch., Mar. 25, 1993, 157 RIDA 1993, 354 (Fr.).
\textsuperscript{45} Id.
\textsuperscript{46} Ong, supra note 12, at 302; Hansmann & Santilli, supra note 16, at 102–07.
\textsuperscript{47} Ong, supra note 12, at 302; see also Hansmann & Santilli, supra note 16, at 102–03. (Physical alteration of an artist’s work after the work has left the artist’s hands, or prejudicial display of the work, can harm the artist in a variety of ways. The most direct is simply the subjective personal anguish the artist feels from seeing his work abused, quite apart from-and even in spite of-what anyone else might think about it.).
\textsuperscript{48} Ong, supra note 12, at 302; see also Hansmann & Santilli, supra note 16, at 102–03.
\textsuperscript{49} See Van Velzen, supra note 28, at 633 (arguing that “[c]urrent French law reflects the concept that an artist shall ‘enjoy an exclusive incorporeal property right in the work, effective against all persons.’ French artists enjoy droit moral as a personal right that remains with the original creator of the work, as a perpetual right that can be transferred to heirs at the artist's death, and as a nonwaivable inalienable right.”). As to the survival of moral rights after an author’s death, modifications to his work that damage the author’s reputation could be just as, if not more injurious, because the author no longer can defend the integrity of his work. Kwall, supra note \textit{continued} . . .
Moral rights litigation is no different from the woes of litigation generally—it is expensive and time consuming. Perhaps, therefore, it is unsurprising that moral rights have also been eroded elsewhere, such as Canada.

C. American Copyright Law

The centerpiece of American copyright law is the Copyright Act of 1976. The Act covers thirteen chapters, the first of which defines the scope of copyrights to include only “original works of authorship fixed in any tangible medium of expression.” Section 106 of the Copyright Act covers the rights authors have in their works, including reproduction, distribution, and performance. There are also rights conferred to artists that protect their works from being attributed to another and distorted. However, these rights are limited by four factors: the extent of modification, the life of the author, transfer, and the defense of fair use. Chapter 5 of the Act lists the remedies for copyright infringement, such as injunctions, impounding, and the award of damages and attorney’s fees.

I. A Creator’s Waiver of Rights

The Copyright Act of 1976 allows no protection for the personal rights of creators, but instead focuses on the inherent economic value of a copyright. This lack of personal, non-economic protection is criticized because copyrighted works may be considered products of the creator’s mind, heart, and soul for which protection beyond

50 Lipton, supra note 20, at 19 nn.133–34.
51 Id.
54 Id. at § 102(a).
55 Id. at § 106.
56 Id. at § 106(a).
57 Id. at §§ 106(a), 107, 109–12.
58 Id. at §§ 501-505.
59 The Lanham Act only protects against misattribution; it does not truly provide a right of attribution or integrity. See Hughes, supra note 16, at 659; Heymann, supra note 2, at 1401.
financial returns is warranted. To the extent that a creator’s personality interests can be recognized, U.S. courts are forced to rely upon other established legal theories to address issues implicating moral rights, such as unfair competition law, contract law, defamation, invasion of privacy, and copyright law. Yet even in these areas of U.S. law, most states only recognize one component of moral rights: the right of disclosure. Similarly, American case law rarely recognizes an author’s rights. In fact, U.S. courts infer a waiver of moral rights from the artist’s sale of a property right, even if the owner severely distorts the art or fails to credit the artist.

Additionally, the United States tends to have a presumption in favor of alleged waivers of the creator’s “right of paternity.” American law follows the traditional rule that the creator is not entitled to credit unless a contractual provision requires such credit. In other words, if the contract is silent as to crediting the author of the work, the contract is viewed as a waiver of the right of paternity. This rule contrasts with the more modern rule adopted in some foreign countries: there is no presumption that the creator waived the right of paternity if the written contract includes nothing about that right. A major criticism of the traditional U.S. approach is that relatively unknown creators face a disparity of bargaining power that frequently

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61 Kwall, supra note 26, at 2–3. See generally Hughes, supra note 16, at 659 (discussing the fact that the United States, the biggest producer of copyrighted works, “stubbornly” refused to align with the Berne Convention).

62 Kwall, supra note 26, at 18.

63 See generally, Kwall, supra note 26, at 18–33 (detailing the doctrines which American courts rely upon when protecting an artist’s moral rights). “Implementation of the moral right doctrine in the United States not only would provide a uniform means of protecting a creator’s personal interests, but also would free courts from reliance on legal theories that are not adequate substitutes for the moral right doctrine.” Id. at 4.

64 See generally Serra v. United States Gen. Servs. Admin., 664 F. Supp. 798 (S.D.N.Y. 1987) (holding that there is no right to prevent relocation of a sculpture within the signed boiler plate contract between artist and third party).

65 Van Velzen, supra note 28, at 640.


68 Kwall, supra note 26, at 14.

69 Kwall, supra note 26, at 21–22.
results in a loss of valuable protections.\textsuperscript{70} This is analogous to problems in franchising, where the franchisee is easily “outgunned” by the franchisor.\textsuperscript{71}

On the other hand, there is one situation in which U.S. courts recognize rights for the creator of a work.\textsuperscript{72} In \textit{Gilliam}, the court held that significant editing, without permission, of a work protected by common law copyright constitutes copyright infringement, even without a contract between the parties.\textsuperscript{73} The court recognized this limited right under the Lanham Act, i.e., U.S. trademark legislation, so the decision falls short of granting true moral rights protection.\textsuperscript{74} Overall, if a contract does not contemplate modification, American courts will only protect an artist against excessive mutilation of her work.\textsuperscript{75} American creators are thus less successful in lawsuits regarding modification than artists protected by moral rights.\textsuperscript{76}

\section{2. The Moral Rights Doctrine Should be Applied in the United States}

A creator’s personality rights and society’s interest in preserving the integrity of its culture are not the primary focus of any of the alternative theories, all of which developed in response to completely different social concerns.\textsuperscript{77} For example, as a consequence of a creator’s inability to take its moral rights cause of action into any other existing theory, consider \textit{Shostakovich v. Twentieth Century-Fox Film Corp.}\textsuperscript{78} The \textit{Shostakovich} court discussed the inherent difficulties in defining the boundaries of moral rights:

\textit{Id.}\textsuperscript{70} \textit{See infra} notes 118–120 and accompanying text.\textsuperscript{71} \textit{See generally} \textit{Gilliam v. ABC, Inc.}, 538 F.2d 14 (2d. Cir. 1976).\textsuperscript{72} \textit{Id. See also} Kwall, \textit{supra} note 26, at 22 & n.79 (citing cases for the proposition that “injury might take the form of the publication of a mutilated version of the creator’s work under the creator’s name”).\textsuperscript{73} \textit{See Kwall, supra} note 26, at 23–24 & 24 n.89 (noting that while the Lanham Act, at §43(a), may afford some of the same protections as the moral rights of attribution and integrity, the Lanham Act and unfair competition laws have “significantly different objectives” than the moral rights doctrine, which means that any moral rights-like protections under the Act or the unfair competition laws is “fortuitous”).\textsuperscript{74} \textit{See Kwall, supra} note 26, at 21 & n.77.\textsuperscript{75} \textit{See Kwall, supra} note 26, at 22 (stating that “foreign courts that maintain an inalienable moral right will uphold contractual provisions allowing reasonable alterations of a creator’s work in certain contexts, but they will refrain from holding that a creator tacitly has waived his right of integrity by signing an agreement silent on modification rights.”).\textsuperscript{76} \textit{Kwall, supra} note 26, at 23–24.\textsuperscript{77} \textit{See generally} \textit{Shostakovich} v. Twentieth Century-Fox Film Corp., 80 continued...
The application of the doctrine presents much difficulty . . . there arises the question of the norm by which use of such work is to be tested to determine whether or not the author’s moral right as an author has been violated. Is the standard to be good taste, artistic worth, political beliefs, moral concepts or what is it to be? In the present state of our law the very existence of the right is not clear, the relative position of the rights thereunder with reference to the rights of others is not defined nor has the nature of the proper remedy been determined.79

a. Federal Application of Moral Rights

The Visual Artists Rights Act ("VARA") is federal legislation that includes a moral rights provision for works of fine art80 and is thought to be, in essence, the United States’ attempt to conform with the Berne Convention.81 Section 106A of the Act creates rights of attribution and integrity, which belong to an author whether or not the author is the copyright holder and endure until the death of the author.82 VARA also creates an opt-out system that places the burden on the buyer to contract around moral rights.83 This default position to moral rights is more favorable to the artist who is often in a weaker bargaining position and less knowledgeable.84

Otherwise, U.S. copyright law focuses on economic exploitation of an artist, but largely ignores the other sorts of harms that could befall an artist.85 Courts continue to struggle with the lack of federal laws protecting artists. For example, in Stevens v. National Broadcasting Co., the court granted a filmmaker’s request for a preliminary injunction to stop destructive editing of a motion picture.86 The court stated in its decision that “a court of equity has a duty when presented

81 Tang, supra note 15, at 221.
82 Id. at 225. See also Lipton, supra note 20, at 19 nn.133–34.
83 Tang, supra note 15, at 225.
84 See generally Nicholas S. Economides, The Economics of Trademarks, 78 TRADEMARK REP. 523 (1988).
with a novel situation to fashion remedies to protect parties and litigants against new harms where it appears that there is an inadequate remedy at law.\textsuperscript{87}

\textit{b. State Law}

Eleven states have enacted moral rights statutes.\textsuperscript{88} In the California, Massachusetts, and Pennsylvania statutes, the states recognize the right of integrity by prohibiting physical defacement, mutilation, alteration, or destruction of fine art.\textsuperscript{89} These statutes do not require that the work be displayed or published, or that damage to the artist's reputation be proven.\textsuperscript{90} Meanwhile, in the Louisiana, Maine, New Jersey, and New York statutes, any alternations, defacements, mutilations, or modifications are prohibited.\textsuperscript{91} The work, however, must knowingly be displayed or published and proof of damage or likely damage to the artist's reputation is required.\textsuperscript{92} Besides rights of integrity, all seven states recognize the right of paternity.\textsuperscript{93}

Between the lack of moral rights under U.S. federal law and the limited moral rights granted in only seven states, there remains a void to fill to protect the work of artists and authors.\textsuperscript{94} The importance of protecting these rights includes “foster[ing] creativity” and “protect[ing] our cultural heritage.”\textsuperscript{95} On the matter of fostering creativity, moral rights not only protect an artist’s interest in a work, but also give an artist bargaining power when contracting.\textsuperscript{96}

While moral rights may appear to be an intangible ideal, they can grant distinct economic rights, too.\textsuperscript{97} Economic rights that are given to

\textsuperscript{87} Id.
\textsuperscript{88} Zemer, \textit{supra} note 21, at 1527, 1527 n.52.
\textsuperscript{89} CAL. CIV. CODE § 987 (West Supp. 1983); MASS. GEN. LAWS ch. 231, § 855; PA. CONS. STAT. § 2104 (2008).
\textsuperscript{90} Id.
\textsuperscript{91} LA. REV. STAT. ANN. § 2155 (1986); ME. REV. STAT. tit. 27, § 303 (1985); N.J. REV. STAT. § 2A:24A-4 (1986); N.Y. ARTS & CULT. AFF. LAW § 14.03.
\textsuperscript{92} LA. REV. STAT. ANN. § 2153; ME. REV. STAT. tit. 27, § 303(a); N.J. REV. STAT. § 2A:24A-5; N.Y. ARTS & CULT. AFF. LAW § 14.03.1.
\textsuperscript{93} Van Velzen, \textit{supra} note 28, at 665–66.
\textsuperscript{94} See Martin A. Roeder, \textit{The Doctrine of Moral Right: A Study in the Law of Artists, Authors and Creators}, 53 HARV. L. REV. 554, 554 (1940) (“In this country, scant recognition has been given overtly, aside from the copyright law, to the legal problems raised by artistic creativeness. Constant reference must be made to continental jurisprudence where the protection of the artist has been developed to a fine degree.” (internal citations omitted)).
\textsuperscript{95} Kwall, \textit{supra} note 26, at 91.
\textsuperscript{96} Van Velzen, \textit{supra} note 28, at 675–76.
\textsuperscript{97} See Economides, \textit{supra} note 84 (discussing the economic impact of trademark law).
artists under moral rights laws include a decrease in the search costs of buyers and a monetary incentive to create without the worry that others may unfairly reap the benefits.\textsuperscript{98} Additionally, moral rights can help protect our cultural heritage by preserving the work for future generations to enjoy.\textsuperscript{99} To adopt moral rights throughout the United States is not a radical posture, but one grounded on notions of fairness, on its economic benefits, and on the reasoning of various commentators.\textsuperscript{100}

D. Moral Rights Outside the “Box” of the Artist’s Studio

Moral rights are not just useful in protecting the rights of authors and artists in their works. In fact, moral rights may be used to protect something even broader—reputation and business goodwill. For instance, Australian law provides moral rights protection against “passing off,” which is a type of misattribution claim.\textsuperscript{101} However, unlike a general misattribution law, Australian law against passing off targets harm done to a business’s goodwill.\textsuperscript{102} Unlike Australia, American jurisprudence’s implied covenant of good faith and fair dealing does not encompass the expansive rights recognized in other countries.\textsuperscript{103} In other countries, franchise law extends beyond U.S.

\textsuperscript{98} See Economides, supra note 84, at 526–27 (arguing that trademarks make it easier for consumers to search for their favorite brand, and serve as an incentive to manufacturers to make better products).

\textsuperscript{99} Sydney A. Diamond, Legal Protection for the “Moral Rights” of Authors and Other Creators, 68 TRADEMARK REP. 244, 249 (1978); Kwall, supra note 26, at 15–16, 69–70; Van Velzen, supra note 28, at 675–76.

\textsuperscript{100} See ROBERTA ROSENTHAL KWALL, THE SOUL OF CREATIVITY: FORGING A MORAL RIGHTS LAW FOR THE UNITED STATES 147–65 (2010) (discussing the shortcomings of VARA and proposing a new moral rights law that balances rights of authors and the interests of the public); NEIL WEINSTOCK NETANEL, COPYRIGHT’S PARADOX 215–17 (2008) (arguing for a modified moral rights law for the United States); Wilkinson & Gerolami, supra note 52, at 327 (arguing that “inherent reasons [exist] why moral rights protection should be increasingly embraced by nations in the emerging information age.”). However, Wilkinson and Gerolami also argue that there is an international trend of “neglecting” moral rights. ” Wilkinson & Gerolami, supra note 52, at 329.

\textsuperscript{101} See MAREE SAINSBURY, MORAL RIGHTS AND THEIR APPLICATION IN AUSTRALIA, 76 (2003) (stating that “[p]assing off is a tort intended to prevent economic loss by protecting the property in the goodwill of a business which is likely to be injured by the misrepresentation made by creating the impression that one person’s goods or services are the goods or services of another.”).

\textsuperscript{102} Id.

\textsuperscript{103} See Paul Steinberg & Gerald Lescatre, Beguiling Heresy: Regulating the Franchise Relationship, 109 PENN ST. L. REV. 105, 113 (2004) (arguing that the “American view of the implied covenant of good faith and fair dealing is too narrow,” especially in comparison to law in other countries).
protections. For example, South Korea takes an “activist stance” on the franchise relationship.

The general counsel to the International Franchise Association noted "Korea’s ‘repetitive use of a standard of ‘fairness,’ and commented that the Korean franchise dispute resolution mechanism ‘is like nothing we have ever seen in the world of franchising. Much the same can be said of [Korean franchise] legislation in its entirety.”

Perhaps, as with foreign intellectual property law and burgeoning franchise law, the United States could benefit from adopting moral rights to better protect its franchises. In other contexts, for example, French law has more interest in achieving a kind of contractual justice as understood in a moral sense, attained only by examining the parties’ subjective intent to determine if they have broken their promises.

Furthermore, the European Union follows the approach in France and many other Civil Law nations by employing the savoir-faire concept—in effect, a moral duty of franchisors to provide “secret, substantial, and identified” know-how to the franchisee. With that duty, the effect upon the franchise contract may be to make it more than just the mandatory savoir-faire, but a relationship—a for-the-life-of-the-franchise web of communications. This web would constitute “a package of non-patented practical information, resulting from experience and testing by the supplier” of that know-how.

### III. Franchising

Franchises are businesses that operate by creating one brand or identity and, in a sense, licensing that brand or identity to others. Brands, like an artist’s work, include value beyond sheer economics. Like art, franchise brands must also be protected from
misuse, augmentation, and destruction. Indeed, both reputational externalities and negative servitudes signal that franchising networks could be protected with some of the same concepts that lie behind moral rights. Franchisees might be better protected from the actions of franchisors and fellow franchisees through application of moral rights principles.

A. The Dilemmas of Franchising

Although some states have relationship laws, the current general theme is pro-franchisor. Analogizing the franchise relationship to the problems artists face, incorporating moral rights concepts is an option for lending more protection to franchisees. The analogy is difficult, however. Franchisees are not the same as authors or artists. The creativity of a franchisee is different from that of an author or artist. Franchisees are not the usual consumers, and they are often considered independent, advised, experienced, and knowledgeable businesspersons.

112 See Hansmann & Santilli, supra note 16, at 106 (stating that the loss of a major piece of art could negatively impact an entire community); see also Tang, supra note 15, at 218 (stating that legislation has been passed to protect art from destruction).

113 INNOVATIVE CSR: FROM RISK MANAGEMENT TO VALUE CREATION 74 (Céline Louche, Samuel Idowu & Walter Filho, eds.) (2010) (defining reputational externalities as the reputation of one firm being judged by firms that are believed to be comparable in quality; noting, “as a matter of fact, the reputations of many industries have been hurt by the ‘sins’ of single members”).

114 Stephan Kinsella, Intellectual Property Rights as Negative Servitudes, CENTER FOR THE STUDY OF INNOVATIVE FREEDOM, (June 23, 2011), http://c4sif.org/2011/06/intellectual-property-rights-as-negative-servitudes/ (discussing the similarity between intellectual property laws and property law generally, particularly negative easements, which give to the dominant estate the right to deny certain actions of the servient estate on a piece of land).

115 Roger D. Blair & Francine Lafontaine, Understanding the Economics of Franchising and the Laws That Regulate It, 26 FRANCHISE L.J. 55 (2006) (discussing the benefits of franchising as opposed to vertically integrated operations, but recognizing that not all can be “smooth sailing” even though the franchisor and franchisee contribute to their mutual success).

116 William L. Killion, The Modern Myth of the Vulnerable Franchisee: The Case for A More Balanced View of the Franchisor-Franchisee Relationship, 28 FRANCHISE L.J. 23, 28 (2008) (positing that there is a false narrative about vulnerable franchisees of two franchising “myths” leading to franchise case law decisions and reasoning that “do disservice to franchisors, franchisees, and even the public welfare”: first, that–when compared to franchisors–franchisees usually are naïve and unsophisticated and thus in need of special protection from the franchisor’s opportunistic conduct; second, that a “gross bargaining disparity” continued . . .
On the other hand, there is a well-informed argument that many franchisees are not on equal footing with franchisors. Many franchisees have a limited business background. This may be due to the franchisor’s business model, which takes a legal approach to relationships with franchisees that is “positivist, adversarial, and centered on a commercial model targeted at unsophisticated consumers.” Such an approach works against the franchisee, and “is at variance with the trend in consumer law both domestically and abroad.” Meanwhile, the franchise contract document itself has become “one-sided and unfair.” The typical franchise contract now exceeds seventy-five pages, nearly triple the length of contracts written several years ago. The Chairman of the American Bar Association’s franchise forum testified that the lengthy listing of contractual rights of franchisors and obligations and acknowledgements of franchisees has “gone beyond reasonable limits.”

between the larger, more experienced franchisor and the franchisee results in one-sided franchise agreements permitting franchisors to control unfairly the fortunes of franchisees.

117 Steinberg & Lescatre, supra note 103, at 108 (“Franchisors speak of the sophistication of two parties to a commercial business contract, but the evidence belies this, as does the franchisors own marketing strategy.”).

118 Id. In point of fact, most franchisees may not have obtained any legal advice or negotiation assistance before they signed a franchise agreement. See Robert W. Emerson, Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether to Hire Counsel, 51 SAN DIEGO L. REV. (forthcoming 2014) (including a survey of franchisor lawyers).

119 Steinberg & Lescatre, supra note 103, at 108.

120 Id. See Robert W. Emerson, Franchisees as Consumers: The South African Example, 37 FORDHAM INT'L L. REV. 455 (2014) (comparing the South African consumer protection laws that include franchisees among the protected class (consumers) with the laws in Australia, China, France, and the United States).


One particular franchise contract issue concerns advertising funds. Franchisees “may reasonably believe that the ‘fruits of the contract’ include advertising and marketing support and may reasonably believe that the advertising monies will be spent in a manner benefiting the franchisees who contribute the advertising dollars.” Yet franchisors can concentrate their advertising to areas with more company-owned sites. The importance of the freedom to contract gives franchisors considerable bargaining power. Franchisees need better protections if this form of business operations is to have a bright future, especially given the potential for encroachment on the franchisee’s market or territory, perhaps especially with the burgeoning option of Internet-based sales.

As discussed in more detail, there is a debate about who owns the goodwill of a franchise. Start-up franchises have not built their brand and customer loyalty yet, so the franchisee could be significantly contributing to the franchise's goodwill. On the other hand, there is likely not much franchisee-developed goodwill concerning well-established franchises such as McDonalds, Holiday Inn, and H&R Block. There are many issues facing this area of business law, such as disparity of bargaining power and ownership of goodwill, that are unaddressed by legislation, with courts often coming to inconsistent decisions.

124 Steinberg & Lescatre, supra note 103, at 230; Emerson, supra note 121. Of the 2013 contracts surveyed by the author, 96% (an increase from 77% in the 1993 contracts) state that the franchisor controls and manages the franchise system’s advertising, 63% (just 1% more than the 1993 contracts) affirm that the franchisor outright runs the advertisements, and almost all (99%, up from 94% for the 1993 contracts) dictate that the franchisee must spend on advertising a percentage of gross sales revenue—a median of 2.0% (down from 3.0% in the 1993 contracts). Emerson, supra note 121, at 696 app. § F(2)(a)-(c).
125 Steinberg & Lescatre, supra note 103, at 230.  
126 Id.  
127 Id. at 112-15.  
128 For more on encroachment and territory, see infra Parts II, II.B, II.B.2. See also DAVID A. Beyer, CONSIDERATIONS IN THE DEVELOPMENT OF A FRANCHISE SYSTEM, (1993) (discussing many advantages and disadvantages of a franchise to the parties).  
129 See supra II, II.A, II.A.1; infra Parts II.A.1.b., II.B.  
130 Emerson, supra note 6.  
131 Id.  
132 Id.
1. Franchise Problems

At heart, the issues in franchising law arise as matters of contract—the terms, alleged breaches, and remedies.\textsuperscript{133} Rarely is it the case that a court finds the franchisor to be a fiduciary of the franchisee.\textsuperscript{134} Thus, franchise relationships are guided by contract terms, which are skewed in favor of the franchisor.\textsuperscript{135} Furthermore, franchisors often use operations manuals, contractual collective action clauses, reviews when deciding for or against renewal, and compliance audits so that, among other things, they can “exercise nearly total discretion over the franchisee.”\textsuperscript{136} Although franchisees may not be forced or coerced into signing a franchise contract, franchisees may still be confused due to the complex, dense, and lengthy terms, perhaps compounded by the franchisor’s deception or the franchisee’s lack of business knowledge.\textsuperscript{137}

\textsuperscript{133} See Emerson, supra note 121; Emerson, supra note 110.

\textsuperscript{134} Steinberg & Lescatre, supra note 103, at 174. But see Arnott v. Am. Oil Co., 609 F.2d 873 (8th Cir.1979) (holding franchisor has fiduciary duty to franchisee at termination). Over the years, a number of definitions have been advanced to define the fiduciary status and relationship. See, e.g., Id. at 881 (holding that the franchisor owed fiduciary duties to the franchisee); Id. at 883 (contending that the treatment of franchisors as fiduciaries would prevent many of the abuses found in, and potential abuses inherent to, most franchising arrangements); BLACK’S LAW DICTIONARY 581, 1402 (9th ed. 2009) (stating that a fiduciary duty is “a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person” and that a fiduciary relationship arises, inter alia: (1) when one person places trust in the faithful integrity of another, who as a result gains superiority or influence over the first, (2) when one person assumes control and responsibility over another, (3) when one person has a duty to act for or give advice to another on matters falling within the scope of the relationship); BLACK’S LAW DICTIONARY 626 (9th ed. 1990) (noting that the law prohibits fiduciaries from engaging in “business shrewdness, hard bargaining, and astuteness to take advantage” of the dependent party); BLACK’S LAW DICTIONARY 564 (5th ed. 1979) (stating that a fiduciary relation “exists where there is special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to interests of one reposeing the confidence”).

\textsuperscript{135} Steinberg & Lescatre, supra note 103, at 115.

\textsuperscript{136} Id. Commentators further note, “[t]he viability of reciprocal altruism as an adaptive behavior in franchising is problematic where the legal environment is tolerant of such practices as misstatements in pre-contractual dealings, encroachment, and price-gouging after the contract is signed and the investment made.” Steinberg & Lescatre, supra note 103, at 130. See also Emerson, supra note 121, at 692–93 (Out of 100 franchise agreements reviewed in 2013, 99 included operating manuals and 98 had provisions for the franchisor to alter the manual. Forty-two agreements specified hours of operation, and 97 allowed for franchisor inspections of the premises.)

\textsuperscript{137} Ungar v. Dunkin’ Donuts of Am., Inc., 531 F.2d 1211, 1223 (3d Cir. 1976).
a. The Franchise as a Relational Contract

Although franchise contracts, in practice, often appear one-sided, the agreement is most beneficial to the franchise when treated as a relational contract.\footnote{Thomas J. Chinonis, *Implied Covenant of Good Faith: A Two-Way Street in Franchising*, 11 DePaul Bus. L.J. 229, 230 (1998) (discussing how the success of a franchise depends on the “degree of cooperation, integration, and coordination between the parties involved” and addresses the potential for many disputes). See also Emerson, *supra* note 121, at 686–701 (listing the concessions made in 100 different franchise agreements and comparing these agreements throughout time).} A relational contract is one that is formed from an ongoing relationship between two parties.\footnote{See Simon Board, *Relational Contracts and the Value of Loyalty*, 101 Am. Econ. Rev. 3349, 3349 (2011); Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 Stan. L. Rev. 927, 929 (1990); see also Emerson, *supra* note 121, at 646 n.21.} Their relationship is such that each party trusts and comes to expect certain concessions from the other. An example would be a franchisor and franchisee negotiating an extended franchising contract, where each side makes sacrifices to ensure the success of the parties’ distinct, but intertwined, businesses.\footnote{See generally Emerson, *supra* note 121, at 646 (Franchising involves a long-term contractual relationship in which the franchisor grants the franchisee a right to use the franchisor’s name and trademark and to sell the franchisor’s products or adopt its overall business plan. In exchange for this right, the franchisee must pay the franchisor a royalty and other fees.).}

The issues franchisors and franchisees must consider when engaging in a business relationship come down to quality control and opportunism.\footnote{Hadfield, *supra* note 139, at 949–51. See also David Hess, *The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors*, 80 Iowa L. Rev. 333, 340 (1995) (discussing problems in the franchise system).} The quality control issue stems from an inherent difference between the goals of the franchisee and franchisor.\footnote{Hadfield, *supra* note 139, at 950.} According to Gillian K. Hadfield, a professor of law and economics at the University of Southern California, “[a] franchisee wants to maximize her profits from the operation of the outlet; she does not wish to undertake any efforts or expenditures that will not compensate the undertaking.”\footnote{Id.} Conversely, the franchisor’s mission is to increase the number of franchise locations and thus revenue.\footnote{Id. For general information on the economics of franchisor opportunism and sales maximization, see ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 214–18 (2005).} The more a particular franchise location sells, the more royalties the
franchisor can collect.\textsuperscript{145} Also, for the franchisor, creating a recognizable brand name or trademark is key.\textsuperscript{146} The more sales that occur under a brand, the more likely that a potential customer has seen the trademark, thus increasing the value of the brand name.\textsuperscript{147} The importance of the trademark to creating sales gives way to a free riding problem.\textsuperscript{148} Franchisees want to profit from a strong brand name, yet do not want to compete with other franchise locations or contribute to the strengthening of the brand name as a whole.\textsuperscript{149} Franchisors, on the other hand, have been accused of simply seeking to “saturate the market with franchises.”\textsuperscript{150} Franchisors may also want a franchisee to act in ways that seem contrary to the franchisee’s interest, but help the trademark to grow.\textsuperscript{151} For example, a franchisor may ask a franchise location to operate twenty-four hours a day to create a reputation for “consumer convenience,” although the franchisee does not profit from late night sales.\textsuperscript{152} As Hadfield states, “[f]rom the franchisor’s perspective, bringing the franchisee’s interests

\textsuperscript{145} Hadfield, supra note 139, at 950.

\textsuperscript{146} Hadfield, supra note 139, at 950–51. See also Steinberg & Lescatre, supra note 103, at 108 (discussing the International Franchise Association (IFA) definition of a business format franchise, which includes “the licensing of a protected trademark”).

\textsuperscript{147} Hadfield, supra note 139, at 950–51.

\textsuperscript{148} Consider the franchisee operating a unit for which repeat customers are relatively rare compared to other franchisees for the same system—e.g., a fast-food restaurant along an interstate highway. Absent effective franchisor monitoring, the franchisee may be able to shortchange customers with relative impunity. The franchisee thereby reduces its own short-term expenses (thus increase its profits), while the long-term costs of mistreating these customers pass to the system as a whole insofar as the customers generalize about their experience and blame the franchised network, not the undifferentiated individual franchisee.

A franchisee who reduces the quality of the good or service he offers for a given price might increase his own profits, yet by disappointing buyers’ expectations he could reduce by a greater amount the net returns to the common intangible goodwill asset—maintained by the franchisor and used jointly by his other franchisees.\textsuperscript{149}


\textsuperscript{149} Hadfield, supra note 139, at 950–51.

\textsuperscript{150} See id. See generally Photovest Corp. v. Fotomat Corp., 606 F.2d 704 (7th Cir. 1979) (discussing the actions of a franchisor who saturated franchisees’ territories with company-owned outlets).

\textsuperscript{151} See Emerson, supra note 122, at 652 n.60.

\textsuperscript{152} Hadfield, supra note 139, at 950–51.
in line with its own is the central difficulty of this method of doing business."

The second major issue in franchising relationships is opportunism. When a franchisee operates a business despite her sustaining losses and incurring sizeable sunk costs, a “franchisor can make decisions that induce such losses without the franchisee going out of business” and can extract value from these losses. The franchisor may directly raise the price of goods sold to the franchisee, increase rent, or levy fees. Indirectly, the franchisor can extract value from the franchisee’s losses by requiring franchisees to make excessive advertising investments, participate in non-cost effective promotional programs, and undertake unnecessary renovations.

b. Trademark Litigation

American trademark law, like its copyright law, is covered under federal legislation, also known as the Lanham Act. The Lanham Act gives rights to the owner of a trademark, which is defined as any symbol, mark, word, phrase, etc. that signifies a brand. Trademark protection can last indefinitely, but the protection is largely dependent on the holder’s ability to police the use of the mark. Similar to copyright law, a trademark holder can lose his rights. Limitations for holders include the mark becoming generic or allowing the mark to be used in association with anything other than what was registered. To ensure trademark rights persist over time, owners can

153 Id. at 951.
154 Id. at 951–52. See generally Steinberg & Lescatre, supra note 103 (discussing the various ways in which franchisors use franchisees to gain profits, despite the harm done to the franchisee, as well as remedies to this situation).
155 Hadfield, supra note 139, at 952.
156 Id. Emerson, supra note 6 at 367 (“Once the franchisee commits to the franchisor-crafted contract, ‘franchisor opportunism’ often results in a Hobson’s choice for franchisees: acquiescence to, and uneasy dependence upon, the franchisor, or a separation from the franchisor accompanied by relative franchisee indigence”).
159 Id. at § 1127.
160 Id. at §§ 1058(a), 1059(a).
161 Id. at § 1064(3).
162 Id.
enjoin use, recover damages against misuse, or seek destruction of infringing articles.\textsuperscript{163}

In the context of franchising, a franchisor maintains the brand by ensuring consistent use of the trademark and quality of goods or service by the franchisee.\textsuperscript{164} Failure to do so may result in the franchisor losing its trademark protection.\textsuperscript{165} While a franchisor is concerned with building goodwill associated with the trademark, the franchisor must also be aware of the legal duties a trademark owner has in maintaining the mark.\textsuperscript{166} Thus, franchisors often include compliance with these principles into the franchise contract and periodically inspect the franchisee’s adherence, even after the end of a franchise relationship.\textsuperscript{167} For example, in \textit{Baskin-Robbins Ice Cream Co. v. D & L Ice Cream Co., Inc.}, Baskin-Robins sued D & L Ice Cream, a franchisee, for trademark infringement.\textsuperscript{168} The franchisee used the Baskin-Robins’ trademark after the franchise contract ended.\textsuperscript{169}

However, there are brand concerns that can be overlooked by a franchisor. In \textit{What's in A Name? A Lot: Trademark and Brand Protection Strategies for Franchisors}, Marisa Faunce and Benjamin Reed argue that franchisors need to “monitor and control” the use of trademarks in Internet advertising as well.\textsuperscript{170} They argue that “[s]uch policies enable franchise companies and their franchisees to utilize the web while simultaneously protecting the goodwill and property interests associated with the marks.”\textsuperscript{171} The importance of the use of trademarks over the Internet can also be seen in court cases, such as

\textsuperscript{163} \textit{Id.} at §§ 1116–1118.
\textsuperscript{166} 15 U.S.C. §1064(3) (2012). \textit{See also} Ong, supra note 12 and accompanying text.
\textsuperscript{167} Faunce & Reed, supra note 164 at 34. \textit{See infra} note 168.
\textsuperscript{169} \textit{Id.} at 1058–59.
\textsuperscript{170} Faunce & Reed, supra note 164, at 34.
\textsuperscript{171} \textit{Id.} \textit{See also} Duvall, supra note 165, at 180 (proposing that the approach to franchise trademark and marketing be centralized).
California Closet Co. v. Space Organizational Systems, Inc.\textsuperscript{172} A U.S. District Court temporarily enjoined a franchisee from using a trademark as a domain name.\textsuperscript{173}

A separate but related issue is trade secrets.\textsuperscript{174} In *Who Takes What: The Parties’ Rights to Franchise Materials at the Relationship’s End*, Clay A. Tillack and Mark E. Ashton discuss problems that franchisors and franchisees encounter regarding confidential information.\textsuperscript{175} While franchisors worry that they are imparting information to a franchisee that would empower her to leave the franchise and run her own competing business, the franchisee is concerned that a franchisor expects her to “unlearn” this information and “consciously choose to use a less effective system.”\textsuperscript{176} Tillack and Ashton suggest the parties anticipate these issues and draft appropriate provisions into a franchise contract.\textsuperscript{177} The result of competing interests between parties and contractual oversight, as discussed above, is the rapid increase of franchise trademark, trade secret, and related litigation.\textsuperscript{178}

2. Specific Franchise Problems

While there are “big picture” issues in franchise law, such as the nature of the franchise agreement and any subsequent trademark litigation, there are also specific problems not necessarily inherent to franchising. However, these issues of fraud, encroachment, general

\textsuperscript{172} BUSINESS FRANCHISE GUIDE ¶ 11,150, available at 2009 WL 3957032.
\textsuperscript{173} Id.
\textsuperscript{174} Tillack & Ashton, supra note 7, at 123.
\textsuperscript{175} Id.
\textsuperscript{176} Id.
\textsuperscript{177} Id.
\textsuperscript{178} BUSINESS FRANCHISE GUIDE, supra note 121 (“[The increase in franchise-related lawsuits] illustrate that franchise relationships are becoming less harmonious and more prone to conflict and litigation. Indeed, many franchisees now appear to question whether any type of harmonious relationship was ever intended to exist.”). See Beck Oil Co., Inc. v. Texaco Ref. & Mktg., Inc., 25 F.3d 559 (7th Cir. 1994) (summarizing Congress’ concerns when enacting the Petroleum Marketing Practices Act, including discrimination and exercising “superior bargaining power”); See also Brach v. Amoco Oil Co., 677 F.2d 1213, 1216 (7th Cir. 1982) (discussing legislation in the field of petroleum marketing practices designed to strengthen franchisee independence, even bargaining power between the parties, and protect franchisees from “arbitrary or discriminatory” nonrenewal of contracts). Congress has taken a progressive stance on the protection of both petroleum and motor vehicle franchisees, targeting issues that are general to franchise relationships. Reynolds Publishers, Inc. v. Graphics Fin. Grp., Ltd., 938 F. Supp. 256, 265 (D.N.J. 1996) (detailing the legislature’s concerns for motor vehicle franchisees when enacting the Franchise Act, such as inequality of bargaining power and its consequences).
abuse, termination, and collective bargaining arise with regularity and need to be addressed as well.

a. Fraud

Franchise fraud refers to fraud in the formation of a franchise contract and is most often seen in the form of franchisors allegedly misrepresenting the terms of an agreement with a franchisee.¹⁷⁹ Fraud is a franchise problem some contend is increasing in frequency.¹⁸⁰ The recent recession is thought to be the catalyst for a “new wave of fraudulent franchising activity.”¹⁸¹ Particularly, franchise business failures and the extended abuse of franchisees in established companies result in more fraud in franchise arrangements.¹⁸² According to the Federal Trade Commission, many investigations of franchise fraud and misrepresentation target on nationally established franchisors.¹⁸³

b. Territory and Encroachment

Another specific issue in the world of franchising is territory and encroachment.¹⁸⁴ As discussed earlier, franchisees inherently want less competition, including competition from their own franchise.¹⁸⁵ However, franchisors have an interest in increasing the number of franchise locations, even at the expense of a particular franchisee’s business.¹⁸⁶ Additionally, franchisors can use this tactic to push out

¹⁷⁹ Steinberg & Lescatre, supra note 103, at 196–97 (“Franchisors are not liable for fraudulent misrepresentation where they promise a prospective franchisee that the franchisor will not encroach the franchisee, since failure ‘to make good subsequent conditions which have been assured’ or otherwise fulfill ‘an agreement to do something at a future time’ is breach of contract, not fraud.”).
¹⁸¹ Id.
¹⁸² Id.
¹⁸⁴ Id. (“One of the most vital legal debates in the field of franchise law has focused on one central question: whether encroachment—that is, the phenomenon in which the franchisor establishes a new franchise unit in unreasonable proximity to its existing franchisee—should be restricted by law.”). See also Uri Benoliel, Criticizing the Economic Analysis of Franchise Encroachment Law, 75 ALB. L. REV. 205 (2012); Robert W. Emerson, Franchise Encroachment, 47 AM. BUS. L.J. 191 (2010).
¹⁸⁵ See generally Hadfield, supra note 139.
¹⁸⁶ See generally id.
franchisees that the franchisor does not wish to be bound to by agreement.\textsuperscript{187} Instead of breaking a franchise contract, with all of its associated legal costs, the franchisor may simply make the franchisee’s business too unprofitable to continue.\textsuperscript{188} Regardless of the reasons why a franchisor chooses to do so, when a franchisor allows franchises to open within close proximity to an existing franchisee-owned location, the result is encroachment.\textsuperscript{189} While some franchise contracts anticipate this conflict, others do not, or the bargaining power of the franchisor results in unfavorable contract terms for the franchisee.\textsuperscript{190}

In recent years, the frequency of franchise encroachment based litigation may have risen.\textsuperscript{191} Encroachment, however, is not a new concept, as there were lawsuits on this issue in the 1970s. For instance, in \textit{Photovest Corp. v. Fotomat Corp.}, a franchisor was found to have breached the implied covenant of good faith and fair dealing by trying to saturate the market with franchisor-owned stores, as well as stopping all pick-up and delivery services to the franchisee.\textsuperscript{192} In \textit{Burger King Corp. v. Family Dining, Inc.}, a franchise contract required a franchisee to open ten outlets in ten years.\textsuperscript{193} When the franchisee only opened nine, the franchisor terminated all nine franchise locations and sought to sell the locations for a higher price, after the franchise became well established.\textsuperscript{194} The court held that giving strict effect to the condition would mean that the franchisee forfeited the franchise.\textsuperscript{195} On the other hand, there have been a

\textsuperscript{187} Benoliel, \textit{supra} note 184, at 214–15.
\textsuperscript{188} \textit{Id.}
\textsuperscript{189} \textit{Id.} See also Steinberg & Lescatre, \textit{supra} note 103, at 182–83 (“Encroachment may be a result of . . . encroachment by one franchisee selling into another franchisee’s territory, or by a shrinkage of the product’s market due to population shifts or reduction in demand for the product itself. In some cases, a franchisor may even establish a second franchise under a different name to compete head-on with its existing franchisees.).
\textsuperscript{190} See Steinberg & Lescatre, \textit{supra} note 103, at 187 (discussing \textit{Scheck v. Burger King}, a case in which the franchisee did not bargain for an encroachment clause in the contract and thus argued the implied covenant of good faith and fair dealing).
\textsuperscript{191} Benoliel, \textit{supra} note 184, at 207 (“Most large restaurant franchisors had been dragged into a court battle with frustrated franchisees over encroachment.”).
\textsuperscript{192} See generally \textit{Photovest Corp. v. Fotomat Corp.}, 606 F.2d 704 (7th Cir. 1979).
\textsuperscript{193} See generally \textit{Burger King Corp. v. Family Dining, Inc.}, 566 F.2d 1168 (3d Cir. 1977).
\textsuperscript{194} \textit{Id.}
\textsuperscript{195} \textit{Id.}
number of cases where courts did not find any contractual provision or theory to stop encroachment by a franchisor.\textsuperscript{196}

c. Abuses Generally

There are franchise problems that do not fall into any particular category, but can generally be referred to as abuse by a franchisor. The danger of abuse by franchisors is inherent in the franchising business format, which gives a franchisor power over many facets of the franchisee’s business.\textsuperscript{197} Alleged franchisor abuses include manipulating price or quantity of products or services sold to the franchisee, adding new fees or requiring additional purchases, collecting more advertising fees, attempting to buy out a successful franchise, increasing exposure of a franchise name, and changing the image of the franchise without considering the impact on the franchisee.\textsuperscript{198}

For example, in \textit{Fox Motors, Inc. v. Mazda Distributors (Gulf), Inc.}, franchisors attempted to make franchisees terminate voluntarily.\textsuperscript{199} The Mazda dealership gave new model vehicles to new franchisees, which attracted customers to the new franchisees. The earlier franchisees could not compete with the sales from these newer models and were in essence put out of business.\textsuperscript{200} Similarly, in \textit{Eastman Kodak Co. v. Image Technical Services}, the U.S. Supreme Court found that franchisor abuses could give rise to an anti-trust claim.\textsuperscript{201} The franchisor tied the aftermarket purchase of supplies to the initial purchase of a xerographic copier, setting a low maximum resale price and tie-ins that forced the franchisee to pay supracompetitive prices for the tied product.\textsuperscript{202} Due to sunken


\textsuperscript{197} Hadfield, supra note 139, at 967–68. See also Steinberg & Lescatre, supra note 103, at 174 (discussing the post-sale relationship between the franchisor and franchisee).

\textsuperscript{198} Hadfield, supra note 139, at 967–68.

\textsuperscript{199} Fox Motors, Inc. v. Mazda Distributors (Gulf), Inc., 806 F.2d 953, 953–61 (10th Cir.1986).

\textsuperscript{200} Id.


\textsuperscript{202} Id.
investments, the franchisee was thus locked into an unprofitable relationship and exploited by the franchisor.203

Another business practice with the potential for abuse is co-branding.204 For example, the Taco Bell, KFC, and Pizza Hut brands are all owned by one company, Yum! Brands,205 a joint franchise location with different franchises offering different products or services (e.g., sales of tacos, or fried chicken, or pizza).206 The main criticism of the co-branding strategy is that while it may increase total gross revenues for a franchisor, it could dilute value in particular brands.207

d. Termination

Termination, or the prospect of termination, is often the focal issue in franchising. It is no exaggeration to call the possibility of a franchise’s early demise, whether forced by circumstances (e.g., poor sales) or by franchisor invocation of contract terms (terminations), as the brooding omnipresence in many franchise relationships.208 Termination or the threat of termination can be the franchisor’s supreme tactic for control over franchisees.209 Franchisors have terminated franchise contracts without cause210 and refused to renew agreements.211 Yet there are cases in which franchisors are within...
their right to terminate a franchise relationship, be that for the franchisee’s failure to pay fees, failure to maintain quality standards, or misbranding of the trademark.

Once a franchise relationship is terminated, there are additional concerns about intellectual property. The removal of trademarks and service marks from the franchisee’s website, Internet directories, domain name, and telephone number are all issues franchisors must consider upon termination. When a franchisee has created a second level domain name, which has gained brand association and goodwill, disputes may arise as to whether the domain name will remain with the franchisee.

e. Collective Action

Another franchise problem concerns collective action. Unions or associations present a method whereby individuals with little

Jersey Act at issue, which states that terminating, canceling, or failing to renew a franchise without good cause is a violation of the act).

212 See generally Bonanza Int'l, Inc. v. Rest. Mgmt. Consultants, Inc., 625 F. Supp. 1431 (E.D. La. 1986) (holding that the franchisor properly terminated the franchise agreement after the franchisee failed to timely pay royalty fees and comply with operational requirements); see generally Robert W. Emerson, Franchise Terminations: “Good Cause” Decoded (Apr. 12, 2014) (on file with author) (a statistical analysis of approximately 300 cases in which franchise parties disputed whether the franchisor had “good cause” to terminate the franchise; failure to pay fees was an important, statistically significant ground for “good cause” termination of the franchise).

213 See generally Chia-Hsin (Charles) Huang v. Holiday Inns, Inc., 594 F. Supp. 352 (C.D. Cal. 1984) (denying the franchisee’s request for an injunction on termination because the franchisee consistently failed to maintain quality standards); see also Emerson, supra note 212 (failure to maintain quality standards was an important, statistically significant ground for “good cause” termination of the franchise).

214 See Wisser Co., Inc. v. Mobil Oil Corp., 730 F.2d 54, 56 (2d Cir. 1984) (holding that the hardship to franchisor outweighed harm to franchisee if termination of franchise agreement was enjoined. The court found that the franchisee was not entitled time to cure a breach where termination was for misbranding, and franchisee was buying from other suppliers and selling under the franchisor’s trademark). See also Emerson, supra note 212 (misbranding of the franchise system’s trademark was an important, statistically significant ground for “good cause” termination of the franchise).


216 Id. at 142.

217 Id.

bargaining power on their own can come together to negotiate more favorable terms with a franchisor. However, it is often the case that franchisees cannot easily form associations.

3. State Legislation

All states have statutes or common law governing trade secrets and confidential information, and many states have relationship laws. Some states even require franchisors to buy back equipment and inventory from franchisees. The problem with these protections is that there is no uniformity of laws and regulations in the franchising context among the states. A few states have taken the lead in addressing franchises particularly. For instance, the Franchise Practices Act in New Jersey was established after the state recognized unequal bargaining power in the motor fuel business. Likewise, Connecticut has enacted a franchise act, the goal of which is to “prevent a franchisor from taking unfair advantage of the relative economic weakness of the franchisee.”

B. Franchise Websites

Courts should look to the websites of franchisors or franchisees in determining questions of ownership of goodwill. In the case of physical locations, courts have divided goodwill between the franchise system as a whole and the goodwill of a particular franchise location. Similar logic can be used to determine the brand ownership rights in websites. Observing who owns and operates the

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219 Id.
220 Independent franchisee associations infrequently form because of high costs, possible franchisor retaliation, the barriers posed by existing franchisee councils, and overall weak incentives for franchisees to support a franchisee “union.” Robert W. Emerson & Uri Benoliel, Can Franchise Associations Serve as a Substitute for Franchise Protection Laws?, 118 PENN ST. L. REV. 99, 108-128 (2013). Associating can sometimes be interpreted as a hostile action against the franchisor, resulting in lawsuits under unfair competition and antitrust. See e.g., McAlpine v. AAMCO Automatic Transmissions, Inc., 461 F. Supp. 1232, 1232–73 (E.D. Mich. 1978) (holding that franchisees did not breach antitrust or unfair competition laws from associating with one another in private).
221 Tillack & Ashton, supra note 7, at 88.
222 Id.
225 Id. at 124–25.
226 Tillack & Ashton, supra note 7, at 124.
website may provide insight in determining who owns the goodwill and work product of the franchise network.\footnote{See Emerson, supra note 6.}

From the franchisor’s perspective, tightly controlling website trademark use may avoid questions of ownership in the future. For example, policing trademarks or the franchise brand can become an issue when a terminated franchisee continues to use the brand name on the franchisee website.\footnote{See Tillack & Ashton, supra note 7 (discussing that use of a trademark after termination is largely considered “per se infringement”); see also Cardservice Int’l, Inc. v. McGee, 950 F. Supp. 737 (E.D. Va. 1997).} Under state unfair competition laws, a franchisor may have a cause of action based on the theory that “people associate the domain name with the franchise system due to its use during the term of the franchise agreement.”\footnote{Tillack & Ashton, supra note 7, at 125.} Such cases may be based on common law claims such as misappropriation of goodwill,\footnote{See generally Coca-Cola N. Am. v. Crawley Juice, Inc., 2011 WL 1882845 (E.D. N.Y. 2011) (holding that New York law for misappropriation of goodwill requires facts proving the wrongful taking of another party’s skills, expenditures, or labor); ITC Ltd. v. Punchgini, Inc., 880 N.E.2d 852 (N.Y. 2007) (noting that this wrongful taking of the plaintiff’s property or commercial advantage is for the defendant to use in competing against the plaintiff).} encroachment,\footnote{W. Michael Garner, Franchise Distribution Law and Practice § 7:36 (2013) (citing Girl Scouts of Manitou Council, Inc. v. Girl Scouts of USA, Inc., 646 F.3d 983 (7th Cir. 2011) for the proposition that a franchisor’s putting additional franchisees in the territory where a franchisee promoted the franchise brand is misappropriation of goodwill).} or dilution of trademark.\footnote{See Garner, supra note 232, at § 7:44 (discussing statutes in at least twenty-one states protecting mark owners and providing damages or injunctions due to dilution of the mark or of its owner’s business reputation).} These cases may also be based on federal law such as the Lanham Act\footnote{Lanham Act, 15 U.S.C. §§ 1125, 1051–1141 (2012) (supporting that this unfair competition claim is based on Section 43 of the Lanham Act).} or the Federal Trademark Dilution Act of 1995.\footnote{Garner, supra note 232, at § 7:43 (citing 15 U.S.C. §§1125(c) and 1127 and stating that the owner of a “famous” mark can obtain relief against another party whose use of a mark or name, or an unauthorized variant thereof, dilutes the mark’s distinctive quality; dilution is all that is needed, as the infringing use need not compete with the plaintiff or even cause a likelihood of confusion or deception).} A franchisor may avoid this problem by providing a central website, therefore eliminating any future questions about goodwill and the need to police a franchisee’s website.\footnote{Tillack & Ashton, supra note 7, at 125.}

There are several cases in which franchising parties disputed Internet territorial rights.\footnote{Duvall, supra note 165, at 175.} In \textit{Hale v. Conroy’s, Inc.}, the parties had
an agreement to operate a flower shop and granted the plaintiff (franchisee) a two-mile exclusive territory in which the defendant (franchisor) would not operate or franchise a store.\textsuperscript{237} The court held that the franchisor’s actions in opening a website did not rise to the level of operating a franchised store when the franchisee explicitly agreed to allow the franchisor to develop new technologies.\textsuperscript{238} In \textit{Franklin 1989 Revocable Family Trust v. H \& R Block, Inc.}, an arbitration panel held that the phrase “from a location within the franchise territory” was ambiguous as to a franchisor’s Internet sales.\textsuperscript{239} The panel reasoned that there was no violation of good faith on the part of the franchisor because there had not been an “unreasonable intrusion” on the franchisee due to the Internet tax preparation by H \& R Block.\textsuperscript{240} Also, in \textit{Armstrong Business Services, Inc. v. H \& R Block, Inc.}, franchisees argued that a franchisor competed with them by selling tax preparation software and selling services accessible from the Internet.\textsuperscript{241} However, the franchise agreements were created long before the existence of the Internet.\textsuperscript{242} Thus, the jury found the defendant was encroaching on the plaintiffs’ territories and awarded damages for the Internet sales.\textsuperscript{243} These cases illustrate that the terms of the franchise agreement are determinative of the judicial outcome.\textsuperscript{244} Whether the implied covenant of good faith and fair dealing will be applied to an ambiguous contract, particularly one that does not anticipate franchisor Internet sales, depends largely on the specific facts of the case.\textsuperscript{245} Even if the franchise agreement does not contemplate Internet sales, franchisors can still “develop an Internet strategy that avoids the franchisees' exclusive territories.”\textsuperscript{246} Within the confines of the agreement, “franchisors might also try to offer somewhat different products or services, or use different trademarks.”\textsuperscript{247}

\textsuperscript{237} Hale v. Conroy's, Inc., No. 1220022498 (2001).
\textsuperscript{238} Id.
\textsuperscript{240} Id.
\textsuperscript{242} Id.
\textsuperscript{243} Id.
\textsuperscript{244} Duvall, \textit{supra} note 165, at 175–76.
\textsuperscript{245} Id. at 176.
\textsuperscript{246} Id. at 175–76.
\textsuperscript{247} Id.
1. Practices in Franchise Website Operations

As may be apparent in the above cases, there is tension between franchisors and franchisees regarding Internet activities, including sales. According to Gaylen L. Knack and Ann K. Bloodhart in *Do Franchisors Need to Rechart the Course to Internet Success?*, “franchisees think that the franchisor[s] are receiv[ing] an unjustified windfall from Internet sales at the expense of the franchisees.”

Sometimes, a disappointed franchisee, in retaliation or to ready an exit strategy, will set up unauthorized websites and advertisements. A landmark case, *Drug Emporium*, became a “wake-up call” to franchisors that Internet sales are not exclusively the domain of the franchisor and must be contemplated in a franchising contract. The decision led to tremendous changes in franchise agreements and Internet practices. The franchise agreement in question did not anticipate the franchisor developing the brand name in any way other than through brick-and-mortar expansion. Rather, it “supported the inference that the franchisees had exclusive rights . . . to exploit the Drug Emporium name so long as they complied with the franchisor’s schedules.”

The *Drug Emporium* outcome should lead franchisors to consider policies and contract terms that protect their rights in all franchise-
related Internet activities.\textsuperscript{255} One option for franchisors is to establish a central marketing website.\textsuperscript{256} If a franchisor opts to allow a franchisee to have a subpage, the franchisor must consider whether a franchisee can add data to that page and, if so, to what extent the franchisor will control the postings.\textsuperscript{257} Franchisee subpages can have a useful purpose in creating “more personal service,” which could “promot[e] local advertising campaigns [and] . . . highlight special offerings to the local public.”\textsuperscript{258} In both cases though, “the best practice is for the franchise agreement to provide that website content on these subpages cannot be changed without the express approval of the franchisor.”\textsuperscript{259}

Another reason why tight controls of franchisee websites are useful is to avoid liability for trademark infringement of another company’s trademark.\textsuperscript{260} Franchisors have a heightened obligation to police the franchisee or be held contributorily liable if the franchisor is aware that the franchisee has a history of infringing on another’s trademark on its website.\textsuperscript{261} To prevent future liability, franchisors should prohibit franchisees from purchasing keyword advertising based on the franchisee’s trademarks. Such advertising may, for example, be susceptible to trademark infringement claims or to claims

\textsuperscript{255} Id. at 101. See generally Powell & Ralls, supra note 249.

\textsuperscript{256} Powell & Ralls, supra note 249, at 231. See also Knack & Bloodhart, supra note 215, at 141 (finding that a central website marketing location could avoid future brand dilution issues).

\textsuperscript{257} Powell & Ralls, supra note 249, at 233. Additionally, franchisors must be concerned with the data that is displayed on the franchisee’s webpage. Knack and Bloodhart argue that a:

Franchisor’s position should be that it owns the information, since the data are acquired using the goodwill of the franchisor’s marks, and the franchisor owns all such goodwill. Some courts do not attribute all goodwill to the franchisor, however, so there remains the possibility that the franchisee will own the data collected by its website.

\textsuperscript{258} Knack & Bloodhart, supra note 215, at 142.

\textsuperscript{259} Knack & Bloodhart, supra note 215, at 140.

\textsuperscript{260} Powell & Ralls, supra note 249, at 233.

\textsuperscript{261} See generally Alexander G. Tuneski, Hey, That’s My Name! Trademark Usage on the Internet, 31 FRANCHISE L.J. 203, 203 (2012).

from other franchisees complaining of encroachment if the
advertisements are not geographic-specific.\textsuperscript{262}

2. \textit{Attribution and Moral Rights in Franchising}

Franchisor websites, like the contracts franchisors draft, tend to
favor franchisor practices and interests. For instance, while a
franchisor typically is reticent to provide detailed information about its
finances and business practices until it must, under law, a vast
majority of franchisor websites ask for background information on the
potential franchisee, such as net worth and income, before
communicating with or providing the Franchise Disclosure Document
to the potential franchisee.\textsuperscript{263} Moreover, many websites have
disclaimers such as the one found on the Century 21 website, “\textit{This
website is not intended, and shall not be deemed, to constitute any
offer to sell a franchise. A franchise offering is made only by a
Franchise Disclosure Document. For more information contact
us.}”\textsuperscript{264}

Upon termination of a franchise agreement, there is the issue of a
franchisee’s website.\textsuperscript{265} If a franchisor controls one webpage, the
franchisor can easily terminate the franchisee’s sub-page.\textsuperscript{266} However,
if the franchisee maintains its own domain name, a franchisor must go
through a lengthy process to terminate the website.\textsuperscript{267} Franchisors
may have to file suit for “breach of the franchise agreement and
trademark infringement,” seek preliminary injunction, and seek to
have the domain name transferred, pursuant to the Anti-
Cybersquatting Consumer Protection Act.\textsuperscript{268}

\textsuperscript{262} See Tuneski, \textit{supra} note 260, at 203 (“Franchisors can use social media
policies and franchise agreements to control the use of trademarks on the Internet by franchisees.”).
\textsuperscript{263} This is based on the author’s reviewing, in January to February 2014, the
websites of 104 restaurant and fast-food franchisors.
\textsuperscript{264} \textit{C21 Franchise: Next Steps}, CENTURY 21,
14, 2014, 8:23 PM).
\textsuperscript{265} Powell \& Ralls \textit{supra} note 249, at 234–40 (2010) (discussing the benefits of
a single website upon termination as well as the need for franchisors to control
content on franchisees’ sites). See also Knack \& Bloodhart, \textit{supra} note 215, at 140
(explaining that terminating a website is particularly important because the
“consuming public may not recognize that a website pertains to only one store out of
an entire system.”).
\textsuperscript{266} Powell \& Ralls, \textit{supra} note 249, at 234.
\textsuperscript{267} \textit{Id}.
\textsuperscript{268} \textit{Id}.
To avoid future litigation, franchise contracts should anticipate Internet use, whether for sales or advertising. The agreement should contemplate whether a franchisee may establish and operate its own website, the franchisor's right to determine the content and use of a franchisee website, the franchisor’s ownership of the system-wide website, the franchisor's right to establish Internet guidelines, a franchisee acknowledgment that its conduct on the Internet will be subject to the terms of the franchise agreement, and a franchisee acknowledgment that certain information obtained through participation in the franchisor's website or other Internet strategies is confidential.269 The franchisor may also wish to create a code of conduct for franchisees to follow when operating on the Internet.270 The code of conduct, if drafted separate from the contract, would allow the franchisor the ability to modify rules when needed.271

C. Good Faith and Fair Dealing: Attribution as a Moral Right in Line with the Lanham Act

Based on both legal doctrine and their own professional conditioning, American jurists may appear to find disquieting any “blending” of morality and contract law.272 However, as an equitable doctrine, good faith and fair dealing reflect societal mores.273 Franchise attorneys, Tillack and Ashton, note that “[e]ven the most carefully crafted and detailed franchise agreement may not clearly address the rights of the respective parties with respect to such assets.”274 Granting broad attribution rights to franchises can help franchise customers with liability claims.275 Indeed, Professor Kwall suggests narrowing integrity rights in conjunction with an expansion of attribution rights,276 which would align the law and the parties’ interests.277 This is particularly efficacious if one considers that a

269 Id. at 234–37.
270 Knack & Bloodhart, supra note 215, at 139.
271 Id.
272 Steinberg & Lescatre, supra note 103, at 239.
273 Id.
274 Tillack & Ashton, supra note 7, at 88.
275 See Lipton, supra note 20, at 54–7 & nn.370–83 (discussing commentary about moral rights).
276 KWALL, supra note 100, at 151 (recommending a “broadly defined right of attribution” and a “narrowly tailored right of integrity”).
277 See NETANEL, supra note 100, at 217 (“Creative Commons has estimated that, as of February 2005, authors chose licenses requiring attribution some 94 percent of the time and, in contrast, chose licenses prohibiting the making of a derivative work less than one-third of the time.”); Lipton, supra note 20, at 56–57 (noting that how most American authors are more interested in attribution than continued . . .
primary concern of laws dealing with the franchise brand is the protection of the brand name. Moral rights offer a way to safeguard the brand name and goodwill of a franchise, and its rightful owner.

IV. CONCLUSION

Franchising conflicts frequently stem from a difference in goals: the franchisor’s aspiration for larger, network-wide gross revenues, and the franchisee’s simple objective of individual profit-maximization (that is, net revenues). Parties may disagree on matters such as goodwill, territory, and termination. As a result, the franchise agreement is often the basis for solving any potential problems. However, the franchisee agreement is commonly drafted by the franchisor, and as a result it tends to favor the interests of the franchisor over those of the franchisee. Contractually-based economic rights thus pose practical limitations on those who seek to create more reasonable standards or at least more equal and robust positions from which franchisees can advance their business interests under that particular brand.

Proactively, franchise parties should draft agreements that anticipate problems and contract around them. This may explain provisions in franchise contracts or operations manuals outlining rules for marketing, be it via advertising, websites, or other methods. Franchise terms of disclosure may lay out strict grounds for activity using the brand name. But a no-holds-barred contract is no way to fashion fair, long-term relationships, or perhaps even to meet the parties’ own expectations. Because franchisors ordinarily have the

278 Rupert M. Barkoff, *Vicarious Liability: A Continuing Enigma*, FRANCHISING BUS. & L. ALERT 1, 7 (2012) (contending that a franchisor’s focus should be on protecting the network’s brand more than on contracting against or insuring coverage for vicarious liability).

279 Territorial conflicts typically arise due to this basic difference in motivation:

[T]he major reason encroachment constitutes a bone of contention between franchisees and franchisors is the simple difference between net profits and gross sales. Franchisees seek to make their individual units as profitable as possible, while franchisors profit from the licensing of the trademark and the collection of royalties across the franchised system. When a market reaches the saturation point, the two goals begin to conflict, with franchisors making money—a percentage of gross franchise revenue—regardless of how profitable the individual franchise was.

Emerson, *supra* note 184, at 203–04 (citations omitted).

upper hand in contracting, which may lead to unfavorable terms for the franchisee, courts must consider employing moral rights.

The moral rights doctrine could assist in filling the gaps sure to exist when evaluating a strictly economically-focused set of intellectual property rights. There is value beyond that of sheer profits, as illustrated by the strong moral rights afforded to artists in almost all other countries besides the United States. Franchise law, with rules advancing moral rights concepts, can protect a franchisee’s name and reputation. The standing and business goodwill of franchises can benefit from treatment holding that what is associated with a franchisor may also be the moral right of a franchisee. Some states have already started to experiment with moral rights, and the grounding of a moral rights approach to franchising is already discernible, based on the parties’ own concerns for developing and maintaining the franchise brand. Whether franchisors or franchisees realize it, they may further protect the franchise network—and thereby shelter the system’s and the individual parties’ reputations—by recognizing that a franchise can constitute a moral right.
INTERNATIONAL OR NATIONAL EXHAUSTION: THE NEED FOR LEGISLATIVE INTERVENTION REGARDING THE FIRST SALE DOCTRINE

B. Chase Smith†

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Imagine that you are a college student short of cash. You already pay tuition, rent, living expenses, cell phone expenses, insurance, and much more. To make matters worse, “college textbook prices are 812 percent higher than they were a little more than three decades ago.”¹ In fact, “college textbook prices have increased faster than tuition, health care costs, and housing prices” in that time.² Not surprisingly, you search for less expensive alternatives; and then you find one—an international edition of the textbook you need. “An international edition textbook is one that has been printed for distribution in markets outside of the United States, usually at a substantially lower cost.”³ The international edition will typically share many of the same characteristics of the original edition, but with a few differences.⁴ International editions are usually soft cover, do not include supplementary materials such as CD-ROMs, and have a different ISBN number.⁵

Now imagine that you are a professor who just spent the past two years researching and writing an academic textbook. As the copyright owner, you have a financial incentive to charge different prices for your work in different parts of the world because supply and demand for particular goods vary across the globe.⁶ Your ability to market and sell your product for different prices, however, “is undermined if arbitrageurs are permitted to import copies from low-price regions and sell them in high-price regions.”⁷ A lack of copyright protection discourages authors, like you, from spending years researching, writing, and compiling textbooks.

While textbooks provide an illustrative example, any copyrighted work lawfully made outside of the United States creates a unique issue. Does the importation and sale of a copyrighted work lawfully made abroad violate a United States copyright owner’s exclusive

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² Id.
⁴ Id.
⁷ Id.
rights? As discussed later, the answer to this question depends on whether the “first sale” doctrine applies to a copyrighted item lawfully made outside of the United States.

Recently, in Kirtsaeng v. John Wiley & Sons, Inc., the Supreme Court of the United States held that the “first sale” doctrine applies to copyrighted works lawfully made abroad. This decision has important implications for companies that rely on copyright protection for materials produced outside the United States or that are in the business of reselling those materials, including technology companies, book, video game, and music publishers, fashion and cosmetics companies, and consumer goods retailers. Following Kirtsaeng, copyright owners cannot prevent the importation of their copyrighted items into the United States. This importation will drive down the prices of the copyrighted items and devalue copyright protection of goods in the United States, while also providing cheaper prices of copyrighted works for American consumers.

This note will argue that the Kirtsaeng court, by holding that the first sale doctrine applies to copyrighted works lawfully made abroad, incorrectly adopted an overbroad international exhaustion approach for United States copyrights. Part II will give a background of the Copyright Act and will discuss the facts, procedural history, and rationale of the lower court holdings in Kirtsaeng. It will also discuss two other Supreme Court cases and explain the difference between national and international exhaustion. Part III will analyze the Kirtsaeng decision, arguing that the Court made mostly the correct decision, but that legislative change to the Copyright Act is needed. Part IV will provide possible solutions to the Kirtsaeng decision so that an international exhaustion approach is adopted which keeps section 602 of the Copyright Act intact and meaningful.

II. BACKGROUND

A. The Copyright Act

In order to understand the holding of Kirtsaeng, a brief understanding of the Copyright Act is necessary. The relevant sections include (i) section 106(3), the Act’s rights-granting provision; (ii) section 109(a), the Act’s codification of the first-sale doctrine; and
(iii) section 602(a), which is entitled ‘Infringing importation of copies or phonorecords.’

1. Section 106(3)

The Copyright Act grants copyright owners, subject to sections 107 through 122, certain exclusive rights, including the right “to distribute copies . . . of the copyrighted work to the public by sale or other transfer of ownership.” The right of distribution “protects a copyright owner’s ability to control the terms on which her work enters the market by providing a remedy against persons who distribute copies of her work without her permission.” In other words, the copyright owner has the exclusive right to control the work’s publication.

2. Section 109(a)

The first sale doctrine, an affirmative defense to copyright infringement that allows owners of copies of copyrighted works to resell those copies, limits a copyright owner’s exclusive distribution right. Section 109(a) sets forth the “first sale” doctrine: “[n]otwithstanding the provisions of section 106(3), the owner of a particular copy or phonorecord lawfully made under this title . . . is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord.” The first sale doctrine “allows the ‘owner of a particular copy’ of a copyrighted work to sell or dispose of his copy without the copyright owner’s authorization.” In copyright jargon, “the ‘first sale’ has ‘exhausted’ the copyright owner’s section 106(3) exclusive distribution right.”

3. Section 602(a)

Section 602(a) addresses how much the copyright owner’s distribution right permits him to control the importation of copies of his work into the United States. It states, “importation into the

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12 Pearson, 656 F. Supp. 2d at 409.
13 Id.
15 Vernor, 621 F.3d at 1107.
17 Pearson, 656 F. Supp. 2d at 410.
United States, without the authority of the owner of copyright under this title, of copies . . . of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute . . . under section 106.”  

There are three exceptions to the section 602(a) importation infringement: (1) for copies imported or exported under the authority of the United States Government; (2) for the private use of the importer or exporter and not for distribution; (3) and for scholarly, educational, or religious purposes that do not include private gain.  

While importing infringing copies is prohibited, copies that are lawfully made can be imported into the United States.

### B. Recent Supreme Court Cases

In Quality King Distributors, Inc. v. L’anza Research Int’l, Inc. and in Costco Wholesale Corp. v. Omega S.A., the Supreme Court discussed the first sale doctrine with copies lawfully made abroad, setting the stage for the Kirtsaeng decision. The first discussed the importance of the location of the first sale and the second failed to conclusively choose a national or international exhaustion approach.

#### 1. Quality King Distributors, Inc. v. L’anza Research Int’l, Inc.

L’anza Research International (“L’anza”), a California corporation who owned the copyrights of all its products, manufactured and sold shampoos, conditioners, and other hair care products. L’anza engaged in extensive advertising in the United States, and sold its products to domestic distributors who agreed to resell within limited geographic areas. Since L’anza did not engage in extensive advertising or promotion in its foreign markets, it sold its products at a discount to foreign distributors. At some point, Quality King Distributors (“Quality King”) purchased L’anza products internationally and then resold them at discounted prices to retailers in the United States. L’anza then brought a copyright infringement suit

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22 Quality King, 523 U.S. at 138.
23 Id.
24 Id. at 139. L’anza would sell its products to foreign distributors at 35 to 40% lower than the prices charged to domestic distributors.
25 Id.
against Quality King for illegally importing and distributing L’anza products, violating L’anza’s exclusive rights under sections 106 and 602. The District Court rejected Quality King’s first sale defense and entered summary judgment for L’anza. The Ninth Circuit affirmed, stating that section 602 would be meaningless if section 109 provided a defense for Quality King. The Supreme Court reversed and entered judgment for Quality King, holding that the section 602(a)(1) importation right incorporates the section 106(3) exclusive distribution right and all its limitations, including the first sale doctrine of section 109.

As Justice Ginsburg stated in a concurring opinion, the Quality King court considered a case of a “round trip” journey where copies of a copyrighted work were manufactured in the United States, sold abroad, and then imported back into the United States. If the copyrighted work was made in the United States, the first sale of that work anywhere in the world ended the copyright owner’s right to control its distribution. Thus, the Court determined that the location of the first sale was irrelevant as long as the work was made in the United States. However, the Quality King decision did not resolve the issue of whether the first sale doctrine applied to copies lawfully manufactured abroad.

2. Costco Wholesale Corp. v. Omega S.A.

Omega manufactured its copyrighted watches in Switzerland and sold them globally through a network of authorized distributors and retailers. After Omega initially sold the watches to authorized distributors overseas, Costco purchased some of the watches and then sold them to consumers in California. Although Omega authorized the initial foreign sale of the watches, it did not authorize their

26 Id.
28 L’Anza Research Int’l, Inc. v. Quality King Distributors, Inc., 98 F.3d 1109, 1114 (9th Cir. 1996), rev’d, 523 U.S. 135 (1998), vacated, 143 F.3d 525 (9th Cir. 1998).
29 Quality King, 523 U.S. at 149. See also Kirtsaeng, 133 S. Ct. at 1355.
30 Quality King, 523 U.S. at 154 (Ginsburg, J., concurring).
32 Quality King, 523 U.S. at 154 (Ginsburg, J., concurring).
34 Id. at 984.
importation into the United States.\textsuperscript{35} Omega then filed suit alleging that Costco infringed its exclusive distribution and importation rights.\textsuperscript{36} Costco claimed that Omega’s first sale of its watches exhausted its exclusive distribution right to control them.\textsuperscript{37} The District Court entered summary judgment for Costco.\textsuperscript{38} The Ninth Circuit reversed, holding that the first sale doctrine applies to copies manufactured outside the United States only if an authorized first sale occurs within the United States, which did not happen here.\textsuperscript{39} Finally, the Supreme Court had an opportunity to definitively say whether the first sale doctrine applied to copies lawfully made outside of the United States. Instead, an equally divided Supreme Court affirmed the judgment with a per curiam decision.\textsuperscript{40} The resulting uncertainty in the lower courts paved the way to the Kirtsaeng case.

C. Kirtsaeng v. John Wiley & Sons, Inc.

1. Initial Suit

John Wiley & Sons, Inc. ("Wiley") published academic textbooks.\textsuperscript{41} Wiley obtained copyright ownership from the authors of its academic textbooks and assigned to its wholly owned foreign subsidiary the rights to publish, print, and sell Wiley’s English language textbooks abroad.\textsuperscript{42} Copies of Wiley foreign edition textbooks clearly state that, without Wiley’s authorization, the copies are available for sale only in a particular country or area outside of the United States.\textsuperscript{43} As a result, there were two equivalent versions of a

\textsuperscript{35} Id.
\textsuperscript{36} Id.
\textsuperscript{37} Id.
\textsuperscript{39} Omega S.A., 541 F.3d at 986. See also Kirtsaeng, 133 S. Ct. at 1357.
\textsuperscript{40} Costco Wholesale Corp. v. Omega, S.A., 131 S. Ct. 565, 565 (2010) (providing that, although the Supreme Court granted certiorari, Justice Kagan took no part in the decision because she was involved in the case while serving as the United States Solicitor General. The remaining eight Justices issued a per curiam decision with a four-to-four split). See also Benjamin Hamborg, John Wiley & Sons, Inc. v. Kirtsaeng: The Uncertain Future of the First-Sale Doctrine, 13 MINN. J.L. SCI. & TECH. 899, 910 (2012).
\textsuperscript{41} Kirtsaeng, 133 S. Ct. at 1356.
\textsuperscript{42} Id.
\textsuperscript{43} Id. A copy of Wiley’s Asian edition of Fundamentals of Physics says, “this book is authorized for sale in Europe, Asia, Africa, and the Middle East only and may not be exported out of these territories. Exportation from or importation of this book to another region without the Publisher’s authorization is illegal and is a continued . . .
Wiley textbook: (1) an American version printed and sold in the United States and (2) a foreign version in English made and sold abroad.\textsuperscript{44}

Supap Kirtsaeng, a citizen of Thailand, moved to the United States to study mathematics at Cornell University.\textsuperscript{45} After graduation, he completed a Ph.D. program in mathematics at the University of Southern California.\textsuperscript{46} While he was a student in the United States, Kirtsaeng saw an opportunity to finance his education when he discovered that Thai textbook editions were sold at a substantially lower price than the American editions. He asked family and friends in Thailand to buy copies of foreign edition English-language textbooks at Thai bookstores and mail them to him in the United States.\textsuperscript{47} Kirtsaeng then sold the books, reimbursed his family and friends, and kept the profit.\textsuperscript{48} Over a few years, Kirtsaeng made close to $37,000.\textsuperscript{49}

In 2008, Wiley brought a copyright infringement suit against Kirtsaeng alleging that he violated Wiley’s section 106(3) exclusive right to distribute its textbooks as well as section 602’s prohibition against the unauthorized importation of its textbooks.\textsuperscript{50} Kirtsaeng replied that the books he had sold were “lawfully made” and that he acquired them legitimately.\textsuperscript{51} He argued that the first sale doctrine permitted him to resell the textbooks without Wiley’s permission.\textsuperscript{52}

2. The District Court and Second Circuit Opinions

The District Court held that Kirtsaeng could not assert a section 109(a) defense because the first sale doctrine did not apply to goods manufactured in a foreign country.\textsuperscript{53} The District Court determined that the statutory language, statutory context, legislative history, and public policy of the Copyright Act were inconclusive, and used dicta


\textsuperscript{45} Id.

\textsuperscript{46} Id.

\textsuperscript{47} Id.

\textsuperscript{48} Id.

\textsuperscript{49} Id.

\textsuperscript{50} Kirtsaeng, 133 S. Ct. at 1357.

\textsuperscript{51} Id.

\textsuperscript{52} Id.

\textsuperscript{53} John Wiley & Sons, Inc., 2009 WL 3364037, at *5.
from *Quality King* to reach its conclusion. The jury then found that Kirtsaeng willfully infringed Wiley’s copyrights by importing and selling Wiley’s copyrighted textbooks.

The Second Circuit affirmed the District Court’s opinion, holding that the phrase “lawfully made under this title” in section 109(a) refers only to copies that are made in territories in which the Copyright Act is law, and not to works manufactured abroad. Given the split amongst the circuit courts, the Supreme Court granted Kirtsaeng’s petition for certiorari to finally decide whether the first sale doctrine applied to non-piratical works made outside the United States. However, before analyzing the *Kirtsaeng* decision, it is necessary to understand the two main frameworks of intellectual property rights: national and international exhaustion.

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54 *Id.* at *9. The District Court specifically focused on the following:

Even in the absence of a market allocation agreement between, for example, a publisher of the United States edition and a publisher of the British edition of the same work, each such publisher could make lawful copies. If the author of the work gave the exclusive United States distribution rights-enforceable under the Act-to the publisher of the United States edition and the exclusive British distribution rights to the publisher of the British edition, however, presumably only those made by the publisher of the United States edition would be “lawfully made under this title” within the meaning of § 109(a). The first sale doctrine would not provide the publisher of the British edition who decided to sell in the American market with a defense to an action under § 602(a) (or, for that matter, to an action under § 106(3), if there was a distribution of the copies).

55 John Wiley & Sons, Inc. v. Kirtsaeng, 654 F. 3d 210, 215 (2d Cir. 2011) *rev’d* and *remanded*, 133 S. Ct. 1351 (U.S. 2013). The jury found Kirtsaeng liable for willful copyright infringement of the eight works that Kirtsaeng imported and sold. The jury imposed $75,000 in damages for each work, for a total of $600,000.

56 *Id.* at 222.

57 *Compare* Pearson Educ., Inc. v. Liu 656 F. Supp. 2d 407 (S.D.N.Y. 2009) (holding that the first sale doctrine does not apply to textbooks manufactured and sold in foreign countries and then imported to the United States); *Id.* (finding that the first sale doctrine does not apply to works made outside the United States), *with* Omega S.A. v. Costco Wholesale Corp., 541 F.3d 982, 986 (9th Cir. 2008), *abrogated* by Kirtsaeng v. John Wiley & Sons, Inc., 133 S. Ct. 1351 (2013) (holding that the first sale doctrine applies to copies manufactured outside the United States only if an authorized first sale occurs within the United States), and Sebastian Int’l, Inc. v. Consumer Contacts (PTY) Ltd., 847 F. 2d 1093, 1098, n.1 (C.A.3 1988) (stating that the “lawfully made under this title” language restricting the scope of the first sale doctrine “does not fit comfortably within the scheme of the Copyright Act”).

D. National or International Exhaustion

Since intellectual property law is territorial in nature, intellectual property creators may own parallel intellectual property rights in a variety of jurisdictions. For example, Wiley has parallel intellectual property rights to publish, print, and distribute its textbooks in both Thailand and the United States. The relationship between these parallel intellectual property rights is really the core of the first sale question posed to the Kirtsaeng court. According to the Court, “[t]here is no international consensus on whether the sale in one country of a good incorporating protected intellectual property exhausts the intellectual property owner’s right to control the distribution of that good elsewhere.” Without such an agreement, individual countries have chosen their own exhaustion approaches. In Kirtsaeng, the Supreme Court discussed two different exhaustion options. First, a national exhaustion regime holds that a copyright owner’s right to control distribution of a particular copy is exhausted only within the country in which the copy is sold. In a national exhaustion regime, each parallel intellectual property right is treated as a separate national right and is fully enforceable in its jurisdiction. The copyright owner may block the importation of even authorized products first sold in another jurisdiction, thereby allowing copyright owners of parallel intellectual property rights to divide global markets to account for differences in supply and demand. So the sale of a foreign edition textbook in Thailand would exhaust Wiley’s right to control that edition only in Thailand. Wiley would not have made a first sale in the United States, and thus would still have the exclusive distribution right of the foreign edition textbook within American borders.

Another option is an international exhaustion approach, under which the authorized distribution of a particular copy anywhere in the

59 Id. at 1383 (Ginsburg, J., dissenting).
60 See generally id.
61 Id.
62 Id.
63 Id. The European Union has adopted another exhaustion approach called regional exhaustion, where a sale anywhere in the European Union exhausts the copyright owner’s distribution right anywhere in that region. However, the United States is not a member of an economic or political union like that found in Europe, so this regional exhaustion approach is inapplicable.
64 Id.
66 Id.
world exhausts the copyright owner’s distribution right everywhere with respect to that copy.\textsuperscript{67} In an international exhaustion regime, the first sale of a work in any jurisdiction automatically exhausts the copyright owner’s parallel intellectual property rights in all other jurisdictions.\textsuperscript{68} Products may move freely through international markets following any first sale.\textsuperscript{69} In contrast with copyright owners in a national exhaustion regime, copyright owners in an international exhaustion approach cannot divide global markets to account for differences in supply and demand. Therefore, Wiley’s first sale of a textbook in Thailand would exhaust its ability to control that textbook’s distribution anywhere else in the world, including the United States. The \textit{Kirtsaeng} court had to choose which exhaustion regime it would implement.

\section*{III. \textbf{Analysis}}

\subsection*{A. Why the \textit{Kirtsaeng} Majority Got it Mostly Right}

\subsubsection*{1. The Good}

The Supreme Court in \textit{Kirtsaeng} looked at the language, statutory context, and common law history of the first sale doctrine to determine whether the words “lawfully made under this title” restrict the scope of the first sale doctrine geographically.\textsuperscript{70} The majority answered negatively, adopting a non-geographical interpretation.\textsuperscript{71} The Court also focused on the practical problems that a geographic interpretation would pose.\textsuperscript{72} This non-geographic interpretation of the first sale doctrine might implement an international exhaustion regime in the United States.\textsuperscript{73}

\subsubsection*{a. Statutory language of section109(a)}

The majority found that “lawfully made under this title” means made “in accordance with” or “in compliance with” the Copyright Act, and is consistent with a non-geographical reading of the statute.\textsuperscript{74}

\begin{footnotesize}
\begin{enumerate}
\item \textit{Kirtsaeng}, 133 S. Ct. at 1383 (Ginsburg, J., dissenting).
\item See supra note 66, at 341.
\item \textit{Id}.
\item \textit{Kirtsaeng}, 133 S. Ct. at 1357–58 (majority opinion).
\item \textit{Id}.
\item at 1358.
\item \textit{Id}.
\item at 1358–59.
\item \textit{See id}.
\item at 1384 (Ginsburg, J., dissenting) (arguing that the Court's decision in this case commits the United States to the international-exhaustion framework).
\item \textit{Id}.
\item at 1358.
\end{enumerate}
\end{footnotesize}
In contrast, a geographical interpretation inserts geography into a statute that says nothing explicitly about geography. The geographic interpretation reads “lawfully made under this title” to mean “in conformance with the Copyright Act where the Copyright Act is applicable.” Thus, both the non-geographic and geographic interpretations agree that “lawfully made under this title” means “in conformance with the Copyright Act,” but the geographic interpretation requires an extra step to determine where the Copyright Act is applicable. Since the geographic reading requires this extra step, the majority made the correct, simpler reading of “lawfully made under this title,” to be nongeographic. Furthermore, section 104(b)(2) states, “the works . . . when published, are subject to protection under this title if – the work is first published . . . in a foreign nation that, on the date of first publication, is a treaty party.” Thus, the Copyright Act explicitly covers works published in foreign countries, and is not restricted solely to the United States.

b. Statutory context and common law history of section 109(a)

Since the statutory predecessor of section 109(a) says nothing about geography, the Court asked whether Congress implicitly introduced a geographical limitation when it wrote the present version of section 109(a). The former version covered mere possessors who lawfully obtained a copy, while the present version covers owners of a lawfully made copy. The change in this language was meant to exclude persons, like lessees and bailees who lawfully obtained a copy without actually owning it, from asserting a first sale defense. Thus, the present version of section 109(a) does not explicitly or implicitly mention a geographic limitation.

The Court presumed that the words “lawfully made under this title” carry the same meaning in separate but related sections of the Copyright Act. However, applying a geographical interpretation to these words in other sections of the Copyright Act results in an

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75 Id. at 1359.
76 Id. (emphasis removed).
77 See id. (arguing that proponents of the geographic interpretation must “take a second step” and argue where the Copyright Act is applicable).
79 Kirtsaeng, 133 S. Ct. at 1360.
80 Id. at 1361.
81 Id. A lessee of a copy cannot assert a first sale defense, while an actual owner of a copy can.
82 Id. at 1362.
untenable application. First, section 109(c) states that the owner of a particular copy “lawfully made under this title” may publicly display it without further authorization. Using a geographic interpretation would mean that someone who buys a copyrighted poster or bumper sticker in Canada or Europe could not display it in America without the copyright owner’s authorization. Second, section 110(1) says that a teacher, without the copyright owner’s authorization, is allowed to display a copyrighted work in teaching activities unless the teacher knows that the copy was not “lawfully made under this title.” A geographic interpretation means that a teacher could not show a copy of a video during class if the copy was lawfully made in Mexico, Africa, or Asia. In sum, a geographic interpretation of “lawfully made under this title” creates practical problems for owners of copyrighted items, and gives copyright holders too much control over the distribution or display of copies already sold.

The common law history of section 109(a) also favors a non-geographical interpretation. The Supreme Court first applied the first sale doctrine in *Bobbs-Merrill Co. v. Straus*, where there is no mention of a geographical restriction. When a statute covers an issue previously governed by the common law, the Court presumes that Congress intended to retain the substance of the common law unless explicitly stated otherwise.

**c. Practical problems of geographic reading of section 109(a)**

A geographical interpretation also threatens normal scholarly, artistic, commercial, and consumer activities, and fails to further the basic constitutional copyright objective of “promoting the Progress of

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83 *Id.*
84 *Id.*
85 *Id.*
86 *Id.* The Court also mentioned two other sections of the Copyright Act where a geographic interpretation of “lawfully made under this title” does not make sense. Section 109(e) says that the owner of a particular copy of a copyrighted video arcade game “lawfully made under this title” may “publicly perform or display that game” without the authorization of the copyright owner. A geographic interpretation means that the arcade owner could not use arcade games lawfully made in Japan without the copyright owner’s authorization. Finally, section 106 grants the Act’s exclusive rights to an “owner of a copyright under this title.” It is hard to decipher how an “owner” may be limited geographically by “under this title.”
87 *Id.* at 1363.
88 *Id.*
89 *Id.*
90 *Id.* at 1358.
Science and useful Arts.” For example, a geographical interpretation will require libraries to obtain permission from the copyright owner before circulating or distributing books that were printed abroad. Likewise, an American tourist in France who buys copies of a foreign book to give to her American friends would commit copyright infringement. Many items, including cars, microwaves, calculators, cell phones, tablets, and computers contain copyrightable software programs that are made abroad and then sold and imported, with the copyright owner’s permission, into the United States. A geographical interpretation would not allow someone to resell his car without the permission of the holder of each copyright on copyrightable software in the car. American retailers may not be able to buy foreign goods without the threat of copyright infringement suits. Finally, a geographic interpretation would require museums to obtain permission from copyright owners before they could display any artistic work.

Although the dissent argues that these problems are theoretical in nature, the majority correctly disagreed. These untenable issues give copyright owners almost perpetual control over copies they have already sold, create much uncertainty and confusion in American copyright law, and threaten liability for innocent American consumers who purchase cheap products that happen to have been made abroad. The statutory language, statutory context, common law history, and practical problems with a geographic interpretation of section 109(a) all support the majority’s nongeographic interpretation of the first sale doctrine. Thus, the majority correctly held that the first sale doctrine applies to copies lawfully made abroad.

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91 Id. at 1364; U.S. CONST., ART. I, § 8, cl. 8.
92 *Kirtsaeng*, 133 S. Ct. at 1364. According to the amicus curiae brief of the American Library Association, American libraries contain at least 200 million books published abroad.
93 Id. at 1365.
94 Id.
95 Id. It is difficult to believe that a person selling his foreign used car actually obtains permission from all the copyright owners.
96 Id. Over $2.3 trillion worth of foreign goods were imported in 2011, and American retailers buy many of these goods after a first sale abroad. American retail sales of foreign books, music, movies, and magazines likely exceed over $220 billion.
97 Id.
2. The Bad

Following *Quality King*, a copyright owner’s section 602(a)(1) importation right is limited by the section 109(a) first sale doctrine.\footnote{98}{Quality King Distributors, Inc. v. L’anza Research Int'l, Inc., 523 U.S. 135, 145 (1998).} If the first sale doctrine applies, then a copyright owner cannot prohibit a legitimate owner of a copy from importing it into the United States. As a result, the *Kirtsaeng* holding creates two problems regarding section 602.

\[a. \text{Insignificance of section 602(a)(1) and section 602(a)(3)}\]

First, the majority’s holding reduces section 602(a)(1) and its exceptions to insignificance. Now section 602(a)(1)’s only effect is to prohibit the unauthorized importations by persons, like licensees, who merely have possession of imported copies, but do not own them.\footnote{99}{*Kirtsaeng*, 133 S. Ct. at 1378 (Ginsburg, J., dissenting).} However, the specific person who imports the copy is inconsequential because section 602(a)(1) does not distinguish between owners and licensees.\footnote{100}{See 17 U.S.C. § 602(a)(1) (2012) (“Importation into the United States, without the authority of the owner of copyright under this title, of copies . . . of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute . . . under section 106.”).} The plain meaning of section 602(a)(1) prohibits the unauthorized importation of copies acquired abroad.\footnote{101}{Id.} If Congress wanted to provide a copyright infringement remedy only against non-owners, it would have written section 602(a)(1) with much more specific language for that narrow purpose.\footnote{102}{*Kirtsaeng*, 133 S. Ct. at 1378 (Ginsburg, J., dissenting).} Instead, Congress drafted section 602(a)(1) very broadly to stop all importation.\footnote{103}{*Kirtsaeng*, 133 S. Ct. at 1378 (Ginsburg, J., dissenting).} The majority’s holding allows owners of copies to import those copies into the United States without the copyright owner’s authorization, which clearly goes against congressional intent to stop the unauthorized importation of copies.

The majority’s holding also reduces the section 602(a)(3) exceptions to insignificance. Even without the copyright owner’s authorization, a legal owner may import copies (1) under the authority
of the United States Government, (2) for the private use of the importer or exporter and not for distribution, and (3) for scholarly, educational, or religious purposes that do not include private gain. Why would Congress provide these specific exceptions to a copyright owner’s importation right if the first sale doctrine already completely extinguished section 602(a)(1)? The answer is that there is no reason, and the section 602(a)(3) exceptions are superfluous, except to prevent non-owners from importing copies into the United States. For example, section 602(a)(3)(B) allows an individual to import one work of a copyrighted item at a time, as long as the work is for the private use of the individual and not for distribution. There is no purpose for this exception, and the other two exceptions, if the first sale doctrine already allows the individual to import the copyrighted work.

b. Disregard of public policy behind section 602

The second problem with the majority’s holding is that it contravenes the policy behind section 602. Section 602(a)(1) was enacted as part of the Copyright Act of 1976, and went through multiple drafts and revisions. The Copyright Office prepared a preliminary draft that was very similar to the current version of section 602(a)(1), but that did not reference section 106. Congress’s revised draft referenced the section 106 exclusive distribution right, and the majority concluded that Congress wanted the first sale doctrine to limit the importation right. While the legislative history of section 602 is inconclusive, there is evidence that its purpose was to allow copyright owners to bring infringement actions against unauthorized importers in cases “where the copyright owner had

106 Kirtsaeng, 133 S. Ct. at 1380 (Ginsburg, J., dissenting).
107 Id. at 1381. Section 44(a) was the relevant section of the Copyright Office’s preliminary draft, and it said:

[i]mportation into the United States of copies or records of a work for the purpose of distribution to the public shall, if such articles are imported without the authority of the owner of the exclusive right to distribute copies or records under this title, constitute an infringement of copyright actionable under section 35.

Abe Goldman, the Copyright Office’s General Counsel, said that this preliminary draft “would allow copyright owners to bring infringement actions against importers of ‘foreign copies that were made under proper authority.’” Id.
108 Id. at 1369–70 (majority opinion). The majority then focused on the legislative history of section 109(a).
authorized the making of copies in a foreign country for distribution only in that country. Thus, Congress passed section 602 so that copyright owners could divide global markets to take into account differences in supply and demand, which increases the monetary incentive to create copyrightable works.

Without section 602 protection, a professor who has finished a United States textbook edition does not have much incentive to spend further effort to make an international version. The international version will make its way back into the United States, lowering the price of the American edition and undermining domestic sales. This devaluation of American copyrights discourages American inventors from developing new products. The lack of section 602 protection will also result in a lack of educational, cultural, and technological materials in developing parts of the world. If textbooks sold abroad will re-enter the United States and lower the copyright owner’s profits, then the copyright owner will simply stop making the foreign edition textbook.

B. Why the Kirtsaeng Dissent Got it Mostly Wrong

The dissent argued that a national exhaustion approach should be implemented to strengthen American copyrights and leave section 602 intact. However, a national exhaustion approach presents a few problems. First, it would contradict congressional intent by allowing copyright owners to have almost continuous distribution control over foreign-made copies. The first sale doctrine was implemented to prevent a copyright owner’s perpetual control by allowing him to profit only from the initial sale of his copy. Second, a national exhaustion framework is at odds with the Quality King decision. National exhaustion says that a copyright owner’s right to control distribution of a particular copy is exhausted only within the country in which the copy is sold, but Quality King determined that the location of the sale was irrelevant as long as the copy was legally

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110 Kirtsaeng, 133 S. Ct. at 1378 (Ginsburg, J., dissenting). Justice Ginsburg said that section 602(a)(1) ties the United States to a national exhaustion framework.

111 Id. at 1391. Under a national exhaustion approach, the first sale doctrine would only apply to copies lawfully manufactured in the United States.

112 See supra Part II.A.2.
made in the United States. Under the dissent’s national exhaustion approach, a publisher could not control the distribution in the United States of a textbook made in the United States and sold in Thailand. The location of the sale is what matters under national exhaustion, and the publisher could control only the textbook’s distribution in Thailand. However, Quality King tells us that the first sale doctrine applies when a textbook is made in the United States and sold in Thailand. The location of the sale is irrelevant, and all that matters in that the textbook was legally made in the United States. Thus, Quality King conflicts with national exhaustion, and the copyright owner could control the textbook’s distribution within American borders.

Finally, a geographic limitation on the first sale doctrine would incentivize copyright owners to manufacture their products abroad, shifting jobs and economic stimulation outside of the United States. Under a national exhaustion regime, the first sale doctrine does not apply to Wiley’s Thailand made books, so it can control the distribution of those books in the United States. Why would Wiley make a book in the United States that is limited by the first sale doctrine when Wiley can make a book in Thailand that is not limited by it? The United States should promote policy that causes American copyright owners to want to produce their products domestically, not internationally.

Although the dissent correctly realized that section 602 was superfluous in light of the Quality King and Kirtsaeng decisions, it incorrectly argued to fix a problem (insignificance of section 602) with another problem (limiting the first sale doctrine geographically). Is there a way to harmonize a non-geographic section 109(a) first sale doctrine with a significant section 602 importation right?

C. What Is Next?

In her concurrence in Kirtsaeng, Justice Kagan provides a way to harmonize a non-geographic section 109(a) first sale doctrine with a significant section 602 importation right: reversing Quality King. Following Quality King and Kirtsaeng, a copyright owner cannot stop the importation of his copyrighted items from outside the United States when the first sale doctrine applies. However, if the first sale doctrine did not limit the importation right, then a copyright owner could restrict the importation of copies irrespective of the first sale

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113 See supra Part II.D (defining national exhaustion); see supra Part II.B.1 (explaining Quality King).
114 Kirtsaeng, 133 S. Ct. at 1372 (Kagan, J., concurring). Quality King held that section 602(a)(1) is limited by section 109(a). See supra Part II.B.1.
doctrine. Section 109(a) should not limit section 602(a)(1) because the first sale doctrine allows owners of copies to “sell” or “dispose” of their copies, but does not authorize them to “import” them. Thus, under this new standard, when Kirtsaeng purchases a Wiley textbook in Thailand, the first sale would exhaust Wiley’s exclusive distribution right over that textbook. Wiley would have no control over whether Kirtsaeng sells, burns, or gives the textbook away. However, the first sale doctrine does not authorize Kirtsaeng to import that textbook into the United States, and Wiley could assert its section 602 importation right to stop this unauthorized importation, even though Wiley has already exhausted its exclusive distribution right.

This solution provides monetary incentive to American copyright creators who can segment international markets, and would not impose downstream liability on those who purchase and resell in the United States copies that happen to have been made abroad. A copyright owner could bring an infringement suit against the unauthorized importer only, and not against libraries, used-book dealers, technology companies, retailers like eBay and Amazon, and museums. By holding that the first sale doctrine applies to copies lawfully made abroad, the Supreme Court appears to implement an international exhaustion framework. However, by reversing Quality King, the first sale doctrine would not limit the importation right. The result is a mixture of national and international exhaustion, where the sale of a copy anywhere in the world exhausts the copyright owner’s distribution right everywhere with respect to that copy, except for the United States, where the copyright owner can ban the unauthorized importation of the copy. Copyright owners would not have perpetual control over foreign made copies, and could segment global markets while imposing liability on the actual guilty party, the unauthorized importer, instead of innocent third parties who happen to buy and resell the copy. Also, the mixed exhaustion approach, unlike the dissent’s national exhaustion, would not incentivize copyright owners to outsource their production overseas, keeping jobs in America.

In sum, this mixed exhaustion approach provides numerous advantages: (1) copyright owners do not retain extensive control on the downstream distribution of a copy once it is sold; (2) copyright owners would not have perpetual control over foreign made copies, and could segment global markets while imposing liability on the actual guilty party, the unauthorized importer, instead of innocent third parties who happen to buy and resell the copy. Also, the mixed exhaustion approach, unlike the dissent’s national exhaustion, would not incentivize copyright owners to outsource their production overseas, keeping jobs in America.

In sum, this mixed exhaustion approach provides numerous advantages: (1) copyright owners do not retain extensive control on the downstream distribution of a copy once it is sold; (2) copyright owners would not have perpetual control over foreign made copies, and could segment global markets while imposing liability on the actual guilty party, the unauthorized importer, instead of innocent third parties who happen to buy and resell the copy. Also, the mixed exhaustion approach, unlike the dissent’s national exhaustion, would not incentivize copyright owners to outsource their production overseas, keeping jobs in America.

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115 Id.
116 Id. at 1391 n.1. The first sale doctrine and the importation right thus regulate separate, non-overlapping spheres of conduct.
117 Id. at 1372.
118 Id.
119 Id.
owners can segment global markets to benefit from different supply and demand; (3) copyright owners can only bring infringement suits against the actual guilty party, the unauthorized importer, rather than innocent third parties like retailers and museums that happen to buy products lawfully made abroad; (4) copyright owners are not incentivized to outsource their manufacturing overseas; and (5) strong section 602(a)(1) protection will result in increased educational, cultural, and technological materials in developing parts of the world.

If *Kirtsaeng* were decided using this mixed exhaustion approach, Wiley would have won at trial. Kirtsaeng would be guilty of importing Wiley’s textbooks into the United States without Wiley’s authorization. It is irrelevant that Wiley made a first sale in Thailand because the first sale doctrine would not authorize Kirtsaeng to import the textbook into the United States.

D. Possible Solutions

There are a few possible solutions that should be implemented to adopt this mixed exhaustion approach. First, the Supreme Court should reverse the *Quality King* holding. Next, section 109(a) should be amended as follows:

(a) Notwithstanding the provisions of section 106(3), the owner of a particular copy or phonorecord lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord. *This limitation on a copyright owner’s exclusive rights does not limit a copyright owner’s right to prohibit importation under section 602(a)(1).*

Section 602(a)(1) should also be amended as follows:

Importation into the United States, without the authority of the owner of copyright under this title, of copies or phonorecords of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies or phonorecords under section 106, actionable under section 501. *This importation right is not limited by section 109(a).*

This legislative intervention clarifies that the section 109(a) first sale doctrine does not limit the section 602(a)(1) importation right.

Alternatively, the United States may implement an international exhaustion system with a more limited importation right by creating a
treaty with other countries. In this way, if Britain and the United States were signatories of the treaty and a product were sold in Britain and then imported into the United States, the copyright owner would have no right to control the importation. On the other hand, if a product were sold in a non-signatory country, such as Thailand, and then imported into the United States, the copyright owner could bar the importation of the product.

IV. CONCLUSION

Although the Supreme Court ultimately made the correct decision that the section 109(a) first sale doctrine is not limited by geography, thus applying to copies lawfully manufactured outside the United States, its holdings in Kirtsaeng and Quality King mistakenly made the section 602(a)(1) importation right ineffective. Quality King should be reversed and amendments to the Copyright Act made so that the importation right is clearly not limited by the first sale doctrine. In this way, the first sale of a copy anywhere in the world exhausts the copyright owner’s exclusive distribution right everywhere with respect to that copy. However, the copyright owner may block the owner of the particular copy from importing it into the United States because the first sale doctrine only authorizes the owner of the copy to sell or dispose of the copy, but not import it into the United States.

Even though Kirtsaeng and other American college students will complain of high textbook prices, Congress intended a non-geographic first sale doctrine and a strong importation right, allowing textbook authors to divide international markets. The mixed exhaustion approach achieved through the proposed statutory amendments incentivizes works of authorship and strengthens domestic copyright protection.
TRADEMARKS IN FRANCHISING: THE BASICS

W. Michael Garner†

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I. INTRODUCTION

It has been said that a trademark is the cornerstone of a franchise system. The product or service that is franchised, the advertising of the “brand,” and the license that binds the franchisee and franchisor together all have at their heart the franchisor’s trademarks or other identifying names or symbols.

The law of trademarks and unfair competition provides the legal basis for creating and maintaining a franchise system. These laws enable the franchisor to license its trademarks, commercial symbols, and marketing operations to franchisees; to defend the franchise system from unlawful imitation and competition; and to protect the franchise system’s trade secrets and business image. Trademark law gives cohesion to the franchise system; it binds individually owned and operated units into a functioning whole, with a uniform image and uniform product or service.

This article will describe the basic principles of trademark and unfair competition law and how they are applied in franchising.

II. THE NATURE OF TRADEMARKS

Trademarks, trade names, and service marks and names ("marks") are names or marks that identify a product or service with the provider of the product or service. Ownership of a valid mark gives the right to license its use, prevent others from using it, and to obtain injunctive relief or damages for unauthorized use.

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2 See id. (noting that “[i]t is [the trademark’s] uniformity of product and control of its quality and distribution which causes the public to turn to franchise stores for the product.”); see also, WORLD INTELLECTUAL PROP. ORG., FRANCHISE OR TRADEMARK LICENSE AGREEMENTS, available at http://www.wipo.int/sme/en/ip_business/licensing/franchise_license.htm (last visited May 24, 2014).
5 See generally WORLD INTELLECTUAL PROP. ORG., supra note 2.
7 See infra text accompanying notes 74 through 82.
Marks may include “trade names,” which are names that identify a business, vocation, or occupation. They may include individual names, surnames, firm names, or names of associations, corporations, unions, and entities “engaged in trade or commerce and capable of suing and being sued in a court of law.” Logos or logotypes, slogans and mottos, characters, color schemes, and musical themes may also be protected as trademarks, although some are also subject to copyright protection.

“Trade dress” is a broad term that includes some of the most visible identifying characteristics of a business, such as decor, color schemes, furnishings, uniforms, distinctive vehicles, and possibly certain distinctive operating characteristics. Trade dress is especially important to some franchised industries, such as restaurant franchises, because it is one of the most visible characteristics of the system. Trade dress may be protected to the same degree as a trademark if it is non-functional and either inherently distinctive or has achieved secondary meaning.

Trademark law is part of the broader law of unfair competition and is rooted in common law. Unlike copyrights and patents, trademarks do not have a constitutional basis but are created and exist at common law by virtue of their use in identifying a product or service; there is no property right in a trademark except to the extent that it is used in business or commerce. Federal registration of trademarks provides certain procedural rights and presumptions.

Two principal limitations on whether a symbol is a trademark are whether it is descriptive and whether it is functional. A descriptive or generic word, for example, does not identify the source; rather, it

8 See infra text accompanying notes 84 through 97.
10 See LEGAL INFO. INST., supra note 6.
12 See generally, LEGAL INFO. INSTITUTE, supra note 6.
17 See generally id.
18 Id. at 773.
19 Am. Footwear Corp. v. Gen. Footwear Co. Ltd., 609 F.2d 655, 663-64 (2d Cir. 1979), disapproved of on other grounds by, Prudential Ins. Co. of America v. Gibraltar Fin. Corp. of California, 694 F.2d 1150 (9th Cir. 1982).
20 E.g., Am. Footwear Corp., 609 F.2d at 661.
describes the service or product. Similarly, a mark, name, or object may not be a trademark if its primary purpose is functional, since it performs a function instead of identifying the source of the products.

Determining which aspects of a franchised business are subject to trademark protection and which are not is of primary importance in setting up a franchise system. On the one hand, while a franchisor has “no protectable interest in the mere method and style of doing business,” it should take all reasonable steps to protect those aspects of the business that are subject to protection.

III. ACQUISITION OF TRADemark RIGHTS

Rights in a trademark at common law are acquired by appropriation and exclusive use by the user or owner. Reflecting fundamental notions of proprietary rights rooted in possession, the common law gives the right to own the mark to the first user; priority in time is usually priority in right. Thus, the owner of a mark acquires rights in it by actually using it in connection with the goods or services sold or offered for sale in commerce. Actual use occurs by placing the mark on the product and offering it for sale or selling it to the public. It does not occur by merely creating a name or design or by using it indiscriminately on a variety of different products or services. A corollary of this principle is that the extent of the rights acquired at common law is consistent with the extent of exclusive use.

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22 See Norwich Pharmacal Co. v. Sterling Drug, Inc., 271 F.2d 569 (2d Cir. 1959) (holding that the color of Pepto-Bismol is functional); Sylvania Elec. Prods., Inc. v. Dura Elec. Lamp Co., 247 F.2d 730 (3d Cir. 1957) (holding that a flashbulb’s blue dot is functional); Marvel Co. v. Pearl, 133 F. 160 (2d Cir. 1904).
23 Denton v. Mr. Swiss of Missouri, Inc., 564 F.2d 236, 243 (8th Cir. 1977).
25 See Neva-Wet Corp. v. Never Wet Processing Corp., 277 N.Y. 163 (1938) (applying the doctrine by examining who was the first user of the trademark).
27 See Kelly-Brown v. Winfrey, 717 F.3d 295, 305 (2d Cir. 2013); Rearden LLC v. Rearden Commerce, Inc., 683 F.3d 1190, 1203 (9th Cir. 2012).
29 Id. (providing that while the low level of exclusive use in advertisements is not enough to constitute a trademark right, the higher level of use on goods can constitute a trademark right).
There are notable exceptions to the rule of priority. The owner's rights extend geographically only so far as its actual use and reputation; a junior user in a remote area would be unlikely to be found infringing.\textsuperscript{30} Priority is not acquired by use outside the United States.\textsuperscript{31} In addition, the owner must maintain the use or risk abandonment,\textsuperscript{32} and the owner must police infringers, lest they encroach upon and eventually take over the owner's rights.\textsuperscript{33}

Trademarks differ in their strength. Some, such as “McDonald’s” are strong and instantly recognizable as reflecting the source of particular goods, while others, for example “National Supplies,” are descriptive and do not, without more, connote a particular source. The strength of a mark determines the amount and extent of protection that it will receive under trademark and unfair competition law.\textsuperscript{34} Strong marks receive greater protection in infringement suits and are more likely to be accepted for federal registration.\textsuperscript{35} Thus, in selecting a mark, the user should consider the factors that determine whether a mark is strong or weak.

The strength of a mark refers to its distinctiveness or its ability to identify the goods as emanating from a particular, though anonymous, source.\textsuperscript{36} A strong mark is usually a mark that is rarely used by others; a weak mark may be used often by other parties.\textsuperscript{37} Courts typically classify marks into four types or categories in measuring their strength: generic, descriptive, suggestive, and arbitrary or fanciful.\textsuperscript{38}

In order to be distinctive, and therefore strong, a mark must have three characteristics: it must be different from other marks to a degree sufficient to be distinguishable from them; it must not be descriptive or signify characteristics that the products or services share with those from other sources; and it must be recognizable as an indication of source rather than as a decorative symbol or pattern.\textsuperscript{39}

\begin{itemize}
  \item \textsuperscript{30} See Junior Food Stores of West Florida, Inc. v. Junior Food Stores, Inc., 226 So.2d 393, 396 (Fla. 1969).
  \item \textsuperscript{31} ITC Ltd. v. Punchgini, Inc., 482 F.3d 135, (2d Cir. 2007), \textit{cert’d question accepted}, 8 N.Y.3d 994 (2007), \textit{and cert’d question answered}, 9 N.Y.3d 467 (2007).
  \item \textsuperscript{32} See id.
  \item \textsuperscript{33} See \textit{generally} Junior Food Stores of West Florida, Inc., 226 So.2d at 393-99.
  \item \textsuperscript{35} See id.
  \item \textsuperscript{36} Dorpan, S.L. v. Hotel Melia, Inc., 728 F.3d 55, 68 (1st Cir. 2013).
  \item \textsuperscript{37} See Water Pik, Inc. v. Med-Sys., Inc., 726 F.3d 1136 (10th Cir. 2013); John H. Harland Co. v. Clarke Checks, Inc., 711 F.2d 966, 973-74 (11th Cir. 1983); \textit{and Amstar Corp. v. Domino's Pizza, Inc.}, 615 F.2d 252 (5th Cir. 1980).
  \item \textsuperscript{38} Hornady Mfg. Co., Inc. v. Doubletap, Inc., 746 F.3d 995 (10th Cir. 2014); Pizzeria Uno Corp. v. Temple, 747 F.2d 1522 (4th Cir. 1984).
  \item \textsuperscript{39} Team Cent. Inc. v. Xerox Corp., 606 F. Supp. 1408 (D. Minn. 1985).
\end{itemize}
Arbitrary and fanciful marks are stronger than descriptive or generic marks because they do not suggest anything about the product or service, and therefore are easily identified with a particular product or service.\(^{40}\) Arbitrary or fanciful marks are given wide protection not only against infringing marks used on identical products but also over related products; similarly, they are widely protected against variations in the appearance or sound of the mark, while weaker marks are not.\(^{41}\)

Arbitrary or fanciful marks include coined names such as “KODAK,” “XEROX,” and “PEPSI.” Arbitrary or fanciful marks also include marks in which a common word is applied to a product or service that is unrelated to its meaning, such as “POLO” when applied to a man’s fragrance.\(^{42}\)

A suggestive mark suggests some characteristic of the product but requires the consumer to use his imagination to determine the nature of the product or service.\(^{43}\) The distinction between descriptive and suggestive marks is difficult to draw; as one court said, “if the mark imparts information directly, it is descriptive. If it stands for an idea which requires some operation of the imagination to connect it with the goods, it is suggestive.”\(^{44}\) A suggestive mark, even if it is comparatively weak, can be protected without evidence that it has acquired secondary meaning.\(^{45}\) The mark “pet silk” was a suggestive mark for use with dog groomer products.\(^{46}\)

The mark “It’s a 10” was suggestive when used for hair care products, inasmuch as it suggested high quality or beauty.\(^{47}\)

A descriptive mark identifies the characteristics or qualities of the product or service, including color, design, dimensions, ingredients, and appearance.\(^{48}\) A mark that is descriptive is considered to be weak and is not accorded trademark protection without proof of secondary

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\(^{41}\) John H. Harland Co. v. Clarke Checks, Inc., 711 F.2d 966, 974 (11th Cir. 1983).


\(^{44}\) Union Carbide Corp. v. Ever-Ready Inc., 531 F.2d 366, 379 (7th Cir. 1976).

\(^{45}\) John H. Harland Co., 711 F.2d at 974.


\(^{47}\) It’s a 10, Inc., 932 F. Supp. 2d at 1325.

meaning. Thus, a descriptive mark may not be registered on the Principal Register, nor will it be accorded protection in an infringement suit. Similarly, a generic term refers to a genus or class of article or service and suggests its basic nature. Like a descriptive mark, a generic mark is not accorded trademark protection in the absence of secondary meaning.

Descriptive and generic terms are typically words in common usage that describe the product or service offered. Geographic terms such as “national” are typically descriptive. A common source of evidence that a term is generic is the dictionary. For example, the name “BEEF & BREW” was descriptive because it was a “name that tells the diner what his dinner will be.” The mark “MASTERCLEAN” was a descriptive mark for a carpet cleaning service and therefore was intrinsically weak, particularly when there were dozens of companies that used the name and the owner knew it. The term “for a gym on wheels” was suggestive rather than merely descriptive.

Foreign words, when used in a descriptive sense, are also descriptive; for example, “uno” as used in “PIZZERIA UNO” was descriptive, and in the absence of secondary meaning did not preclude the defendant from using the mark “TACO UNO.” In some cases, the courts have held that marks that might have been fanciful or at least suggestive have been weakened through extensive use—or the extent of their exclusive use has been narrowed—so as to limit the owner’s power to preclude others from using them on different products or services. For example, when the word “Mustang” had been used on aircraft, automobile mufflers, automobile springs,

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49 Coach Serv., Inc. v. Triumph Learning LLC, 668 F.3d 1356, 1377-78 (Fed. Cir. 2012).
50 However, the mark will be presumed to have acquired secondary meaning if it has actually been used for at least five years and will qualify for registration on that basis. Lanham Act, 15 U.S.C. § 1052(f) (2012).
52 Coach Serv., 668 F.3d at 1378-79.
53 Id. at 1377–78.
58 Tumblebus Inc. v. Cranmer, 399 F.3d 754, 763 (6th Cir. 2005).
automobile and truck brake linings, farm tractors, motorcycles, and rebuilt automobile engines, among other things, a manufacturer of “MUSTANG” recreational vehicles could not prevent its use on an automobile by an automobile manufacturer.\textsuperscript{60} The extent of third-party use is probative evidence that the public considers a mark to be descriptive and weak.\textsuperscript{61}

Combining two generic or descriptive terms does not necessarily strengthen the character of the mark. For example, the combination of “computer” and “land” into “COMPUTERLAND” did not make the name suggestive or fanciful. To the contrary, the combined name was simply descriptive and not entitled to protection.\textsuperscript{62}

Secondary meaning is the distinct association with a source that a mark acquires over lengthy exposure to the public.\textsuperscript{63} For example, “National Car Rental” is associated in the public mind with a particular car rental company even though it is a descriptive name; it is the association in the public mind of the name with a particular source that constitutes secondary meaning.\textsuperscript{64}

Ironically, in order to have secondary meaning, the primary significance of the mark in the mind of the consuming public must be the particular source, not the description of the product.\textsuperscript{65} Thus, particularly where the mark is descriptive or generic, proof of secondary meaning requires that the public think of the source, rather than what it describes, when it sees or hears the mark: “National Car Rental” must mean a particular car rental company, not any car rental company that does business nationally.\textsuperscript{66} Issues of secondary meaning most frequently arise with respect to generic or descriptive marks.\textsuperscript{67} If such marks have not acquired secondary meaning, they cannot be


\textsuperscript{65} Fair Isaac Corp. v. Experian Info. Solutions, Inc., 650 F.3d 1139 (8th Cir. 2011); Caliber Auto. Liquidators, Inc. v. Premier Chrysler, Jeep, Dodge, LLC, 605 F.3d 931 (11th Cir. 2010).

\textsuperscript{66} Id.

registered with the Patent and Trademark Office and will not receive protection in an infringement suit. Where marks have achieved secondary meaning, they may be registered, and secondary meaning will be considered in assessing their strength in an infringement action.

Whether a mark has acquired secondary meaning usually is an issue of fact, determined on the basis of a number of different factors including the duration of the plaintiff's exclusive use of its mark, the nature and extent of the plaintiff's advertising and promotion of the mark, the extent to which the plaintiff's business has come to the attention of the consuming public, the patronage of the plaintiff, and the defendant's conscious copying of the plaintiff's mark. Where a franchisor did not produce a consumer study linking its mark to itself, it failed to show an existence of secondary meaning sufficient to raise a triable issue of fact as to whether it had a famous name for purposes of the Lanham Act.

IV. Federal Registration of Trademarks

Federal registration of trademarks upon the Principal Register is the most important single step in securing protection of trademarks for a franchise system. A trademark owner may register a mark prior to its actual use by filing an affidavit of intent to use the mark in commerce. Within six months of receipt of a notice of allowance from the trademark office (or such longer period as is allowed), the owner must file a verified statement of actual use, at which time the trademark may be registered. Once registered, the owner enjoys a presumption of the mark's validity and of his rightful ownership. For the first five years of registration, these presumptions are rebuttable in an infringement action, and the registration may be challenged and

68 However, a descriptive mark may be registered if it has been used in commerce for a period of no less than five years, in which case the mark will be presumed to have secondary meaning. 15 U.S.C. § 1052(f) (2012).
70 Water Pik, Inc. v. Med-Systems, Inc., 726 F.3d 1136 (10th Cir. 2013); George & Co. v. Imagination Entm’t Ltd., 575 F.3d 383 (4th Cir. 2009).
72 USPTO, supra note 67.
cancelled.\textsuperscript{76} After five years, if the owner files an affidavit that he has used the mark continuously in commerce, the presumptions become incontestable,\textsuperscript{77} and the defenses available to a defendant in an infringement action will be limited to seven enumerated defenses.\textsuperscript{78} The registration procedure is also designed to alert other trademark owners of new and possibly conflicting applications so as to resolve disputes over use at an early stage.\textsuperscript{79} Marks used in a franchise system should be registered as soon as they are conceived and the franchisor can safely assume that they will be used in commerce promptly; this way, they can be registered in order to invoke the statutory presumptions, to start the period for incontestability running, and to put the world on notice of the use and existence of the mark.

In order to be registered on the Principal Register, a mark must be distinctive; it must be actually used in commerce to identify the source of goods, and it must be owned by the registrant.\textsuperscript{80} In order to be distinctive, a mark must distinguish the goods of the trademark owner from those of others.\textsuperscript{81} The mark may not be merely descriptive, geographically descriptive, or deceptively misdescriptive.\textsuperscript{82} However, an owner may register a merely descriptive mark that has acquired secondary meaning, that is, one that has become “distinctive of the applicant’s goods in commerce.”\textsuperscript{83} Proof of use during the five-year period preceding the registration application is prima facie evidence of such distinctiveness.\textsuperscript{84} Registration may be refused if the mark falls into one of several categories enumerated in United States Code Section 1052,\textsuperscript{85} which

\textsuperscript{78} 15 U.S.C. § 1115(b) (2012).
\textsuperscript{79} See 15 U.S.C. §§ 1063, 1064 (2012) (providing for how a person who has a conflict with a newly registered trademark can oppose the trademark and can file a petition to cancel the registration of the trademark).
\textsuperscript{81} 15 U.S.C. § 1051(d) (2012).
\textsuperscript{84} Id.
\textsuperscript{85} The mark cannot consist of or comprise immoral, deceptive, scandalous, or disparaging matter; it cannot consist of or comprise the United States or a foreign flag, coat of arms or that of a state, municipality, or foreign nation. 15 U.S.C. § 1052(a)-(b) (2012). Nor can the mark be the name or portrait of a living individual except by his written consent, or the portrait of a deceased president without the consent of his widow. 15 U.S.C. § 1052(c) (2012). The mark cannot resemble one previously used if it will cause confusion, mistake, or deception. 15 U.S.C. § 1052(d) (2012). And, the mark cannot be “merely descriptive” or “deceptively misdescriptive” when applied to the applicant's goods. 15 U.S.C. § 1052(e)(1) (2012). Finally, the statute proscribes the registration of a mark that is primarily

\textit{continued...}
include marks that may be confusingly similar to marks already registered.⁸⁶

V. TRADEMARK OBLIGATIONS IN FRANCHISING

The Federal Trade Commission requires that franchisors provide prospective franchisees with a “Franchise Disclosure Document” (“FDD”) prior to the sale of a franchise.⁸⁷ The FDD contains 22 “items” of information that the franchisor must disclose, and it is intended to provide the prospective franchisee with comprehensive information about the franchise, the franchisor, and the franchise system so that the franchisee may make an informed purchase.⁸⁸ Fifteen states have legislation that parallels the FTC Rule,¹⁹ thirteen of which require registration of the franchise offering with the state.⁹⁰ Trademarks are relevant to franchise regulations and laws because the FTC Rule and most state franchise disclosure statutes define a franchise in terms of three requirements, one of which is the grant of a right to the franchisee to use a trademark or commercial symbol in connection with the sale or offer of sale of a product or service.⁹¹ The FTC Rule and state statutes do not require a formal trademark license; if a putative franchisor merely allows the use of its name or mark, the requirement will be satisfied.⁹²

Once it is determined that the arrangement is a franchise, the FTC Rule and state statutes require that the franchisor provide an FDD to a prospective franchise buyer.⁹³ One of the items of information

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“geographically descriptive or deceptively misdescriptive” or that is “primarily merely a surname.” 15 U.S.C.A. § 1052(e)(2) (2012).


⁹⁰ Michigan and Oregon permit the franchisor to file a simple notice that it is selling franchises in the state, but disclosure is required under the state statute. See Mich. Comp. Laws § 445.1502 (1974); Or. Rev. Stat. §650.005(4).


⁹² Permagraphics Int’l, Inc., 2 Bus. Franchise Guide (CCH) ¶6433, Sept. 21, 1982 (if mark is prominently displayed so as to give impression that the putative franchisee is part of the franchisor’s chain, then this element is satisfied, even if the formal agreement between the parties prohibits use of the mark).

required in the FDD is information concerning franchisor’s trademarks.

Under Item 13 of the FTC Rule, the franchisor must describe the principal trademarks, service marks, and other commercial symbols that are licensed to the franchisee, including a statement of whether the marks are registered with the Patent and Trademark Office and, if so, whether the registration is on the Principal or Supplemental Register; whether the marks have become incontestable; and whether all required affidavits have been filed.

If any principal mark has not been registered, Item 13 requires disclosure of whether the franchisor has filed any trademark application, and to identify it. Significantly, if the mark is not federally registered, the franchisor must include this language in the FDD: “We do not have a federal registration for our principal trademark. Therefore, our trademark does not have as many legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses.”

The FDD also requires detailed disclosure of any defects in the rights in trademarks and commercial symbols, such as decisions of the Patent and Trademark Office rejecting a mark for registration, the existence of pending oppositions to the mark, claims or lawsuits challenging the validity of the mark, and agreements that may limit the rights of the franchisor.

The franchisor must also disclose and describe whether it must protect the franchisee’s right to use the marks, whether the franchisee must report any infringements, and other details concerning the rights between the parties. Finally, the franchisor must disclose whether it is aware of any superior prior rights or infringing uses that could affect the franchisee’s use of the marks.

The items called for by the FTC Rule highlight the importance to the franchisor of establishing its rights to a mark in the first instance, and of documenting potentially infringing uses. It is not unusual, for example, for franchisors to have defects or weaknesses in their trademark rights. For example, a franchised moving business called

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94 16 C.F.R. § 436.5(m) (2007).
100 16 C.F.R. § 436.5(m)(9) (2007).
“Two Men and a Truck” had conflicting rights with a system called “Two Guys and Two Trucks” and “Truck and Two Guys Moving.”  

Disclosure statutes raise the questions whether defects in trademark rights are material and the extent of the franchisor’s duty, if any, to investigate or discover other users with identical or similar marks. Since a trademark is of primary importance to the system, defects or potential defects in trademark rights may well be material facts that should be disclosed. A closer question is whether the franchisor has a duty to discover all infringing or potentially infringing uses and what it should do if it discovers any. If, for example, the franchisor has given a naked license to an early franchisee or founder, the ultimate result might be abandonment of the trademark rights; a fact like this should usually be disclosed. On the other hand, an innocent infringement in a geographic area in which the franchisor is not selling franchises might not be truly material, particularly if the infringer is not expanding.

VI. LICENSING OF TRADEMARKS

Trademarks used in a franchise system may be licensed in many ways. Franchisees are licensed to use the franchisor’s trademarks during the term of the franchise agreement. Suppliers may be licensed to place the mark on supplies, equipment, or inventory delivered to the franchisor or franchisees. In addition, area developers or subfranchisors may be licensed to sublicense the trademarks.

The statutory foundation for licensing federally-registered trademarks is Section 5 of the Lanham Act. That section permits a trademark owner to license the use of a trademark by related companies. A related company is one that is controlled by the trademark owner with respect to the nature and quality of the goods or services used in connection with the mark. The courts generally take the position that actual control, not merely the right to control, must be demonstrated for the license to be valid. Failure to exercise

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103 16 C.F.R. § 436.5(m) (2007).
105 Id.
107 Id.
109 Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 368 (2d Cir.)
quality control may result in abandonment of the mark. 110 This statutory duty to enforce quality control underlies the existence and enforcement of quality and uniformity standards in a franchise system. 111 A corollary of this duty is that the trademark owner has a legal obligation to prevent the sale of unauthorized products under the trademark. 112

A license to use a trademark is coextensive with its terms; the mark may be used only in the manner, location, and for the duration permitted by the license. 113 Usually, licenses to franchisees are nonexclusive; distribution licenses for the sale of products in large geographic areas are more frequently exclusive. 114 A license that does not specify whether it is exclusive or nonexclusive will usually be construed as nonexclusive. 115

While a failure to exercise actual control may amount to abandonment, sublicensing itself does not constitute such a surrender where the trademark owner retains control over the nature and quality of goods and services. 116 Thus, arrangements by which a trademark owner licenses the trademark to a company that franchises a product or a service, or arrangements through which a franchisor develops territories through area development arrangements, subfranchising, and other multilayered systems, do not necessarily reflect a loss of control. Provisions of agreements in such arrangements, however, should be drafted so as to ensure continuing oversight by the trademark owner. 117 Although it is not necessary that there be formal

111 See Mini Maid Services Co. v. Maid Brigade Sys., Inc., 967 F.2d 1516 (11th Cir. 1992); Dawn Donut Co., 267 F.2d at 364.
112 Dawn Donut Co., 267 F.2d at 364.
113 ALAN N. RIESREICH & HENRY J. SOMMER, COLLIER GUIDE TO CHAPTER 11: KEY TOPICS AND SELECTED INDUSTRIES (2013).
quality control provisions for a trademark owner to retain rights to the trademark, where there is absolutely no control, formal or informal, it is a naked license.\textsuperscript{118}

It is of great importance that the license agreement defines clearly the rights being licensed. For example, a license agreement was found to be ambiguous when it granted the licensee a nonexclusive, nontransferable license to use a particular trademark, “together with all the rights and privileges of the licensees under programs developed for licensees” of the licensor.\textsuperscript{119} The "rights and privileges" clause may have expanded the scope of the license so as to provide the licensee with the right to an exclusive three-mile radius, as promised by the licensor in certain policy and promotional materials.\textsuperscript{120}

\textbf{VII. INFRINGEMENT ACTIONS}

Section 16 of the Lanham Act\textsuperscript{121} provides that the owner of a registered mark may sue a person who, without consent of the owner, uses in commerce a reproduction or “colorable imitation” of a registered mark in connection with the sale, offer for sale, distribution, or advertising of goods or services, when the use of such imitation is likely to cause confusion.\textsuperscript{122} Damages and injunctive relief are available for infringement.\textsuperscript{123}

A plaintiff pursuing an infringement action must demonstrate that its mark is protectable; that the defendant’s use is without the owner’s permission, and that defendant’s use of the mark is likely to cause confusion among consumers.\textsuperscript{124} In determining whether there is a likelihood of confusion or deception, the courts look to several factors: the type of the trademark, the similarity of design, the similarity of the product, the identity of retail outlets and purchasers, the similarity of advertising media used, the defendant's intent, and actual confusion.\textsuperscript{125} Where a franchisee materially defaults under a franchise agreement

\begin{footnotesize} 
\textsuperscript{118} Barcamerica Intern. USA Trust v. Tyfield Importers, Inc., 289 F.3d 589, 596 (9th Cir. 2002).
\textsuperscript{119} May v. Roundy’s Inc., No. 92-3182, 188 Wis. 2d 78, at *2 (Wis. Sept. 13, 1994).
\textsuperscript{120} Id. at *3.
\textsuperscript{124} Virgin Enters. Ltd. v. Nawab, 335 F.3d 141, 142 (2d Cir. 2003); Packman v. Chicago Tribune Co., 267 F.3d 628, 638 (7th Cir. 2001).
\end{footnotesize}
and the agreement is validly terminated, but the franchisee continues to use the franchisor’s marks without the franchisor’s consent, the continued use is unlawful under the Lanham Act and constitutes likelihood of confusion as a matter of law.\textsuperscript{126} A franchisor is usually entitled to obtain a preliminary injunction against a terminated franchisee’s continued use of the franchisor’s marks.\textsuperscript{127}

The limits of confusion as to sponsorship or affiliation were explored in one franchise case.\textsuperscript{128} There, the plaintiff and the defendant were sublicensees in adjacent geographic territories of the trademark and other properties associated with “Big Boy” hamburgers.\textsuperscript{129} The defendant had done business as “Shoney's Big Boy” in a territory adjacent to plaintiffs, then sought to open restaurants in the plaintiff’s territory as “Shoney's Towne and Country.”\textsuperscript{130} Plaintiff Frisch’s contended that the public associated the name “Shoney’s” with the “Big Boy” trademark such that use of the Shoney name in its territory would confuse prospective purchasers.\textsuperscript{131} The court denied an injunction upon the grounds that proof of confusion “by association” was inadequate.\textsuperscript{132}

The franchisor may, in the franchise agreement, provide for protection in addition to its common law and statutory rights, particularly if the marks have not been registered or become incontestable or if they may be subject to attack as lacking validity.\textsuperscript{133} A clause in the franchise agreement in which the franchisee agrees that the marks are valid and are the property of the franchisor will usually estop the franchisee from claiming otherwise.\textsuperscript{134} Interestingly, where a


\textsuperscript{127} S \& R Corp., 968 F.2d 371, 379 (3d Cir. 1992); Century 21 Real Estate LLC v. All Prof'l Realty, Inc., 2011 WL 221651 (E.D. Ca. Jan 24, 2011).


\textsuperscript{129} Id. at 1262.

\textsuperscript{130} Id.

\textsuperscript{131} Id.

\textsuperscript{132} Id. at 1271.

\textsuperscript{133} See Foremost Corp. of America v. Burdge, 638 F. Supp. 496 (D.N.M. 1986).

distribution agreement stated that the distributor could not carry any product that was imitative of, or that could be passed off in unfair competition with the manufacturer’s products, as determined by the manufacturer, the contract’s unambiguous language provided that the manufacturer could make the determination of unfair competition.\textsuperscript{135} The language of the contract did not require the manufacturer to compare the two products in their containers; they could be otherwise compared by the manufacturer.\textsuperscript{136} Indeed, a franchisor may have to prove that the goodwill associated with a product or service in a particular location is its goodwill, not that of the franchisee, unless there is such a clause.\textsuperscript{137}

The franchise agreement, moreover, may provide for protection of intellectual property that cannot be protected under trademark or unfair competition laws.\textsuperscript{138} For example, in one case, the court found that a prohibition upon a distributor’s sales of corn chips in a brown bag similar to that of the manufacturer could be enforced since the brown bag was similar to, but perhaps not confusingly similar to, the bag marketed by the licensor.\textsuperscript{139} In another case, a contract provision prohibiting use of the “days of the week” was construed in light of another contract provision prohibiting use of five named days of the week; one of the excepted days was Saturday.\textsuperscript{140} Thus, a restaurant chain called “Friday’s” could not enjoin the use of “Saturday’s” for a similar establishment on the basis of that contract.\textsuperscript{141}

VIII. Practical Steps For Protecting Trademarks

A franchise system should have an employee or officer whose responsibilities include maintaining and enforcing trademark rights. This person should be responsible for monitoring possible infringements and complaints from the public of imitations and for seeing that affidavits of use are timely filed with the Patent and Trademark Office.\textsuperscript{142} A franchise system also should have a thorough, ongoing training program on the proper use of trademarks and the

\begin{itemize}
\item \textsuperscript{135} Swire Pac. Holdings, Inc. v. Dr. Pepper/Seven-Up Corp., 1997 WL 153794, at *1 (Tex. App. Apr. 3, 1997).
\item \textsuperscript{136} Id. at *3.
\item \textsuperscript{137} See Heaton Distrib. Co. v. Union Tank Car Co., 387 F.2d 477, 484 (8th Cir. 1967).
\item \textsuperscript{138} See Frito Lay, Inc. v. So Good Potato Chip Co., 540 F.2d 927, 929 (8th Cir. 1976).
\item \textsuperscript{139} Id. at 931.
\item \textsuperscript{140} T.G.I.Friday’s, Inc. v. Int’l Rest. Group, 405 F. Supp. 698, 710 (M.D. La. 1975), aff’d, 569 F.2d 895 (5th Cir. 1978).
\item \textsuperscript{141} Id.
\item \textsuperscript{142} See 15 U.S.C. §§ 1058(a), 1059 (2012).
\end{itemize}
preservation of trade secrets. Significant points that should be included are:

(1) Trademarks should always be used as adjectives, not nouns or verbs, lest they become descriptive or generic; this is particularly true with respect to internal use of the marks within a company.  

(2) The use of descriptive words in close proximity to a mark (e.g., “Contac” brand decorative adhesive paper) distinguishes the mark as a trademark.

(3) Trademarks should always be identified as such, either by the symbol “R” for registered marks or “TM” or “SM” for unregistered trademarks or service marks.

(4) Trademarks should not be corrupted or varied unless the owner intends to use the variants as trademarks themselves. Thus, if the mark “SMITH’S” is applied to restaurants, “SMITTY’S” should not be used as a diminutive form of the name unless it is done deliberately, in which case it should be treated as a separate mark.

Employees and franchisees should be instructed to be alert to the use of marks similar to those of the franchise system and to report them to the person charged with enforcing trademark rights.

Upon discovery of a potential infringement, the franchisor should usually send the infringer a letter, informing the infringer that the franchisor is the owner of the mark and that proceedings to enforce its rights might follow if the infringer does not cease the infringing use.

143 See Donald F. Duncan, Inc. v. Royal Tops Mfg. Co., 343 F.2d 655, 660-61 (7th Cir. 1965) (describing how “yo-yo” became generic through improper use by owner of the mark for a toy); Dixi-Cola Laboratories v. Coca-Cola Co., 117 F.2d 352, 357-58 (4th Cir. 1941) (finding the term “cola” had become generic); Dry Ice Corp. of America v. Louisiana Dry Ice Cor., 54 F.2d 882 (5th Cir. 1932) (addressing the protectability of the term “dry-ice”).


147 SARA YEVICS BECCIA, ESQ. ET AL., INTELLECTUAL PROPERTY PRACTICE continued . . .
Such a cease-and-desist letter will, at the least, put the infringer on notice of the owner’s rights so that further infringing uses will be at the infringer’s own risk; the letter also may negate a finding of laches, abandonment of the mark, or acquiescence in the infringing use. If the infringer persists, litigation should be considered to enjoin the infringement.  

Whether to litigate will depend upon the type of infringement, the impact of the infringement upon the rights of the plaintiff, and whether the infringer has some claim of right or defense to the action. In some franchise cases, for example, infringement litigation has produced the unanticipated result that the infringing use would be permitted to continue in some circumstances.  

A complete record of each potential infringement should be kept, together with a record of the action taken.  

As between franchisors and franchisees, the most important step that the franchisor must take with respect to maintaining the value of its marks is enforcement of standards concerning the quality and nature of the products or services offered under the marks. “[C]lose supervision over distribution outlets is essential to guard against an inferior product” and consequent dilution of the value of the mark. The measures appropriate for any given franchise system will differ according to the nature of the industry; in any event, the control should be actively exercised.  

In addition, the franchise agreement should contain covenants by the franchisee that it will use and preserve rights in trademarks in accordance with the franchise agreement and the franchisor’s instructions. Those instructions, which should parallel instructions to employees on the proper use of marks, should be set forth in detail in the operations manual or similar permanent document and should be the subject of training of franchisee principals and franchisee employees. Franchisees also should undertake in the franchise

§ 6.7.3(a) (2nd ed. 2011).
149 Id.
150 BECCIA, supra note 147, at § 6.7.3(c).
151 See generally id. at § 6.7.3 Practice Note.
agreement to report to the franchisor any misuse of the franchisor’s marks and any apparent infringement.

Another important aspect to preserving rights in a mark is the avoidance of inadvertent abandonment when use of a trademark is discontinued or suspended. Abandonment of a mark may be inferred from nonuse for a continuous period of three years.155 Hence, a franchise system should be careful to keep marks in use, at least every two years, if it wishes to avoid the claim that the mark was abandoned. This issue also may arise unexpectedly as the result of discontinuance or suspension of a product line; obviously, the person responsible for trademark usage should take steps to avoid inadvertent loss of a trademark as the result of deliberate discontinuance of a product line.

JUSTICE DELAYED IS JUSTICE DENIED? THE PRINCIPLE OF BIFURCATION IN THE GERMAN PATENT LITIGATION SYSTEM

Charleen Fei†

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German courts are currently one of the most influential jurisdictions in which to conduct patent litigation. The specialized district courts of Germany handle nearly a thousand cases a year, constituting about sixty to seventy percent of all patent infringement cases filed annually in the European Union. However, patent litigation in Germany has a unique feature—bifurcation of infringement and validity proceedings. In a typical case of patent infringement, the defendant will usually try to raise two types of defences—that the defendant’s actions fall outside the exclusive scope of the patent, or that the defendant’s actions do infringe the scope of the patent right, but the infringed patent is actually invalid.

In German patent litigation, this type of invalidity defence is not available to the defendant, as patent infringement and nullity actions are not heard in the same instance. Because deciding the validity of a patent is technically an administrative act, nullity actions lay exclusively in federal jurisdiction—namely, of the Federal Patent Court. Patent infringement, on the other hand, is a civil matter, and here the Landgerichte and Oberlandesgerichte (District Courts and Court of Appeals) have jurisdiction. This federal–civil divide has been formally maintained in the German legal system through the system of bifurcation.

Despite the major importance of Germany as a patent jurisdiction, there has been little literature about the impacts of bifurcation on its patent litigation system. This thesis aims to answer the following question: “What are the consequences of the bifurcation in German patent litigation for the global patent ecosystem?” This thesis will argue that in spite of purported benefits of bifurcation, which have been argued as increased technical expertise or monetary/time efficiency for the parties involved, bifurcation has resulted in a German patent litigation system which is heavily skewed towards the plaintiff. As the German court system is the most trafficked in Europe and the third most trafficked in the world for patent litigation, this underlying bias of the legal system has the potential to become a dangerous fault line in the preservation of a patent system that provides the proper incentives for technological innovation.

The structure of this thesis will start with a discussion of the role of the German market as well as the German court system in European patent litigation. This will be followed by a descriptive overview of the procedural facets of patent litigation in Germany. The thesis will then offer a more in-depth analysis of one particular procedural aspect: the bifurcation of patent infringement and revocation proceedings to two different courts. This analysis will explain the historical roots of bifurcation, followed by an articulation of the two main critiques of bifurcation. Namely, these critiques focus on the time lag between infringement and revocation decisions and differing claim interpretations between the infringement and nullity court. The final section will return to the question of whether bifurcation has impacted the German patent litigation system, and what remedies might be able to ameliorate the biases of the current system.
I. ACRONYMS AND ABBREVIATIONS

EPC = European Patent Convention

EPO = European Patent Organization

DPA = Deutsches Patentamt, German Patent Office

DPMA = Deutsches Patent-und Markenamt, German Patent and Trademark Office

FRAND = Fair, Reasonable, and Non-Discriminatory

BGH = Bundesgerichtshof, Federal Supreme Court

NZB = Nichtzulassungsbeschwerde, Complaint against denial of leave to appeal

OLG = Oberlandesgericht, Court of Appeals

PI = preliminary injunction

PPP = purchasing power parity

PATG = Patentgesetz, Patent Act

ZPO = Zivilprozeordnung, Code of Civil Procedure
II. INTRODUCTION

Patent rights in the European Union are unlike patent rights in any other territory. On the one hand, many substantive aspects of the patent system are harmonized across national laws through the European Patent Convention (EPC), a treaty that has binding legal effect for thirty-eight European states.\(^1\) The EPC provides for a uniform patent system administered through the European Patent Organization, as well as European patents based on this patent system that are issued through the European Patent Office (EPO).\(^2\) On the other hand, a parallel system of national patent laws rests alongside the European patent system. These are the patent acts of each individual state, which give legal effect to nationally-granted patents and grant exclusive enforceability for the area of the national territory.

The reluctance of European states to give up their national patent law systems, coupled with the evident push of the EPC towards a patent law harmonized across the contracting states, has resulted in a somewhat awkward legal construction. A patent holder filing for a European patent will designate which contracting states he or she wishes the patent to have exclusive scope.\(^3\) These designated states will then validate the patent, allowing it to be enforced in the national territory of that state.\(^4\) These validated European patents will, under the EPC, have some legal conditions and exclusive scope as national patents.\(^5\) This is why European patents are often construed as a “bundle of national patents,”\(^6\) or a bundle of nationally-enforceable patent rights.

European patents, then, are assessed through both the European system and the national patent law systems chosen by the patentee. European patent grant activity is conducted through the EPO Examining Divisions, Opposition Divisions, Boards of Appeal, and Enlarged Boards of Appeal.\(^7\) As the patent rights are validated by each designated state, the members of national patent law authorities oversee the determination of the final scope of the patent. Due to the splintered nature of the patent after validation, assertion of

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\(^2\) Id.

\(^3\) Id. at art. 79.

\(^4\) Id. at art. 64.

\(^5\) Id.


\(^7\) Id.
the patent through litigation and revocation through nullity actions are also handled by the national courts of each contracting state for which the patent was validated.\footnote{Id.}

In this way, each validated piece of the European patent bundle is able to capture the entirety of the exclusive rights granted to its original European patent for that designated territory. At the same time, the “bundled” approach allows the contracting national member states to control the fate of its “copy” of the patent. As the EPC has only harmonized some substantive issues of patent law, such as patentable subject matter, minimum length of protection, criteria for granting patents, priority, scope of the patent right, but not others—compulsory licensing, indirect infringement, patent litigation and nullity procedures\footnote{Id. at 4.}—there is much room for the national member states to interpret the patent according to their own judicial traditions. In the end, this means that the European patent will undergo different infringement and validity determinations in each national forum. For example, the same European patent may be invalidated in the United Kingdom, while in Germany it may be held valid and infringed as asserted\footnote{See id.}.

The strategic importance of understanding these differing national patent litigation regimes cannot be understated. Many patent-wielding companies are large, multinational corporations spanning many jurisdictions, or companies belonging to industries such as pharmaceuticals in which revenues from a patent in one country can easily compensate for the costs of litigation in many others.\footnote{Joff Wild, Finding a Way Through the EU Patent Litigation Maze, INTELL. ASSET MGMT., Sept.–Oct. 2011, at 68.} In other cases, the concentration of patent litigation in one national forum can be more beneficial. For example, patents essential to the MPEG-2 standard have for the most part been litigated in Germany, perhaps due to its status as a powerhouse of electronics engineering.\footnote{Id.} In both cases, an understanding of how the national patent litigation systems operate—what procedural and institutional biases each system might have—gives rise to a clearer grasp about how much power lies in the patent right.

Germany occupies a particularly important position in the system of national patent regimes. As the fifth largest economy in the world and the largest in the European Union (in PPP),\footnote{World Economic Outlook Database: Report for Selected Countries and Subjects (2013), INT’L MONETARY FUND, continued . . . } Germany is one of
the most important markets in the world which can be secured through exclusive patent rights. The domestic industries, strongly export-oriented and reputed for quality high tech engineering and automotive products, have also made much use of the patent system to protect their investments. German inventors file the third most number of patent applications in the world, after Japan and the United States. German courts—though not specialized per se—are renowned for their high level of expertise regarding patent cases. The same can be said for German patent attorneys and attorneys at law. It is likely that the expertise of the German patent law body and the number of protected patent rights in Germany, coupled with the devastating impact of securing an injunction on the German market, all contribute to why over two thirds of all patent claims in Europe are filed in Germany.

It is unsurprising that the German system is subject to much criticism and controversy, with so much value in the form of patents disputed in its courts. The most controversial issue is that of bifurcated proceedings, in which the validity and infringement actions are heard by two separate courts. This system is seen as being highly—perhaps overtly—patentee friendly, to the detriment of global technological innovation. As one of ten countries in the world that incorporate bifurcated proceedings into the patent litigation system, Germany is certainly not alone in this controversial practice. However, it is the most important and influential one for


14 See generally Wild, supra note 11, at 86.


18 See id.

the patent sphere. In an increasingly globalized market in which German courts have great international significance and authority, an understanding of the German patent system—and in particular, its unique trait of bifurcation—will facilitate an understanding as to the changes in and future prospects of the global patent ecosystem.

This thesis will start with a discussion of the German court system. This will be followed by a descriptive overview of the procedural facets of patent litigation in Germany, covering infringement and nullity proceedings. The thesis will then offer a more in-depth analysis of one particular procedural aspect: the bifurcation of patent infringement and revocation proceedings to two different courts. This analysis will begin with the historical roots of bifurcation, followed by a critique of bifurcation which will examine the time lag between infringement and revocation decisions, as well as differing claim interpretations between the infringement and nullity court. The final section will offer conclusions based on this analysis.

III. GERMAN PATENT LITIGATION: A PROCEDURAL OVERVIEW

A. The Court System

1. Courts of First Instance

Both federal and civil courts in Germany have jurisdiction over patent litigation.\(^{20}\) There are no designated patent courts in Germany, as over 120 civil district courts (Landgericht) technically have jurisdiction over preliminary injunctions and exclusive jurisdiction on infringement proceedings.\(^{21}\) However, the sixteen federal states (Bundesländer) in which these district courts are located have, through statutory orders granted by the German Patent Act, conferred exclusive jurisdiction on patent infringement to only twelve courts.\(^{22}\)

Infringement proceedings can thus be initiated by filing a claim in one of these twelve district courts, each of which has at least one specialized patent dispute chamber (Patentstreitkammer).\(^{23}\) Each of these patent dispute chambers consists of three judges who are

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\(^{20}\) LUGINBUEHL, supra note 6, at 26.

\(^{21}\) Id.

\(^{22}\) Patentgesetz [PatG] [Patent Act], May 5, 1936, BUNDESGESETZBLATT, TEIL I [BGBl.I] at § 143(2) (Ger.).

legally-trained. Though these judges generally do not have a technical background, they deal exclusively with patent and utility model infringement and therefore have developed vast expertise and technical insight in these fields. In particular, the patent chambers at the Düsseldorf, Mannheim, and Munich district courts have gained a reputation for their considerable expertise in patent infringement cases, and currently handle at least eighty to ninety percent of the average one thousand patent infringement cases which arise in Germany annually. These cases in turn constitute sixty to seventy percent of all patent infringement cases filed in the Europe Union.

However, the ability for plaintiffs to forum-shop has led to a sort of “market competition” between the German district courts, particularly among Düsseldorf, Mannheim, and Munich. For example, Düsseldorf hears the highest number of cases at about 600 pending cases a year, and is about to have a third patent infringement chamber, which will allow it to hear more cases more quickly and thus better “compete” with Mannheim and Munich. Although these two courts still hear fewer cases than Düsseldorf, averaging 250 and 100 cases a year, respectively, the growing case backlog at Düsseldorf has led to a lengthier first instance infringement proceeding, and plaintiffs looking for quicker judgments have found the courts at Mannheim and Munich increasingly appealing. In particular, Mannheim has tried to attract plaintiffs to file suit at its court by shortening its first instance proceeding to only seven or eight months in comparison to the nine to twelve months needed at Düsseldorf.

24 Id.
25 Id. at 29.
27 HARHOF, supra note 26, at 27.
28 Id. at 16-17.
30 HARHOF, supra note 26; Interview with Dr. jur. Carl-Richard Haarmann, Attorney at Law and Partner at Boehmert & Boehmert (July 12, 2012).
Further, in a struggle to become a local division patent infringement court in a unitary European Patent system,\textsuperscript{32} Mannheim has tried to raise the average number of cases it hears in a year by being even more favorable to patent owners than Düsseldorf.\textsuperscript{33} This type of patentee-friendly behavior by the Mannheim court was exhibited during the May 2, 2012 ruling of *Motorola Mobility v. Microsoft*, which dealt with standard essential patents on certain video-compression software in products, including Windows 7 and Xbox software.\textsuperscript{34}

Typically, holders of patents that are essential to a standard can only charge royalties which are considered “fair, reasonable, and non-discriminatory” (FRAND).\textsuperscript{35} Accordingly, parties charged with infringing standard essential patents would be able to claim—under certain conditions—that they were forced to infringe because the licensing royalties charged by the patent holder were too high, and thus did not conform to the FRAND standard.\textsuperscript{36} This claim would constitute a FRAND defense, and would typically be an additional defensive option in addition to filing a nullity action.

\textsuperscript{32} According to many practitioners, the competition to be the local division patent infringement court has caused Mannheim and Düsseldorf to engage in increasingly patentee-friendly behavior. This is because the decision of which court will be the German local division patent infringement court—and other decisions related to promotion of judges—are evaluated on the basis of judicial experience. A judge who has presided over more patent infringement cases will be seen as more experienced, and therefore more promotable, than one who has not. Therefore the role of the judge’s personal ambitions in the patentee friendliness of Mannheim and Düsseldorf should not be underestimated.

\textsuperscript{33} Haarmann, *supra* note 30.


\textsuperscript{35} This standard is set in order to try to prevent abusive anticompetitive effects of granting a patent monopoly on a technology that is necessary to meet an industry standard. Setting royalties that conform to this FRAND standard has been a very controversial topic. However, at the very least, these royalties must be set at the lower end of the scale.

\textsuperscript{36} In Germany, these conditions have been articulated by the *Orange Book Standard* ruling. First, the prospective licensee must have first approached the licensor with an unconditional offer, which the licensor could not have refused without violating competition law principles. Secondly, the potential licensee must act as though it has already secured the license by, for example, depositing said offered license fee into an escrow account. Florian Mueller, *Mannheim Court Continues to Weaken the FRAND Defense -- Bad News for Apple, Nokia, HTC, Others* (Feb. 9, 2012), http://www.fosspatents.com/2012/02/mannheim-court-continues-to-weaken.html.
In *Motorola*, the Mannheim court forced Microsoft to stay nullity proceedings contesting the validity of Motorola’s asserted standard essential patent in order for the court to consider a FRAND defense—to, in effect, choose between either a FRAND defense or an invalidity defense. 37 The court argued that to assert that the patent in question was invalid would not fulfill the second condition of the *Orange Book Standard*—that the prospective licensee must act as though it has signed a license agreement. 38 In an extreme interpretation of the *Orange Book Standard* ruling, the Mannheim court also stated that only in cases where there was an “obvious violation” of antitrust law in the rejection of a licensing offer would the court deny an injunction on allegedly-infringing embodiments of standard essential patents. 39 In comparison to Mannheim and Düsseldorf, Munich is generally seen as being the most “defendant-friendly,” and therefore attracts the fewest number of plaintiffs. 40

a. The Federal Patent Court

In contrast to the twelve district courts that have jurisdiction on patent infringement issues, the *Bundespatentgericht* (Federal Patent Court) is exclusively competent to handle patent nullity proceedings. 41 Based in Munich, the Federal Patent Court is composed of chambers, or senates, which are separated into chambers for appeal and nullity chambers for deciding on patent validity. 42 Each nullity chamber is composed of five judges, of which three have technical training and two are legally trained, with the presiding judge always a judge with legal training. 43

The Federal Patent Court is relatively young court that was established in 1961 through an amendment to the German Constitution, which granted the state the authority to create a

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37 *Id.*

38 This is similar to the United States common law doctrine of licensee estoppel. However, this doctrine was overturned under *Lear v. Adkins*, 395 U.S. 653 (1969) and further under *Medimmune v. Genentech*, 549 U.S. 118 (Wash. 2007).

39 The extremely advantageous ability to enforce injunction based on a standard essential patent was compared by Motorola’s legal team to having a powerful weapon in which, “it takes only one bullet to kill.” For more on these two rulings, as well as English translations of the ruling, see Mueller, *supra* note 34; Florian Mueller, *The German Approach to FRAND: Let’s Err on the Side of Injunctions* (May 23, 2012), http://www.fosspatents.com/2012/05/german-approach-to-frand-lets-err-on.html.

40 Haarman, *supra* note 30.

41 *PATG* AT § 65(1).

42 *PATG* AT § 66(1).

43 *PATG* AT § 67(2).
specialized court for intellectual property disputes.\textsuperscript{44} Prior to its creation, patent nullity and revocation was decided solely by the Deutsches Patentamt (German Patent Office (“DPA”), now Deutsches Patent- und Markenamt (“DPMA”)) in an effort to maintain consistency concerning patent applications.\textsuperscript{45} The proceedings before the DPMA were subsequently classed as administrative acts by the Bundesverwaltungsgericht (Federal Administrative Court).\textsuperscript{46} However, implementation of that decision without the independent judicial body of the Federal Patent Court would have necessitated very complicated legal proceedings, with up to five instances.\textsuperscript{47} Therefore, the existing Nichtigkeitsenate (nullity senates) and boards of appeal in the DPMA were transferred to create a new, independent judicial body.\textsuperscript{48}

The makeup of the Federal Patent Court is conducive to sound judicial rulings on patent validity. Out of the five judges who make up the Federal Patent Court, three must have a technical background, and are assigned to nullity proceedings in their realm of technical expertise.\textsuperscript{49} Because of their technical background, this panel of judges is able to assess the technical configuration necessary to determine patent validity without resorting to an expert opinion.\textsuperscript{50} This not only results in a technically sound judgment which grants patent holders security in their rights, but also nullity proceedings which are more cost effective and time efficient.\textsuperscript{51}

2. Courts of Higher Instance

The decisions of the Landgericht may be appealed to the second instance Court of Appeals (Oberlandesgerich, (“OLG”)), which has

\textsuperscript{44} GRUNDEGEZETZ FÜR DIE BUNDESREPUBLIK DEUTSCHLAND [GRUNDEGEZETZ][GG][BASIC LAW], May 23, 1949, BGBl. § 96(1) (Ger.).

\textsuperscript{45} Eustace Hopkins, HANDBOOK OF THE GERMAN PATENT LAW preface (1902).

\textsuperscript{46} LUGINBUEHL, supra note 6, at 25.

\textsuperscript{47} \textit{Id.} (citing RÜDIGER ROGGE, \textit{preface to DIE ZUSTÄNDIGKEIT DES BUNDESGERICHTSHOFES ALS BERUFUNGSNSTANZEN IM PATENTNICTIGKEITSVERFAHREN—EIN ALTER ZOPF?, in GEBUNDENE AUSBAGE, FESTSCHRIFT FUR WALTER OEDERSKY ZUM 65 GEBURTSTAG AM 17. JULI 1996 639, 642-643 (Reinhard Böttcher ed., 1996)).

\textsuperscript{48} \textit{Id.}

\textsuperscript{49} LUGINBUEHL, supra note 6, at 25.


competence to decide on matters of both fact and law. However, appeals are limited to those cases which have disputed values of over 600 EUR, or in which there is a matter of great legal significance for the development of the law or maintenance of uniform adjudication. As in the District Courts, three judges with legal training sit on the Senate of the Court of Appeals. Theoretically speaking, the OLG conducts a de novo study of the case. However, since the revision of the German Civil Procedure Act in 2002, appellants must specify exactly how the first instance court erred in establishing the facts of the case in order for the OLG to perform a de novo review of the facts. Therefore, the OLG gives deference to the facts established by the first instance court in most cases. In practice, about a third of district court judgments are appealed to the Oberlandesgericht.

From the Court of Appeals, a further appeal may be made to Bundesgerichtshof (Federal Supreme Court (“BGH”)). This is the court of last instance for both nullity and infringement proceedings, though appeals against the decision of the Federal Patent Court in nullity proceedings are filed directly at the BGH with no intermediary appellate court. Located in Karlsruhe, the Federal Supreme Court is divided into twenty-five senates composed of five judges each.

Patent appeal matters are heard by the Tenth Senate of the Federal Court of Justice of the BGH. These judges, all of which have legal training but not a technical background, are recruited from patent infringement chambers and senates of District and Appellate courts as well as the Federal Patent Court, and are specialized in handling intellectual property issues. One criterion that is particular to the BGH is that attorneys at law who wish to represent a client before the BGH must be admitted to its exclusive bar. Patent attorneys, however, are entitled in invalidation proceedings to represent clients without additional qualifications and even without the assistance of an attorney at law.

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52 Luginbuehl, supra note 6, at 29.
54 Goddar & Haarmann, supra note 17, at 68.
55 See ZPO § 529(1).
56 Luginbuehl, supra note 6, at 30.
57 Id.
58 Id.
59 Goddar & Haarmann, supra note 17, at 68.
60 Id.
61 Id. at 69.
62 Id.
Federal Supreme Court revisions of patent infringement cases only arise in appeals concerning a point of law, and require the Court of Appeals to expressly allow the appeal in its judgment, or the BGH to allow the appeal based on a complaint by a participating party.  

Similar to the OLG, BGH revisions arise only if an issue to be decided is of basic importance or if the decision is necessary for the further development of the law or uniform adjudication. This decision can be unconditionally enforced without a security deposit.  

“In most cases, only a general decision on awarding of damage claims can be made, with the specific amount of damage claims to be determined only following full disclosure of information.”

In contrast to infringement appeals, a nullity appeal before the BGH comprises a de novo review of both the factual and legal questions of the case. Judgment is rendered at the end of the oral hearing and remanded down to the Federal Patent Court if the appealed court order has been reversed. Further, this judgment is final and effective immediately with no possibility of appeal or dissenting opinion—the Federal Patent Court is bound by the legal assessment of the BGH. There are three possible outcomes: the patent is maintained, maintained with amended and limited claims, or declared invalid as covered by the German designation of the European patent.

B. Procedural Aspects of Infringement Proceedings

1. Preliminary Injunctions

German national patents and European patents with effect in Germany allow the patent holder to enforce sole, exclusive rights. If a patent proprietor feels that his or her patent right has been infringed, German and European Union law grants the patent holder the right to file for a cease and desist order—commonly known as a preliminary injunction (PI)—on the allegedly infringing product.
A PI order is obtainable by having an attorney at law file an application for injunctive relief at a civil court possessing the relevant jurisdiction. This is typically over areas where infringement took place or at the business seat or domicile of the defendant. In order to secure a PI order from the court, the plaintiff must clearly prove three issues: that he or she is the proprietor of a valid patent right enforceable in Germany, that there is an obvious and easily understood case of infringement and that curtailment of the purported infringement is urgent. Regarding this last point, at least the courts of Munich and Düsseldorf will usually require that the plaintiff file the application for the PI order within a month of cognizance of the infringement.

After receiving the application, the court will typically reach its decision to reject the requested PI order, grant it, or order oral proceedings in no more than forty-eight hours. The Zivilprozessordnung (Code of Civil Procedure) does not require any kind of mandatory oral hearing or discovery prior to the issuance of the PI order—this is one of the reasons why German courts are able to deliver swift judgments for a preliminary injunction. However, the court will generally order oral proceedings unless patent in question has had a history of unsuccessful opposition or nullity litigation. One way for a defendant to elevate the chances of a court requesting oral proceedings is to file a protective memorandum or protective writ, as well as filing a nullity action or nullity complaint and attaching it to the protective memorandum. This will typically raise

Parliament and of the Council of 29 April 2004 on the Enforcement of Intellectual Property Rights, art. 9. This right, with which a patent proprietor can always access a preliminary injunction, differs greatly from the rights of a patent holder in the United States, who must first satisfy the *Ebay v MercExchange* “four-factor test” in order to be entitled to a PI order.


74 *Id.*

75 *Alexander R. Klett, Matthias Sonntag & Stephan Wilske, INTELLECTUAL PROPERTY LAW IN GERMANY: PROTECTION, ENFORCEMENT, AND DISPUTE RESOLUTION 26 (2008).* However, the timeline differs from court to court. For example, the court of Hamburg tolerates later filings, even up to 6 months after the applicant discovers the infringing activities.

76 Goddar & Haarmann, *supra* note 73.

77 *Id.*

78 *Id.*

79 A legal instrument filed with the competent courts. The aim is to show lack of infringement by the letter filer, lack of validity of patents which may be infringed, or at least that the matter is too complicated for a PI order to be granted *ex parte*. See also Goddar & Haarmann, *supra* note 73.
doubt on the validity of the asserted patent right and encourage the court to order oral proceedings prior to the issuance of the PI order.\textsuperscript{80}

If the court decides to grant a PI order, it will notify the applicant, who must then serve the judgment to the alleged infringer within one month of the grant.\textsuperscript{81} “A preliminary injunction of a civil court must be unconditionally observed by the opposing party immediately upon being served.”\textsuperscript{82} If there is a violation of the PI order, the court will typically issue a large monetary fine of up to 250,000 EUR or a six month imprisonment sentence on the party which violated the PI order.\textsuperscript{83}

For many years, German practitioners saw the preliminary injunction as only a theoretical option, because no one could ever remember having successfully obtained one.\textsuperscript{84} This was because infringement courts, in particular the Court of Düsseldorf, had strong principles that complicated issues, such as the principle that patent infringement cases should not be decided without prior oral hearing.\textsuperscript{85} Accordingly, the filing of a protective memorandum was, in the past, an effective preventive measure against unexpected PI orders.

However, the courts of Düsseldorf and Mannheim have apparently moved away from their traditional anti-PI order stance towards a more favorable treatment of PI order applications.\textsuperscript{86} The competition for “market share,” and the prestige of becoming a local division court of the European Unitary Patent have triggered a series of patent-courting changes in these two courts towards the grant of PI orders.\textsuperscript{87} First, the Court of Düsseldorf began to treat PI orders more liberally.\textsuperscript{88} PI orders were usually not granted ex parte, but the court would usually hold two to three week written proceedings, followed by an oral hearing that often resulted in the granting of a PI order.

\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} Id.
\textsuperscript{83} Dieter Kehl & Meiting Zhu, German IP Legal System and Judicial Protection—From the Special Perspective of Temporary Injunction for Exhibition, 21 CHINA INTELL. PROP. (Dec. 2007).
\textsuperscript{84} Haarmann, supra note 30.
\textsuperscript{85} Id.
\textsuperscript{87} Haarmann, supra note 30.
\textsuperscript{88} Id.
Mannheim followed by granting more PI orders ex parte. In turn, Düsseldorf—in particular the 4b chamber—began to grant PI orders in high litigation value cases without oral proceedings or the chance for the targeted party to provide a defense.

These changes have accordingly led to a rise in the number of preliminary injunction applications filed by patent holders wishing to enforce their rights, leading to growing concern among prospective defendants. As practitioners have suggested, almost all PI orders which are issued are enforced, as the risk of the plaintiff enforcing a PI order even if they are not completely sure they can later defend it is not high.

PI orders are often issued before the allegedly infringing product enters the market, so one may assume that damages suffered by the defendant from a PI order would thus be less than the damages from a regular injunction. However, estimates have shown that the defendant suffers damages in at least fifty percent of all cases where there is a wrongful enforcement of a PI order. In an industry such as pharmaceuticals, the enforcement of such a preliminary injunction may effectually sign a “death warrant for the defendant.”

Another exacerbating factor is the flawed and generally unavailable “no-fault liability” remedy within the German Zivilprozessordnung. This provision grants statutory grounds to defendants who have suffered damages due to a wrongly enforced preliminary injunction to file for compensation from the plaintiff, and will be further discussed in a later section. Suffice it to say, the general lack of a security bond necessary for PI order enforcement and the difficulty of successfully enforcing the no-fault liability provision combine for a very favorable situation for the patent holder.

However, it is important to note that the successful application for a preliminary injunction is still quite difficult and far from a standard

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89 Id.
90 Id.
91 Id.
92 Id.
93 Id.
94 Quoted from a conversation with an industry practitioner who was at one time involved in such a case. However, it should be noted that the damages which a patentee can collect for infringement are quite low in comparison to many other jurisdictions, such that the system might overall be slightly more balanced than is usually depicted. See Haarmann, supra note 30.
95 ZIVILPROZESSORDNUNG [ZPO][CIVIL CODE] § 945 (Ger.).
96 Namely, because the patent right turned out to be invalid, or the PI order was later lifted.
97 See discussion infra Section VA.2(b).
case. An estimated five percent of all current patent litigation cases in Germany involve PI orders, most likely all issued by the District Courts of Düsseldorf and Mannheim. At these courts, then, the ratio of cases involving PI orders may be higher than five percent, but not more than ten percent.

Moreover, the courts of higher instance have not indulged in the trend toward granting PI orders, and have made efforts to restrain liberal the tendencies of the District Courts. The Court of Appeals of Düsseldorf is still quite reluctant to issue PI orders, and has lifted several PI orders which were granted in the first instance by the Düsseldorf District Court. Whether these efforts will bear fruit in terms of changes by the lower District Courts remains to be seen.

2. Infringement Proceedings

If the plaintiff does not wish to obtain a preliminary injunction, he or she may directly file an infringement suit in any civil court that has jurisdiction over the alleged infringement case. A typical infringement action will proceed as follows: once selected, the court will serve the defendant with the writ of claims. In the court of Düsseldorf, there is typically a first oral hearing, which takes place approximately four to six weeks after the claim has been served. Formalities and procedural issues compose the bulk of this oral hearing—terms for filing defense as well as counterarguments (Replik) and the second defense (Duplik) are set in this initial oral hearing, and the date for main oral proceedings is fixed. In other courts, preliminary written proceedings substitute for these first oral hearings, and the date for main oral proceedings is typically only fixed after the defence writ.

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98 Haarmann, supra note 30.
99 Id.
100 Id.
101 Haarmann, supra note 30. Dr. Haarmann also noted that the Federal Supreme Court, although it does not have jurisdiction over PI orders, is not happy with the prevalence of PI order grants. He felt that this sentiment, along with the activities of the OLG, indicates that there is “some kind of reverse movement currently going on, with the High Courts trying to fence in a too liberal approach by the District Courts to granting PI orders.” Id.
103 Id. at 139.
104 Id. at 138.
105 Id. at 162.
All facts and evidence must be presented in writing prior to oral hearing. The plaintiff has the burden of proof to submit facts and evidence supporting that the invention as understood from the teachings of the claim has been used, as well as the details of the infringement in case the alleged infringer refutes the alleged infringement as such. The defendant must show that at least one feature is not realized. To prove infringement under the doctrine of equivalence, the plaintiff must show that the defendant’s invention achieves the essential advantages of the allegedly infringed invention to a practically significant extent.

No depositions are allowed in the evidence, and each party must present all evidence in support of its claims and statements, as well as on the disputed facts, in the form of exhibits sent to the court. The court does not investigate facts autonomously, but relies completely on the facts and evidence presented by the parties. Parties may name witnesses, but witness statements are rarely given much weight by the court, as there is no cross examination process and witness statements are rarely sworn in. In addition, parties may present expert opinions and test results, but a court typically does not order expert testimony unless the two parties present contradictory expert statements. Following the parties’ pleadings, the court will render a decision a few days after oral hearing, with written grounds issued after four weeks. The losing party may file an appeal to the Oberlandesgericht within the appeal term, which is one month after the service of the first instance judgment with grounds.

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106 Id. at 199.
107 Id. at 133.
110 However, as articulated below, the courts have demonstrated their willingness to apply provisions of the EU Enforcement Directive for the benefit of the patentee.
112 Radcliffe, supra note 109.
113 Zivilprozessordnung [ZPO][CODE OF CIVIL PROCEDURE], Jan. 30, 1877, Bundesgesetzblatt I [BGBl. I] 3202, as amended, § 517 (Ger.).
The European Union Enforcement Directive—in force since 2006—has presented some new changes to the situation of patent infringement litigation in Germany. Among these changes is a provision in Chapter II, Section 2, Article 6 of the Enforcement Directive, in which courts may order supporting evidence in the control of the defendant be given over to a patent holder who has “presented reasonably available evidence sufficient to support its claims.”

Even more favorable to the patent holder is Article 7 of the Enforcement Directive, which allows a patent holder who has “presented reasonably available evidence to support his/her claims that his/her intellectual property right has been infringed or is about to be infringed” to secure ex parte purportedly necessary evidence from the defendant, including “physical seizure of the infringing goods, and, in appropriate cases, the materials and implements used in the production and/or distribution of these goods and the documents relating thereto.” It is important to note that this provision could be exercised by the court when no actual infringement has occurred yet and, if used abusively, could provide the plaintiff with a way to illicitly gain information about the defendant’s manufacturing processes, distribution channels, or other commercially damaging materials.

Overall, the cost and speed of German infringement proceedings are two of its most highly-regarded and favorable aspects, as the bifurcation of infringement and nullity actions allows judges in patent infringement cases to consider questions of infringement separately from questions related to the examination and validity of the patent, enabling issuance of judgments anywhere between eight months at the

114 Compare 2004 O.J. (L 195) 16, 20 (stating the E.U. position), with PatG § 140(c)(1) (explaining that, under German Law, the plaintiff can require that the defendant hand over any documents or objects in her possession that might “substantiate” the plaintiff’s claims). This procedure had been previously established by a BGH decision in the 2002 case Faxkarte I. See Alexander Duisberg & Henriette Picot, Implementation of EU Enforcement Directive—Codification of Rights to Inspect Infringing Goods, Lexology (Feb. 4, 2009), http://www.lexology.com/library/detail.aspx?g=c3b0434a-eed3-45d4-a2a2-6e40b482a942.


116 There are ways a defendant could curb against abusive evidence taking practices in the German system, such as claiming damages incurred during disclosure of evidence or establishing that there are other ways the IP owner could prove infringement without securing disclosure. Interestingly, one way many practitioners seek evidence disclosure is to file a proceeding on the parallel U.S. patent and use discovery practices to gain information that then can be used in the German proceeding.
district court of Mannheim and twelve months at the district court of Düsseldorf.

Moreover, separate consideration also limits the involvement of court appointed experts, which further reduces the cost and time of proceedings. German practitioners and scholars have often characterized questions of validity as much more technically difficult than those of infringement, and in most cases require an expert technical opinion. However, the general understanding of practitioners is that obtaining an expert technical opinion is expensive and requires a great deal of time. Furthermore, some experts are even sometimes considered to be quite unreliable, and both parties must agree on the expert, necessitating more time and attorney’s fees. Bifurcation thus avoids the involvement of experts in most infringement proceedings, allowing them to be cost effective and time efficient.

Indeed, sample calculations for the total budget needed to litigate on patent disputes support this characterization of the German patent litigation system. For a disputed patent or patent portfolio valued at 1,000,000 EUR the average amount the losing party would have to pay would only be around 229,015 EUR through all three instances of infringement proceedings. This amount includes the cost of paying for the legal fees—namely, court and attorney’s fees—incurred by the winning party as dictated by Germany’s procedural rules. For a disputed patent or patent portfolio valued at five million euro, the average budget needed through all three instances would be 841,015 EUR—far less expensive than the 2,800,000 USD price tag of similarly-valued patent litigation in the United States.

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118 Haarman, supra note 30.

119 Id.

120 Forrester, supra note 1, at 605.

121 Zivilprozessordnung [ZPO][CODE OF CIVIL PROCEDURE], Jan. 30, 1877, Bundesgesetzblatt I [BGBl. I] 3202, as amended, § 91 (Ger.).

122 Forrester, supra note 1, at 605.

123 AMERICAN INTELLECTUAL PROPERTY LAW ASSOCIATES (AIPLA), 2011 REPORT OF THE ECONOMIC SURVEY (2011), available at http://www.aipla.org/learningcenter/library/books/econsurvey2011/Pages/default.aspx. 2.8 million dollars is the cost of patent litigation for disputes valued between one and 25 million dollars; according to the report, 57% of this cost went towards continued...
However, though the overall price is much more affordable for small to medium sized parties, with their correspondingly smaller litigation budgets, the actual interplay of bifurcated nullity and infringement proceedings may exact its own cost—particularly for defendants. This idea will be further discussed in later sections.\textsuperscript{124}

\section*{C. Procedural Aspects of Nullity Proceedings}

Nullity proceedings can be initiated independently of pending infringement action on the same patent if there are grounds for the nullity action,\textsuperscript{125} though they are only admissible after the end of the opposition term and finalization of opposition proceedings.\textsuperscript{126} Proceedings may be filed against the patent as a whole or only selected claims of the patent, particularly if the patent holder asserts that only certain claims in the patent have been infringed.\textsuperscript{127}

The force behind the plaintiff of a nullity proceeding is typically a company being attacked in a parallel infringement proceeding. However, the actual plaintiff could be any third party appointed by the company to file the nullity claim, ranging from a trustee of company board to an appointed representative, and this third party cannot be forced to disclose the party behind him.\textsuperscript{128} Unsolicited nullity actions are also possible, unless there is an abuse of rights such as an unsolicited attack on a large number of patents owned by the same patentee.

A typical nullity action would go as follows: the nullity suit would be filed with Federal Patent Court in Munich.\textsuperscript{129} In addition, written proceedings in the form of two or more writs by each party would be exchanged in preparation for the oral hearing.\textsuperscript{130} Parties

discovery. \textit{Id.}

\textsuperscript{124} \textit{See} discussion \textit{infra} sections VA., VB., & Further Consequences.

\textsuperscript{125} \textit{PATG} AT \S 81(1).

\textsuperscript{126} \textit{PATG} AT \S 81(2).

\textsuperscript{127} \textit{PATG} AT \S 81(1).

\textsuperscript{128} \textit{PATG} \S 99 and \textit{ZPO} \S 325 effectively make a validity judgment binding, such that a plaintiff would not be able to file a second nullity action based on the same grounds of the first failed action. Typically, this plaintiff could hire a representative to file the nullity action. However, a third party representative would not be able to file a second nullity action based on the same grounds of the first if the plaintiff could not file the nullity action because of the previously binding judgment via \textit{PATG} \S 99 and \textit{ZPO} \S 325. Thus, the judgment has \textit{res judicata} effect even for a so-called “straw man.” \textit{PATG} \S 99; \textit{ZIVILPROZESSORDNUNG} [\textit{ZPO}][\textit{CODE OF CIVIL PROCEDURE}], Dec. 5, 2005, \textit{BUNDESGESETZBLATT}, Teil I \textit{[BGBL. I]} at \S 325 (Ger.).

\textsuperscript{129} \textit{HARGUTH \& CARLSON, supra} note 102, at 96-101.

\textsuperscript{130} \textit{Id.}
would be able to submit reports on experiments or expert opinions in these writs.\textsuperscript{131} Prior to the oral hearing, a written opinion on validity of patent in consideration of the submitted writs would be provided to parties by the court.\textsuperscript{132}

Typically, there are no witnesses or experts summoned for the first oral hearing.\textsuperscript{133} The presiding judge introduces into case and court’s opinion. There is a step-by-step approach in the oral proceedings; first, a discussion on novelty is initiated, followed by a discussion on inventiveness. The Court’s opinion resulting from these discussions is conveyed to the parties, with a possible ensuing discussion on auxiliary request. The Court’s decision is either a summoning of witnesses or expert opinion to clarify on a point—a less common occurrence—or a judgment on the proceedings.

For a judgment in nullity proceedings, the patent can be maintained, completely invalidated, or partially invalidated.\textsuperscript{134} This possibility of partial invalidation is the main reason for a patent litigator or attorney at law responsible for infringement proceedings to attend oral hearing in a nullity suit in addition to a patent attorney—in case of partial invalidation, the patent litigator can make certain that the patent maintains useful claims for the continuation of infringement action, as well as verifying that the patent is not maintained with a claim that is hazardous for the infringement case.\textsuperscript{135}

The decision of the Federal Patent Court is always rendered at the end of oral proceedings.\textsuperscript{136} However, this decision is only presented as a rough outline of the court’s reasoning as verbally explained to the parties.\textsuperscript{137} The written judgment without grounds is typically issued within four weeks after oral proceedings, with the full judgment with grounds issued within three to five month after the oral proceedings.\textsuperscript{138}

As previously stated, the decision by the Federal Patent Court may be appealed directly to the Federal Supreme Court. These appeals are very often granted.\textsuperscript{139} However, a problematic aspect of appeals to the BGH is that in these appeals, the BGH performs a \textit{de

\textsuperscript{131} \textit{Id.}
\textsuperscript{132} \textit{Id.}
\textsuperscript{133} \textit{Id.}
\textsuperscript{134} \textit{Id.}
\textsuperscript{135} \textit{Id.}
\textsuperscript{136} \textit{Id.}
\textsuperscript{137} \textit{Id.}
\textsuperscript{138} \textit{Id.}
novo review of the factual and legal questions of the case.\textsuperscript{140} However, the BGH is not a specialized court, and does not have the technical requirements for its judges as does the Federal Patent Court.\textsuperscript{141} It seems, then, that many of the positive consequences of bifurcating nullity proceedings to a technically specialized court are lost in this final appeal.

Problematically, the number of nullity actions initiated has increased substantially over the last decade, leading to a growing backlog of cases awaiting adjudication, as illustrated in Chart 1.\textsuperscript{142}

\textbf{Chart 1: The Federal Patent Court Caseload (in Months)}

![Chart 1: The Federal Patent Court Caseload (in Months)](chart)

The consequences of this caseload is that overall, first instance nullity proceedings require a considerably longer amount of time to process—a little over two years—as compared to the eight to twelve months needed for the first instance district court judgment. This can be seen in Chart 2.\textsuperscript{143}

\textsuperscript{140} Id.
\textsuperscript{141} Id.
\textsuperscript{143} HARGUTH & CARLSON, \textit{supra} note 102.
**CHART 2: THE INCREASING DURATION OF NULLITY ACTIONS (IN MONTHS)**

The nullity appeals process is even lengthier. As the BGH is not a technical court, yet must conduct a *de novo* review of validity issues, court-appointed experts are often used in these appeal procedures.\(^{144}\) As experts typically take two years to come to a recommendation, nullity appeals at the BGH have an average length of five years.\(^{145}\) A 2009 change in the appeal suit procedure sought to make proceedings at the Federal Supreme Court faster, as well as ameliorating the negative consequences of a *de novo* review by a non-specialized court by enforcing that all technical decisions would be made at the Federal Patent Court.\(^{146}\) This effectively removed the necessity of the BGH to regularly obtain court-appointed experts for consultation on highly technical issues.\(^{147}\) However, Federal Patent Court nullity proceedings are bound to become even lengthier, as the necessity of establishing all technical decisions increases the complexity of each case.


\(^{145}\) *Id.*

\(^{146}\) *Id.*

IV. BIFURCATION IN GERMAN PATENT LITIGATION PROCEEDINGS

A. The Historical Roots of Bifurcation

The earliest form of bifurcation in German patent proceedings is found in the first unified patent act of Germany.148 Passed in 1877, the Patentgesetz (German Patent Act) was the culmination of a long struggle between German engineering and industry interests, who saw patents as a way to protect their technical inventions, and their economist counterparts who criticized patent rights as detrimental to commerce.149 When the Patentgesetz finally entered into force, it was accordingly viewed as a triumph for members of the new professional organization of German civil engineers, as well the cementing of bifurcation into Germany’s legal history.150 Perhaps this view of bifurcating nullity and infringement proceedings—as part of a rightly venerable legal tradition—contributes to its vigorous defense today.

However, it is important to note that Germany’s patent law, including bifurcation, is not based on the German legal tradition. This is because uniform statutory patent laws in Germany prior to the enactment of the 1877 Patentgesetz did not exist.151 Prior to the establishment of the German Empire under Prussian Chancellor Otto von Bismarck in 1871, nearly forty free cities, earldoms, kingdoms, and states comprised a large territory that was loosely tied together into a political league termed the German Confederation (Deutscher Bund).152

Although there were some aspects of legal harmonization across the Confederation, such as the establishment of an internal free trade agreement unifying tariff rates (Zollverein), patent laws existed heterogeneously on a state-by-state basis.153 In some territories, patent protection was granted through an administrative regime to remunerate those inventors and manufacturers who had successfully

149 Id.
150 Id.
151 Id.
152 Richard Hudson, The Formation of the North German Confederation, 6 POL. SCI. Q. 424, 424 (1891).
promoted their technologies, though this did not always succeed in practice.\textsuperscript{154} For example, Prussian law offered patent protection, with the tradeoff that publication of patent documents was extremely costly and the term of protection was arbitrary.\textsuperscript{155} In others, the grant of patents—in a display of the historical tension between patent and competition law—was considered by believers of the dominant free trade school to be “monopolies or privileges . . . considered as an obstacle to the free development of art and industry.”\textsuperscript{156}

Even after unification, the need for a uniform patent law system was widely debated. It was only after considerable persuasion by industry interests, as well as the recognition by the German public of the need for patents to create a sustainable and competitive economy, that the German government reluctantly began the process of drafting the first German Patent Act.\textsuperscript{157} In the course of constructing a new patent law system, the German government looked not to its own fragmented legal history, but to the existing models abroad.\textsuperscript{158}

At the time, there were three principal patent laws—those of the British Empire, the French Empire, and the United States of America. After careful study of each system, the German government decided to base its patent legislation on the American system, including retaining a formalistic codification of the American division between the power to decide the validity of a patent and infringement of said patent.\textsuperscript{159}

In the 1887 Patentgesetz, the power to decide validity lay solely with the Patentamt (Patent Office), which could grant patents after a preliminary examination.\textsuperscript{160} Likewise, patents could only be annulled by an action brought before the Patentamt, with no equivalent revocation or annulment action possible by the court.\textsuperscript{161} Patents granted would thus have a “constitutive” or attributive effect.\textsuperscript{162} In other words, German courts—like American courts—assume patent validity during the course of infringement hearing, even if there are ongoing patent nullity proceedings and the patent in question might later be found invalid. Of course, the power to decide the validity of

\textsuperscript{154} Seckman, supra note 148, at 234.
\textsuperscript{155} Id.
\textsuperscript{156} Osterrieth, supra note 51, at 195.
\textsuperscript{157} Seckman, supra note 148, at 238-239.
\textsuperscript{158} Osterrieth, supra note 51, at 196.
\textsuperscript{159} Id. at 197.
\textsuperscript{160} Id.
\textsuperscript{161} Id.
\textsuperscript{162} Id.
a patent in the German patent system was later separated and placed in the jurisdiction of the Federal Patent Court, while the power to
grant patents remained with the German Patent Office. However, the separation of validity and infringement rulings in German patent proceedings—with its roots in a transplanted American legal history—has remained to this day.

V. CONSEQUENCES OF BIFURCATION FOR THE GERMAN PATENT SYSTEM

A. Differing Claim Interpretations Between the Federal Patent Court and Civil Courts

One side effect of a split system is the ability for differing claim interpretations between the infringement action and the nullity action. Commonly termed the “Angora Cat” approach, the argument goes that because infringement and nullity are treated in two separate actions, a patentee will create different claim interpretations for each action. Typically, the patentee will seek in nullity proceedings to construe his patent claims as very narrow, in order to escape revocation. However, the same patent will have a broad claim interpretation in infringement proceedings in order to cover the largest possible scope. This situation can also appear in the actions of the defendant. In the infringement action, an alleged infringer would seek to minimize the inventiveness of the asserted patent in order to exclude their product from the scope of the patent, whereas nullity proceedings would see an enlarged scope of the patent so as to bring it as close as possible to the state of the art.

The judges in the German bifurcated system are aware of this possibility, as evidenced by the BGH decision, which ruled that judges should accurately interpret a patent by applying the same principles of interpretation to the nullity action as to the infringement action, rather than granting one action a more restrictive principle of interpretation than the other. Further, infringement courts will typically view claim constructions arising from the nullity action as persuasive authority.

163 Id.
164 Lord Justice Jacob in a March 19, 2008 ruling: “When validity is challenged, the patentee says his patent is very small: the cat with its fur smoothed down, cuddly and sleepy. But when the patentee goes on the attack, the fur bristles, the cat is twice the size with teeth bared and eyes ablaze.” [EWCA Civ 192—European Centr. Bank vs. Document Sec. Sys. Inc.].
165 Meier-Beck, supra note 147 (citing BGH blasenfreie Gummibahn I (Bubble-less Gummy Track), 2004 GRUR 47).
However, there are several situations in which handling claim interpretation in two separate actions may become problematic. If the nullity action reaches a decision upholding a patent under a certain claim interpretation, is this claim interpretation binding for the appellate infringement court? Even if the nullity action has not reached a decision, is the claim interpretation presented by the patentee in this action binding for the parallel infringement action? If the nullity action restricts or revokes the patent, does this amendment or revocation retroactively affect the decision of the infringement court?

These types of questions have typically been answered by BGH decisions and the case law established therein. As the BGH is the court of last instance for all patent disputes in both infringement and nullity actions, the BGH handles infringement appeals from the OLG as the Supreme Court of Appeals in procedure called a Revision. In nullity proceedings, the BGH is the direct court of appeal.

As the court of final instance, the BGH has considerable power to create case law rectifying differing claim interpretations. For example, the BGH case Ziehmaschinenzugeinheit (Drawing Machine) ruled that if the patent in question was partially revoked, the new patent claim construction resulting from this nullity decision would form the basis for claim construction of the patent in an infringement action. In a similar situation where the patent was partially revoked but there were pending infringement proceedings, the BGH ruled that the limited claim is binding on the infringement court such that the infringement court must consider the limited claim before rendering a decision. In addition, the BGH stated that to avoid a stay by the district court—a great possibility previously due to the presence of new limited claims—the patent holder could amend its infringement action according to the new

\[166\] See supra Section VIB stating that an appeal on infringement will typically be stayed until the first instance nullity action has reached a judgment.

\[167\] ZPO § 542.

\[168\] Id.

\[169\] PATG § 14; Ziehmaschinenzugeinheit (Drawing Machine), 2007 GRUR 778-779. However, the BGH distinguished between the “operative part” of the nullity decision and the grounds, specifying that any restrictive interpretations arising from the grounds of the judgment would not be binding. This is because the grounds are only a means of interpreting the patent claim as changed by the operative part of the decision, similar to drawings or other descriptions which might be in the patent, but are not themselves legally decisive.

\[170\] BGH Machinensatz (Machine Assembly), 2010 GRUR 904.
claim construction from the nullity action.\textsuperscript{171} Consequently, the infringement action would be based on the patent claim as partially revoked by the nullity court, and not on the claims as granted.\textsuperscript{172}

As the court of final appeal for both instances, then, the BGH has the ability to rectify differing claim interpretations within the cases it hears, as well as creating new case law to solve the problems associated with differing claim interpretations. However, as previously stated, the ability to appeal an OLG decision requires either permission from the OLG or permission from the BGH based on a complaint by a participating party.\textsuperscript{173} Furthermore, an appeal to the BGH can occur only if there is a question of law which is of fundamental significance or important to uniform legal development.\textsuperscript{174}

This limit on the ability to appeal a court’s decision is problematic. Specifically, the problem arises when a defendant has lost in the second instance appeals proceeding in the infringement action, feels that there has been a case of broader claim interpretation in the infringement decision than the nullity decision, and wishes to appeal the infringement decision to the BGH. In this case, a defendant seeking to appeal on the basis of differing claim interpretations would have a difficult time, as an appeal against a decision based on a purportedly ‘false’ claim construction would not be considered a question of law.

1. The \textit{Nichtzulassungsbeschwerde} remedy (complaint against denial of leave to appeal)

The BGH has created a legal remedy to this inability to appeal through the previously mentioned complaint lodged with the BGH, the \textit{Nichtzulassungsbeschwerde} (complaint against denial of leave to appeal, NZB).\textsuperscript{175} This statutory option allows the requestor to set out detailed grounds for why the appeal should be granted by the court of appeal.\textsuperscript{176} Most importantly, the complaint articulates how the contested decision is based on either an improper assumption of jurisdiction or a violation of the law.\textsuperscript{177} This could include a number

\textsuperscript{171} Id.
\textsuperscript{172} Id. The amendment of the infringement case could be possible even if the nullity court decision was only provisionally binding and under appeal.
\textsuperscript{173} \textit{See supra} Section V(A); ZPO § 543.
\textsuperscript{174} \textit{See supra} Section V(A); ZPO § 543 (2).
\textsuperscript{175} ZPO § 544.
\textsuperscript{176} ZPO § 544(2).
\textsuperscript{177} ZPO § 545.
of per se violations of the law—a judge who was involved in the decision had previously been recused due to bias, the decision does not set out reasons for the judgment—or an improper application of legal principles.\footnote{ZPO §§ 546–47.}

The first case, \textit{Druckmaschinen-Temperierungssystem} (Printing Press Temperature), involves such a complaint filed by a defendant worried about the possibility of divergent decisions.\footnote{BGH, \textit{Druckmaschinen-Temperierungssystem} (Printing Press Temperature), 2004 GRUR 710, \textit{translated in Google Translate}, https://translate.google.com (last visited June 2, 2014).} In this case, the first instance judgment on infringement was appealed, and this appeal was granted.\footnote{\textit{Id.}} However, the appeal of the second instance judgment by the court of appeal to the BGH was not granted.\footnote{\textit{Id.}} Concurrently, the final validity of the patent had not yet been decided.\footnote{\textit{Id.}} In response to the refusal to grant an appeal, the defendant filed an NZB to secure an appeal at the BGH.\footnote{\textit{Id.}}

In this complaint, the defendant argued that if the patent was limited or revoked in the nullity action, the second instance infringement appellate court decisions would be based on a claim interpretation which was no longer in existence, thus creating two divergent decisions from the nullity action and the infringement action.\footnote{\textit{Id.}}

Based on these grounds and its finding that the nullity action would be likely to succeed, the BGH decided to stay its decision on the NZB until the final outcome of the nullity action.\footnote{\textit{Id.}} However, the BGH noted that if the patent had been maintained without any amendments relevant to the infringed claims, then the complaint based on grounds of divergent decisions would not have been accepted.\footnote{\textit{Id.}} Accordingly, the rationale of avoiding conflicting decisions was, in the view of the BGH, important enough to warrant the procedural delay stemming from an acceptance and stay of the NZB.\footnote{\textit{Id.}}

A second BGH case, \textit{Crimpwerkzeug III} (Crimping Tool III), also dealt with the use of NZBs to contest different claim interpretations.
between the infringement and nullity actions. In this case, the Court of Appeals at Karlsruhe confirmed the infringement ruling of the Munich District Court and did not grant a legal appeal because the court felt that there was no risk of divergent decisions or unsolved questions of law. However, the defendant did not agree with this decision, and filed an NZB with the BGH. Concurrently, the defendant also filed a nullity action with the Federal Patent Court and appealed the results of the first instance nullity action to the BGH.

Accordingly, the BGH had both the nullity appeal action and the NZB remedy stemming from the infringement action before it at the same time. In light of these two pending proceedings, the BGH decided to stay the NZB appeal proceeding until it had first reached a judgment on the validity of the patent. In this judgment, the BGH maintained the asserted patent. However, the patent was maintained through a significantly different claim interpretation than the claim interpretation used by the Karlsruhe Court of Appeals to determine infringement in the infringement action. Therefore, if Karlsruhe had used the same interpretation as the BGH, the actions of the defendant would not have fallen within the exclusive scope of the patent.

When the NZB appeal was reopened after the BGH validity ruling, the BGH noted that the use of the “wrong” claim interpretation by the Karlsruhe Court of Appeals (as opposed to the “right” claim interpretation of the BGH) was not, by itself, a per se statutory ground for legal appeal, although the “wrong” interpretation by the Karlsruhe court resulted in a “wrongful infringement decision.”

Accordingly, the public interest in preventing a wrongful infringement decision could constitute a reason to admit the NZB. After Crimpwerkzeug III, the ability for a defendant to correct such

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189 The Court of Appeals for the Munich District Court.
190 BGH, supra note 188.
191 Id.
192 Id.
193 Id.
194 Id.
195 Id.
196 Id.
197 Id.
198 Id.
wrongful infringement decisions and reconcile differing claim interpretations was greatly improved.\textsuperscript{199}

Overall, the effectiveness of these legal remedies in mitigating differing claim interpretations is difficult to assess. On the one hand, it is clear that extremely obvious cases of differing interpretations are rare.\textsuperscript{200} The cases of deviation that do make their way to the Federal Supreme Court benefit from the BGH’s position as the court of final instance in both nullity and infringement proceedings, as the BGH has the power, with binding effect, to reconcile differing interpretations.\textsuperscript{201} This allows many problems resulting from this scenario to be solved at the BGH.

But what about the cases which do not make it up to the BGH? Due to the lack of available data, it is difficult to reach any solid conclusion on the current state of affairs concerning these types of cases. However, there has been at least one example raised of the continued appearance of differing claim interpretations. In litigation surrounding an IPCom patent essential to the 3G standard, IPCom avoided treading on prior art by arguing before the Federal Patent Court that its patent was “narrow, strictly limited to a system in which threshold values assessed before access class.”\textsuperscript{202} However, in the infringement action against HTC, IPCom argued that the same patent was “broad, also encompassing a system where access class is assessed before threshold value.”\textsuperscript{203} The court of Mannheim accepted this latter argument and granted IPCom an injunction against all HTC devices conforming to the 3G standard.\textsuperscript{204}

Whether this case is an exception to the rule or only the tip of a larger, undisclosed iceberg is unclear. It is likely that the experience of German judges in accounting for this type of target shifting behavior may be enough to keep differing claim interpretations a largely theoretical problem. However, the high values of patents litigated in Germany—one judge at the Federal Patent Court noted that the average value of patents tried for validity ran at about one million euro, with the average telecommunications patent case

\textsuperscript{199} The Crimpwerkzeug III decision also allows for the NZB appeal to be filed after the expiration of the deadline for filing the appeal, restitutio in integrum, if there are relevant ground of admission such as differing claim interpretations which would result in a wrongful infringement decision.

\textsuperscript{200} Meier-Beck, supra note 147, at 22.

\textsuperscript{201} Id.


\textsuperscript{203} Id.

\textsuperscript{204} Id.
valued at anywhere from thirty to sixty million euro—205 may make any added risk of differing claim interpretation quite unappealing.

B. Temporal Interplay between Nullity and Infringement Proceedings

The most widely asserted argument against bifurcating nullity and infringement proceedings is the time lag between the infringement judgment by the German civil courts and the corresponding validity judgment by the Bundespatentgericht.206 In theory, both infringement and nullity proceedings should take approximately fifty-two months through the final instance, as illustrated in Chart 3:207

205 Voit, supra note 144.


This would mean that if the initial infringement action filed by the plaintiff was immediately met with a nullity action from the defendant on the same day, the respective timelines could hypothetically merge at the final hearing. Because the Bundesgerichtshof is the court of last resort for both infringement and nullity proceedings, the corresponding timelines would result in the BGH being able to hear both infringement and nullity actions on the same day. Consequently, the BGH could either issue a unitary judgment comprising issues of both validity and infringement, or first render a judgment on validity and then hear the infringement case. This resulting infringement decision would then have the benefit of being based on prior claim interpretation from the preceding nullity action.

It is unfortunate that the real interplay between infringement and nullity proceedings is not like this idealistic scenario. In reality, the two proceedings rarely—if ever—transpire over equal durations of time, as nullity actions are typically filed several months after the claims of infringement. Therefore, a realistic timeline of the first instance would factor in an addition several months into the theoretical calculation of twenty-four months for the nullity proceeding, so that the first enforceable infringement judgment would most likely be rendered half a year to a year before the Federal Patent Court ruling on validity.

In such a scenario where there is a significant time lag between the nullity and infringement proceedings, the relevant District Court may either choose to judge on an assumption of validity or stay the infringement proceedings until there is a validity ruling. However, the former occurs quite rarely, as courts are not typically predisposed to staying proceedings unless there is a clear indication that the patent in question has substantial issues with validity. This possibility will be discussed further in the section below.

208 Luginbuehl, supra note 6, at 30.
210 Id.
211 See ZPO § 148 (authorizing the district court to stay the proceedings of an infringement suit if there is a high likelihood that the patent will be amended or invalidated).
213 See supra Section V.B.2.(a).
For now, it will suffice to say that unless there is such a clear reason to stay the proceedings, the court will typically render its judgment with the assumption of validity.\textsuperscript{214} For instance, the court of Düsseldorf chooses to stay proceedings in less than ten percent of its cases.\textsuperscript{215}

Thus, a standard case is as follows: first, the patent holder files the infringement action.\textsuperscript{216} The defendant will typically respond by filing a corresponding nullity suit. In most cases, the district court will not stay the infringement case and, accordingly, will render the first instance judgment in the infringement case before the Federal Patent Court has decided in the nullity proceedings.\textsuperscript{217}

As stated previously, if the district court finds infringement and grants the case, the plaintiff will be able to enforce the judgment immediately.\textsuperscript{218} However, this enforcement will be subject to a security deposit corresponding to the estimated monetary impact of enforcing the judgment on the business of the defendant.\textsuperscript{219} This deposit is intended to provide collateral for damages due to the defendant under section 945 of the \textit{Zivilprozessordnung} in the event that the plaintiff enforced a first instance judgment which is overturned.\textsuperscript{220} Another consequence of this section 945 liability clause might be to discourage the plaintiff from provisional enforcement of an infringement judgment on a patent whose validity might be doubtful.\textsuperscript{221} This remedy will be discussed further below.\textsuperscript{222}

In the case that the defendant loses the first instance infringement action, he or she will typically file an appeal on infringement that is stayed by the appeal court until the nullity judgment. In the meantime, any provisional enforcement of the first instance judgment by the plaintiff will continue until either the appeal is heard and the first instance judgment is reversed, or the relevant claims are invalidated or amended by the results of the nullity action.\textsuperscript{223} As the

\textsuperscript{214} Chrocziel, \textit{supra} note 212.
\textsuperscript{215} Haarmann, \textit{supra} note 30.
\textsuperscript{216} Voit, \textit{supra} note 144.
\textsuperscript{217} Id.
\textsuperscript{218} Id.
\textsuperscript{219} ZPO §§ 537, 709, Enforcement Directive § 9.
\textsuperscript{222} See \textit{supra} Section V.B.1.
\textsuperscript{223} LUGINBUEHL, \textit{supra} note 6, at 27.
district courts typically take nine to twelve months to render a judgment, this period will usually be about one to one and a half years.\textsuperscript{224} It is this period of enforceability without the possibility of a validity defense by the defendant that is viewed as highly problematic by many critics of the bifurcated system, and an articulation of this critique will be provided in the following section.\textsuperscript{225}

If the Federal Patent Court does not invalidate the patent in question, the defendant can file another appeal on the nullity action to the BGH, the court of last instance for both nullity and infringement proceedings.\textsuperscript{226} As the second instance appeal on infringement would have been stayed due to the pending nullity proceedings, the BGH will first render its judgment on validity, and the lower courts will be bound by this judgment.

If BGH invalidates the patent, the plaintiff will be forced to withdraw his infringement case at the risk of dismissal by the appeal court. If the plaintiff had provisionally enforced the first instance infringement judgment, the plaintiff would owe the defendant damages.\textsuperscript{227} However, if the BGH completely maintains the patent or an amended set of claims and if there is also a case of undisputable infringement, the defendant will often withdraw his infringement appeal and the first instance judgment will become final.\textsuperscript{228} If infringement is arguable, the appeal will continue to judgment by the appeal court.\textsuperscript{229} As a last option, the defendant can bring a final appeal on infringement to the Bundesgerichtshof.\textsuperscript{230}

1. Consequences of the time lag

In bifurcated proceedings, the lack of a validity defence for the defendant provides the plaintiff with a situation in which he or she does not need to prove patent validity\textsuperscript{231} and is able to focus on convincing the judge that his opponent has infringed his patent. Thus, even if the plaintiff is not extremely confident about the viability of his patent, he can still enforce the results of the first instance judgment without concern over patent validity until months later. This is a key strategic aspect of the German patent litigation

\textsuperscript{224} Id.
\textsuperscript{225} See supra Section V B. 1.
\textsuperscript{226} LUGINBUEHL, supra note 6, at 27.
\textsuperscript{227} Id.
\textsuperscript{228} Id.
\textsuperscript{229} Id.
\textsuperscript{230} Id.
\textsuperscript{231} O’BRIEN, supra note 16.
system which—among other, more positive attributes—has earned it the title of being one of the most “patent-holder friendly” litigation systems in the world.\textsuperscript{232}

This characteristic has been criticized by many academics, industry practitioners, and even members of the German legal system and government.\textsuperscript{233} There is no literature that presents concrete statistics detailing how much damage has been incurred by defendants as a result of provisional enforcement of judgments that are later lifted. However, a typical example might be the case of Nokia, which has been subject to infringement suits for over 150 patents in Europe, none of which after trial have been found valid.\textsuperscript{234} Although some of these 150 patents were EPC patents originally granted by the EPO, others were German national patents granted by the German Patent Office\textsuperscript{235}—an indication that the strong presumption of validity under which the German district courts in a bifurcated system operate does not recognize the reality of the situation.

Historically, the German Patent and Trademark Office has had a reputation of awarding high quality patents, leading a former first assistant commissioner of the US Patent Office to remark that it “cannot be gainsaid that the German patent system was the finest in the world . . . obtaining a German patent on a new invention was tantamount to obtaining an insurance policy on the invention.”\textsuperscript{236} Unfortunately, statistics suggest that nowadays, many patents which are later invalidated do manage to pass the preliminary examination

\textsuperscript{232} Id. (quoting Johannes Sommer, managing director of the Bundesverband Informations-und Kommunikationstechnologie).


\textsuperscript{234} Varè, supra note 202.

\textsuperscript{235} Id.

procedures of the GPTO. In nullity proceedings before the Federal Patent Court from 1986 to 2005, there were 1239 judgments issued in total. Of these, 582 were European patents, with 415 (71%) revoked completely or partially. Out of the remaining 657 German national patents, 387 (59%) were totally or partially nullified.

Altogether, the skyrocketing availability of weak patents enforceable in Germany, coupled with increasingly lengthy nullity actions, have created a very strategic advantage with which patent holders can pursue and win infringement litigation. Indeed, statistics concerning patent holder win rates for German courts—particularly the district court of Düsseldorf—support the image of the bifurcated German system as one that is particularly patentee-friendly. The Düsseldorf court—which handles over 600 new patent infringements claims a year, about 60% of all patent infringement cases in Germany—had a patentee win rate of 62% in 2009. This was substantially higher as compared to other first instance patent infringement courts in other states such as the United Kingdom and the Netherlands (30% and 33%, respectively).

Returning to the case study of Nokia, the first articulated problem is rampant patent litigation due to the combination of the growing numbers of patent applications and a high proportion of invalid patents. The second problem is that in many industries, rapid product and innovation cycles have led to a shorter and shorter crucial time period for profitable market entry or presence. Thus, the already advantageous ability for a plaintiff to provisionally enforce a first instance infringement judgment without having to first prove the validity of the patent in question is augmented by the powerful disadvantage to the defendant in this case.

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238 *Id.*
239 *Id.*
240 *Id.* These numbers could indicate that EPC patents are of lower quality than national German patents.
242 *Id.*
Theoretical versions of this argument have surfaced time and time again in the critiques against inclusion of bifurcation in the European Unitary Patent Court system.\textsuperscript{243} The argument typically is phrased as such: the defendant company, either foreign or German, will be sued by a patent holder in Germany. If the patentee wins, he or she will be able to enforce a provisional injunction on the allegedly infringement product until the appeal court overturns the infringement judgment or the Federal Patent Court has rendered its judgment on nullity, usually about a year. During this time period, the product in question may have already completely lost its value if it is in an industry with quick innovation or product cycles, where the timing of market entry and presence is crucial to financial success.

Of course, the real life counterpart to the theoretical argument is the case of Apple and Samsung in Australia. After Apple won an injunction against Samsung’s Galaxy Tab 10.1 in April 2011, the two companies began a series of embittered lawsuits which have spun off into courts in the United States, Germany, and the United Kingdom.\textsuperscript{244} When the Australian High Court announced its decision in early December 2011 to maintain an overturning of Apple’s injunction, to effectively allow Samsung to sell its tablets in the Australian market, Samsung released a statement welcoming the court’s decision and reaffirming its own view that Apple’s charges had been unsubstantiated.\textsuperscript{245} Samsung trumpeted the decision as a legal victory.\textsuperscript{246} Unspoken was the economic victory that Samsung had won: with the injunction lifted, the Galaxy Tab 10.1 would be able to assert its presence in the Australian market just in time for the Christmas shopping season.\textsuperscript{247}

Finally, the possibility of provisional enforcement without first confirming the validity of the litigated patent, the presence of weak patents, and a forum with less than encouraging German case law on standard essential patents\textsuperscript{248} may incentivize at least the abusive

\textsuperscript{245} Id.
\textsuperscript{246} Id.
\textsuperscript{247} Id.
\textsuperscript{248} BGH—Orange Book Standard, 2009 GRUR 694. The decision itself allows defendants to claim a competition law defense against injunctions enforced during infringement actions concerning the use of standard essential patents if they first fulfill certain conditions. However, this decision has been seen as allowing patent holders to extort higher royalty rates because the defendant must first make an offer that the plaintiff could not reasonably refuse in order to claim the defense. See continued...
enforcement of standard essential patents by companies such as Bosch, if not by non-practicing entities commonly known as “patent trolls.”

Indeed, the German litigation brought by IPCom, a non-practicing entity based in Germany, against Nokia provides further evidence of these incentives for troll activity. The proceedings, in which IPCom asserted a patent portfolio it had acquire from Bosch, were characterized by Lord Justice Jacob in the parallel UK Nokia v. IPCom as “using litigation as a continuation of negotiation by other means.”

One would think that in order to utilize litigation in the manner, as a form of coercive persuasion to reach an agreement on royalty rates, the validity of the asserted patents would be quite certain. However, all sixty-one patents asserted by IPCom that had reached judgment by April 2012 were found invalid. Of these sixty-one, almost one third had been previously examined and passed by the German Patent and Trademark Office. In sum, what resulted from these extensive patent litigation proceedings was sixty-one invalid attempts at securing the amount IPCom had hoped with its patent portfolio to leverage from Nokia in royalty rates—some twelve billion euros.


The debate over the definition and impacts of non-practicing entities is one which is too complex for the scope of this thesis. See Wolfgang von Meibom and Ralph Nack, Patents without Injunctions?—Trolls, Hold-ups, Ambushes and Other Patent Warfare, PATENTS AND TECHNOLOGICAL PROGRESS IN A GLOBALIZED WORLD: LIBER AMICORUM JOSEPH STRAUS 491 (Martin J. Adelmann, Robert Brauneis, Ralph Nack, et al. ed., 2008).

Nokia v. IPCom, [2011] EWCA Civ 6 (U.K). In the same hearing, Lord Justice Jacob noted that,

It is hardly surprising that IPCom chose Germany. For within the bifurcated system there, the infringement court is generally faster than the validity court. So, unless a patent is rather likely to be held invalid (the infringement court will stay proceedings if it is), a party can get a commercial advantage by an early infringement decision in its favour. And, judging by results so far (not only here but also in Austria and the US, though things are not over in either country), it would seem that IPCom’s position on infringement is stronger than that on validity. That may well have been its perception at the outset. If so, Germany would clearly be a commercially good place to sue—the hope would be of getting an early win on infringement followed by negotiation of a commercially advantageous deal.

251 Vary, supra note 202.

252 Id.

253 Nokia v. IPCom, supra note 250.
These types of litigation practices have led Richard Vary, head of litigation at Nokia to remark that,

the result of [the German] system [being] so favorable to the patentee is that injunctions are becoming a little bit like battles wounds to soldiers: they are inevitable if you’ve been in the front line for any length of time. They mark you out from the rookies, the small players: the people who are not worth suing.\footnote{Vary, \textit{supra} note 202.}

It is worth noting that a common argument in favor bifurcation also centers on the temporal issues. The argument centers on the statistic that only in twenty five percent of patent infringement cases filed do the defendants bring a concurrent revocation suit.\footnote{Jacob, \textit{supra} note 233 (citing Raimund Lutz, former president of the Bundespatentgericht).} However, offering an invalidity defense for defendants in patent infringement proceedings would most likely raise the percentage of cases in which a ruling on validity is needed by a huge amount. This would lead to the necessity for an expert witness on almost every case, leading to a huge increase in cost and length of proceedings.

2. Remedies

There are remedies built into the German patent litigation system which seek to curb the negative consequences resulting from the lag between infringement and validity judgments. The first is the authorization of the district courts to stay an infringement action if it is likely that the patent will be invalidated or amended.\footnote{ZPO § 148.} The second is the imposition of a no-fault liability on the execution of provisional judgments.\footnote{ZPO § 945.} The below sections will discuss the effectiveness of these remedies.\footnote{See \textit{supra} Section V.B.}

\textit{a. Stays}

Section 148 of the German Code of Civil Procedure establishes the possibility of staying an infringement proceeding.\footnote{ZPO § 148.} This process was further articulated by the BGH in its case “Transport
Vehicle,” which indicated that, “suspension of the hearing in an infringement process in an appeal is possible if the legal recourse measure taken against the granted patent (in this case an opposition appeal) has some prospect for success.” This seems to be a very effective way to solve the problems associated with enforcement of invalid patents in theory. However, in practice, courts will stay their infringement proceedings under this provision in less than five percent of the cases.

Why might this be? First, the fact that there are parallel nullity actions is not a reason per se to stay the infringement proceedings, as this would effectively curtail the exclusionary rights granted by a patent by making their enforcement significantly less reliable. Thus, a stay is only granted if the invalidation action is likely to be successful. In this determination, the court must evaluate the chances of invalidation under the same framework used by the Bundespatentgericht, and weigh this evaluation with the interests of the parties in obtaining the stay. However, the court will typically place with priority on the interest of the patent holder. For example, if a contested patent may be invalidated but the grant of a stay would strongly prejudice the effective enforcement of the patent, the court would likely place more weight on allowing the patent holder to enforce his patent.

Moreover, a high likelihood of invalidity cannot usually be determined if the relevant prior art asserted by the nullity plaintiff has already been considered by the GPTO during the initial patent granting procedure. The same applies for if the asserted argument is a lack of inventive step, as the district court should not—for the same reasons of technical expertise that infringement and invalidity proceedings are bifurcated—be able to evaluate and assess the level of obviousness or lack of inventiveness of the patent. However, the stay may be granted on the grounds of lack of inventive step if there is no “reasonable argument” indicating that the allegedly infringed invention is inventive.

261 Chrocziel, supra note 212.
262 BGH ZPO § 148 - Transportfahrzeug (Transport Vehicle), 1987 GRUR 284; Landgericht Düsseldorf [District Court Düsseldorf][LG]- Flachdachablauße (Flat Roof Drains), 1979 GRUR 188; Oberlandesgericht München [Munich Court of Appeal][OLG]- Regal-Ordnungs-systeme (Shelf Organisation System), 1990 GRUR 352.
263 Id.
264 Chrocziel, supra note 212.
265 Mes, supra note 117, at 407.
266 Id.
In addition to the legal reasons as to why stays are infrequently issued by German district courts is an underlying current of court politics that may only be seen by experienced practitioners. For example, one practitioner relates that the Munich district court had a standing practice for many years of staying infringement proceedings as soon as any kind of nullity action had been filed which was not completely irrational.\(^{267}\) Therefore, a plaintiff in Munich could not first obtain an infringement judgment in first instance proceedings if the defendant had filed a reasonable validity suit.\(^{268}\) As the plaintiff is the party who chooses the forum for the infringement proceeding, fewer and fewer infringement actions were started at Munich as a result of this practice.\(^{269}\) After this loss of business, the Munich court changed its ways, and the stay became almost only a hypothetical option.\(^{270}\) In fact, an experienced practitioner has noted that in his knowledge, only one such stay has been ordered in the last four years—the last stay by the court of Munich.\(^{271}\)

Unfortunately, the fact that stays rarely occur further shortens the amount of time needed to pursue an infringement proceeding to judgment as compared to a situation in which the raising of nullity issues constituted an automatic stay, and consequently increases the length of time between the infringement judgment and a nullity ruling.

\(b.~\)The District Court Ability to Stay Proceedings is Not without Value

It is important to note that although the actual imposition of a stay is infrequent, district court judges perform evaluations of invalidity in all infringement cases.\(^{272}\) It has been argued that district court judges may perform these preliminary evaluations of invalidity but do not have the technical expertise to render of judgment with binding effect as to the invalidity of a patent.\(^{273}\) This is because judges at the Federal Patent Court must first define the person of skill in the art as a frame of reference before looking into

\(^{267}\) Haarmann, supra note 30.
\(^{268}\) Id.
\(^{269}\) Id.
\(^{270}\) Id.
\(^{271}\) Chrocziel, supra note 212.
\(^{273}\) Id.
the entire prior state of the art in order to determine validity, while infringement judges only assess a probability of invalidity.\footnote{Id.}

However, district courts go through great lengths to obtain accurate assessments of validity, sometimes even enlisting the help of a court appointed expert.\footnote{Bauz, supra note 139, at 972.} Unfortunately, the formalistic bifurcation of the two proceedings leads to the result that the district court will not share the resulting findings with the Federal Patent Court, even if they might be highly relevant—a highly inefficient practice.\footnote{Id.} Indeed, one German judge has critiqued this system, stating that “[i]t is not procedurally economical to amass evidence on the same subject in two separate proceedings. There is also the consideration that the parallel amassing of evidence can lead to contradictory court decisions.”\footnote{Id.}

Additionally, it is arguable that this distinction between highly technical validity determinations and low technicality infringement assessments is based on a false dichotomy.\footnote{See Jacob, supra note 233, at 823.} The scenario has so often been constructed as differences in technical expertise requirements between infringement proceedings and nullity proceedings, when in fact the greater distinction in technical expertise is between low-tech patents—patents on tight-head barrels or hair removal devices—and highly technical patents, such as those incorporated into smart phones or pharmaceuticals. In the case of patents that have a low technical standard, bifurcation should not be necessary to ensure a competent analysis of the patent. In cases of highly technical patents, bifurcation would not solve the problem of technical complexity, as even an evaluation of infringement would necessitate a technical understanding of the patent.

Moreover, the case of utility models raises questions about the emphasis placed on technical expertise residing in only the Federal Patent Court. In 2006, the Federal Supreme Court raised the level of inventive step needed for acquiring enforceable utility models to the same standard as that of patents.\footnote{Bundesgerichtshof [BGH][Federal Court of Justice] 2006 GRUR 842 (Ger.).} This resulted in utility models with no demonstrable difference from patents, in terms of evaluation of validity and infringement. However, district courts in Germany may decide on both the validity and infringement of utility models. This seems to contradict the argument that there is a need for
bifurcation in order to preserve the adequate amount of technical expertise.

Indeed, even in evaluations of potential patent validity, district judges have been highly accurate.\textsuperscript{280} At times, this accuracy may even supersede that of the Federal Patent Court, as was evidenced in the case Olanzapine, where the Court of Appeal in Düsseldorf (OLG Düsseldorf) granted a preliminary injunction for a patent that had been declared invalid by a first instance nullity decision of the Federal Patent Court.\textsuperscript{281} In this case, the Düsseldorf appellate court had two main considerations in issuing the PI order in spite of the invalidation decision by the Federal Patent Court.\textsuperscript{282} The first was that the Federal Patent Court—in the opinion of the OLG Düsseldorf—had misread the prior state of the art to determine lack of novelty and inventive step.\textsuperscript{283} The second was that if the OLG Düsseldorf did not grant the PI order, the patent owner would be unable to secure enforcement of the patent right until the likely reversal of the invalidity decision by the Federal Court Justice—a time which would likely be long past the lifetime of the patent.\textsuperscript{284} The OLG Düsseldorf took the principle in PI orders that the interest of both parties should be balanced to mean that denial of enforcement would constitute a Rechtsverweigerung, or refusal of justice.\textsuperscript{285} Accordingly, the court granted the PI order.\textsuperscript{286} In 2009, the Federal Supreme Court affirmed this decision.\textsuperscript{287} Although Olanzapine was and most likely will remain an exception to the rule, the case at least verifies the technical abilities of the civil court judges. Taking a more extreme view from the case, questions may even arise about the real technical benefits of bifurcation.

Overall, in light of these indicators that civil court judges may have the necessary expertise to perform assessments of patent nullity, rationalization of bifurcation seems quite difficult. In any case, the

\textsuperscript{280} Mes, supra note 117, at 408. Remarks that in his personal experience, “it is substantially less than 5\% of patent infringement cases that the District Court’s assessment with regard to the validity of the patent has deviated from the final decision of the German Federal Patent Court or the Federal Supreme Court.”

\textsuperscript{281} GERHARD BARTH & DR. FRANZ-JOSEF ZIMMER, THE OLANZAPINE PATENT DISPUTE: GERMAN COURT GRANTS A PRELIMINARY INJUNCTION ON A PATENT INVALIDATED BY THE FIRST INSTANCE 1 (Grünecker Kinkeldey Stockmair & Schwanhäusser 2008).

\textsuperscript{282} Id. at 5.

\textsuperscript{283} Id. at 5-6.

\textsuperscript{284} Id. at 6.

\textsuperscript{285} Id.

\textsuperscript{286} Id. at 1.

\textsuperscript{287} Bundesgerichtshof [BGH][Federal Court of Justice] 2009 GRUR 382 (Ger.).
argument is not whether or not a court dealing with patents should have technical judges. That the Federal Patent Court has judges with technical expertise is not a disadvantage, as it is largely agreed that having judges with technical expertise is beneficial as compared to having only legally trained judges. The real disagreement is whether or not a bifurcated system provides this technical expertise better than a non-bifurcated system—a debate that is not so easily resolved.

c. Securities

As stated previously, German courts will impose a security on the plaintiff if the plaintiff wishes to enforce a provisional judgment.288 This security, which is determined by the reasonably expected financial impact of the enforcement of a provisional judgment during the duration of an appeal (approximately two years), is deposited into government accounts that can accrue interest.289 These interest rates are subject to state law, so are determined on a state-by-state basis.290 However, the reason why there is money deposited in these accounts and kept as the security is not just for its own deterrent effect, but also in order to supplement the enforcement of section 945 of the German Code of Civil Procedure.291

ZPO section 945 imposes a no-fault liability on the execution of a provisional judgment by the plaintiff if the judgment is subsequently overturned.292 Thus, if the plaintiff enforces a provisional judgment but is bankrupted in the appeals or nullity process, the damages due to the defendant because of ZPO section 945 can still be imposed and withdrawn from the initial security deposit. Thus, both the security and ZPO section 945 damages are remedies in the German system to discourage abuse of provisional enforcement, a particular problem due to the inability of the defendant to raise a validity defense. This is because, in theory, the amount of security is set as such that the plaintiff would experience financial detriment if he or she enforced a provisional judgment that was later enforced.293 The additional ability of the defendant to sue for damages, then, should augment the deterrent effect of imposing securities.

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288 ZIVILPROZESSORDNUNG [ZPO][CODE OF CIVIL PROCEDURE], 1893, §§ 537, 709 (Ger.); 2004 O.J (L 157) 22.
290 Id. at 3.
291 See id. at 2.
292 ZIVILPROZESSORDNUNG [ZPO][CODE OF CIVIL PROCEDURE], 1893, § 945 (Ger.).
293 See Mueller, supra note 220, at 2.
A final remedy for later nullification of a patent which was ruled to be infringed was established by the Düsseldorf Court in the case “Request for Retrial III.” In this case, the court established the ability of a defendant to request a retrial if the patent which he or she had allegedly infringed was revoked. The defendant would not be able to request a retrial when the patent in subsequent proceedings was merely amended in such a way that the defendant’s actions are not infringing under the scope of the patent.

However, there have been concerns that these remedies have been insufficient to discourage potentially abusive enforcement. For example, the Mannheim Regional court ordered two injunctions after the conclusion of first instance infringement proceedings against Apple in patent litigation between Motorola Mobility and Ireland-based Apple Sales International. One was based on an essential patent for wireless communication owned by Motorola, and the second was for a patent on non-standard essential push notification technology. In each case, a one hundred million euro security was imposed on the enforcement of the injunction by Motorola. However, the amount was seen as inadequate by Apple, who argued in court that particularly in the case of a standard essential patent, the actual loss of profit over the duration of an appeals proceeding due to a sales ban on all products utilizing the allegedly infringed patent would be much more than one hundred million euro. Rather, Apple convincingly argued that in order to cover the actual loss of profit, a two billion euro security deposit would be necessary. However, this was not granted by the court.

294 Oberlandesgericht Düsseldorf [OLG][Düsseldorf Court of Appeal] 2008, 39
RESITUTIONSKLAGE III [OLGZ] 355 (Ger.).
295 See id.
296 See id.
298 Mueller, supra note 220.
299 EP (European Patent) 1010336 (B1) on a “method for performing a countdown function during a mobile- originated transfer for a packet radio system.”
300 EP (European Patent) 0847654 (B1) on a “multiple pager status synchronization system and method.”
301 Mueller, supra note 220.
302 Id.
303 Id.
304 Id. It is worth mentioning that due to the state interest laws of Baden-Württemberg, where the court of Mannheim is situated, the annual interest cost to the state of just one of Motorola’s deposits is about one million euros. Multiplied by several deposits and the duration of appellate proceedings, this could amount to a great deal of financial strain for the state.
In addition to the possible discrepancies between court order securities and the actual loss of profits due to the wrongful enforcement of a provisional judgment, there are questions as to the actual enforceability of ZPO Section 945. The clause allows defendants which are suffering from damages as a consequence of an unjustified enforcement to request damage compensation. However, leading industry practitioners have noted that in reality, it is very difficult to calculate the amount of damage compensation. An experienced practitioner has stated that he himself has never been involved in a case where the defendant later, after having a favorable judgment and lifting of the provisional injunction order, was really able to enforce damage claims against the plaintiff. He furthered that this option was largely seen as only hypothetical, as it would not easy for defendant to specify damages or probable profit, especially if—as in many injunction cases—the plaintiff was able to stop a product early into its market entry.

VI. CONCLUSIONS

How has bifurcation affected patent litigation in the German court system? It is clear that the German patent litigation system as a whole has many positive traits. The professionalism of the German patent body, including judges and lawyers; the lack of unpredictable jury trials; the speed and low cost of proceedings; a more predictable assessment of trial costs due to statutory limitations on reimbursement—these are all positive aspects due to which Germany can be characterized as the most preferred forum for patent litigation.

However, it is equally clear that the bifurcation of infringement and nullity proceedings, in practice, has undesirable consequences. To obtain enough data and evidence to reach any resounding conclusions is extremely difficult, if not near impossible without close sources in industry and the litigation system. Nevertheless, the conclusions once can draw indicate that bifurcated proceedings are not entirely as positive as their reputation may convey.

In regards to the possibility of differing claim interpretations, German courts have covered much ground to greatly diminish this possibility. The availability of a Nichtzulassungsbeschwerde remedy (complaint against denial of leave to appeal) as a result of case law allows the Bundesgerichtshof to rectify any conflicting or differing

305 ZPO § 945.
306 Haarmann, supra note 30.
307 Id.
308 Id.
claim interpretations which are appealed up to the court. In first and second instance hearings, judges in the German patent litigation system typically can anticipate and account for possible differing claim interpretations, and will generally decide on the most accurate version of the claim as opposed to one too much favoring one side or the other.\textsuperscript{309} However, questions linger about whether there is an overreliance on the judge’s ability to balance the final claim interpretation as the internal politics of courts and the personal ambitions of judges are influential factors that cannot be completely discounted from the patent litigation.

The time lag between infringement and nullity rulings is a more clearly problematic area. Records of this time lag show that the length of time needed to reach a first instance infringement ruling has gotten shorter, whereas nullity rulings require much lengthier wait periods.\textsuperscript{310} This results in a litigation system that is overall much more favorable to the patentee, who does not have to defend the validity of his or her patent before enforcing against any alleged infringement. One consequence of this could be an increased number of invalid patents retained in the system as a result of the higher incentives toward settlement. A defendant who does not wish for commercial reasons to pursue a validity proceeding to judgment may, in light of an impending ruling of infringement, offer to settle instead of invalidating the asserted patent. This seems to be the case particularly with companies that have large patent portfolios with which to “facilitate a cooperative resolution.”\textsuperscript{311} It could be concluded that instead of protecting the public interest through weeding out invalid patents from the system, companies litigating in the German system may be even more likely to settle.

What has also occurred in reaction to the patentee-friendliness of the German patent litigation system is a number of cases around the world in which judges have made decisions to, at least partially, combat the perceived bias of the German system. A judge in the United State granted a preliminary injunction in favor of Microsoft to prevent Motorola from enforcing its injunction granted by the court of Mannheim.\textsuperscript{312} The reasoning for the PI order grant indicated concern over the possibly abusive leverage given to the patent owner

\textsuperscript{309} Florian Mueller, Most of Apple’s German lawsuits get stayed (the latest one today): here’s why, FOSS PATENTS (Friday, May 11, 2012), http://www.fosspatents.com/2012/05/most-of-apples-german-lawsuits-get.html.


\textsuperscript{312} See supra Section III.A.1.
(Motorola) in light of its FRAND obligations, as well as “concerns of forum shopping and duplicative and vexatious litigation.” \(^{313}\) In addition, several judges in the UK have expedited validity proceedings on patents that were asserted in German infringement proceedings. \(^{314}\)

Although UK judges have indicated that the presence of German infringement proceedings is not a *per se* reason to expedite proceedings, it seems that these granted expedite orders have been issued in an attempt to promote balance in patent battles which more and more are waged with a pan-European or even international jurisdiction. \(^{315}\)

As the German court system handles the largest caseload for patent litigation in Europe and the third most in the world, the underlying biases of the legal system have the potential to become dangerous fault lines in the preservation of a patent system which provides the proper incentives for technological innovation.

A court system which has a heavy bias towards the patent holder may encourage more money to be spent on litigation—so called “nuisance suits” \(^{316}\)—and less on innovation. This type of system may

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\(^{314}\) In his 2011 decision to expedite validity hearings in *HTC Europe v. Apple*, Justice Arnold explained that,

> “we can no longer consider litigation in England in isolation when at least one of the parties is engaged in pan-European business, as RIM is here. The fact that there may be a determination of an issue of infringement in Germany in January is a fact of life and it is one which I cannot turn a blind eye to. It is not in any sense intended to be taken as a criticism or, indeed, a comment on German procedures, but I think that the fact that issues of infringement will be determined in Germany speedily is itself a reason why the issue of validity in this country for essentially the same patent should also be dealt with speedily. This is not a matter of trying to trump the German courts, but it seems to me that in all senses it would be fairer if RIM’s ability to sell BlackBerry units and, in particular, the risk of it being held to have infringed a valid patent should be determined rapidly rather than slowly. The German courts happen to have in place a means by which infringement, at least in that country, will be determined rapidly. I see every reason for saying that the issue of validity should also be considered rapidly in this country.”

*HTC Europe v Apple*, [2013] EWCA Civ 45.

\(^{315}\) Although the European Court of Justice decisions *Roche Nederland BV v Primus*, Case C-539/03 (2006) and *GAT v. LUK*, Case C-4/03 (2006) have limited the number of cases in which an infringement court can be seized to judge on a foreign patent or foreign part of a European patent and grant a cross-border injunction.

\(^{316}\) O’Brien, *supra* note 16.
also affect the German economy, as evidenced by the decision of Microsoft to move its manufacturing headquarters out of Germany due to the easy availability of injunctions.\footnote{Id.} At the very least, the setup of German patent litigation grants the winning party a hefty amount of leverage in substitute for lower damages—a very encouraging feature for “patent troll” litigation. Even the German Federal Ministry of Economics and Technology has noted the higher possibility of wrongful injunctions and disclosure claimers as an undesirable consequence of this leverage from bifurcated proceedings.\footnote{Id.}

What are possible ways to ameliorate these undesirable consequences? As in the case of any legal reform movement, possible solutions must first confront entrenched interests, historical conservatism and—most importantly—the sheer practical difficulties of changing an entire system of patent litigation. Other bifurcated patent litigation systems have implemented changes that may work as well in the German system. One method, which may merit consideration, is the admission of an invalidity defense in the infringement proceedings. The district courts of Japan may, under a Japanese Supreme Court Decision in 2000 termed the “Kilby Decision,” rule on the validity of a patent without waiting for the validity decision of the Japanese Patent Office (JPO).\footnote{Id.} However, validity decided by the district court applies only \textit{inter partes}, whereas the decision of the JPO would be binding on the patent right itself and thus apply \textit{ex partes}.\footnote{Id.}

In the German version of this amendment, the Federal Patent Court would play the role of the JPO and have final say on the \textit{ex partes} status on the patent. Parties would be able to bring up nullity suits independently at the Federal Patent Court if they wished to invalidate the patent outside of the \textit{inter partes} effect of a district court decision. However, the district court would be able to decide within their jurisdiction the validity of the asserted patent. This would avoid many of the problems associated with bifurcation, as the time lag and differing claim interpretation between Federal Patent Court and district court decisions would be avoided for a prospective defendant. Indeed, the President of the German Federal Supreme Court suggested just this possibility in 2007.\footnote{Stellungnahme des Deutschen Anwaltvereins durch den Ausschuss für Geistiges Eigentum zum Vorschlag des Präsidenten des Bundesgerichtshofs zur continu{\textemdash}}
defense in district court proceedings would have another benefit—that of lightening the heavy caseload of the Federal Patent Court.\textsuperscript{322}

The opinion of the German Bar Association in response to this suggestion by the President of the Federal Supreme Court is, nevertheless, telling of the political and procedural obstacles facing any such amendment to the German bifurcated system of patent litigation. From an admission of feasibility for the suggested amendment—adding the possibility of nullity objections to infringement proceedings would not require explicit statutory authorization; the amendment would not violate the judicial separation between the Federal Patent Court and district court system; the amendment would harmonize German law with the majority of over European patent litigation systems—the opinion quickly moves to the assessment that the legal admission of nullity is a premature option, only to be implemented if the establishment of a European Unitary Patent is imminent.\textsuperscript{323}

The trend of patent litigation towards disputes over multi-state or even international jurisdictions has been marked by legislation and case law aimed at harmonizing various national systems. These acts, along with the rise in judicial cooperation, are both crucial factors in establishing a global uniform patent law, to the benefit of both litigants—who can better determine necessary business decisions in light of a predictable patent law—and courts, which can learn from the case law, discourse, and guidance from other courts. With such a trend towards harmonization, a re-examination of Germany’s outlier patent system is important. Of course, a balance between national character and international jurisprudence must be achieved. One cannot forget an entire legal history in one day. Nevertheless, achieving such a balance between justice for the defendant and justice for the plaintiff could only improve Germany’s patent litigation system as one reputed for both efficiency and equity.

\footnotesize{\textsuperscript{322} Id.  \\
\textsuperscript{323} Id.}