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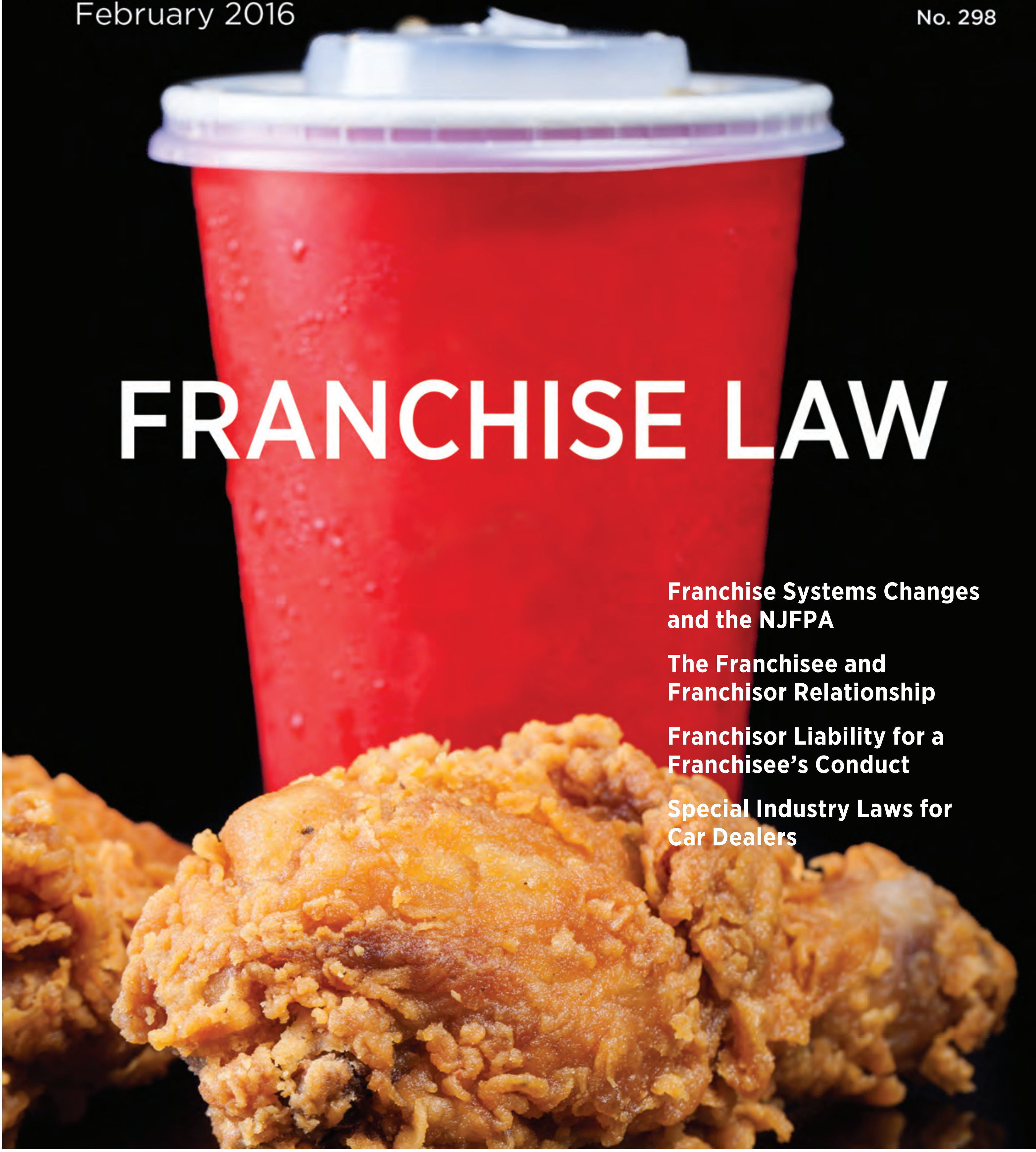

FRANCHISE LAW

Will New Court Rulings Make it Harder for Franchisors to Rescue a Hostage Trademark?

by Bryan Couch

Trademark infringement is a significant concern for all businesses, since trademarks act as a kind of guaranty on behalf of consumers and businesses alike. For consumers, they are an assurance of a standard of quality for the goods and services associated with the mark; while for businesses, trademarks represent the accumulated reputation and goodwill built up by the trademark owner.

Trademark infringement, however, is particularly burdensome for franchisors. That's because in a franchise transaction, the franchisor/trademark holder typically licenses the use of its mark to a franchisee, subject to specified contractual arrangements that may include the payment of fees and, typically, a requirement to maintain certain standards designed to ensure that consumers will associate the brand with a certain style and level of quality. Indeed, a franchise agreement may be terminated if a franchisee fails to comply with its contractual obligations.

A consumer's positive association with a brand may become threatened when a terminated franchisee—especially one that was terminated due to quality deficiencies—continues to use the franchisor's marks after termination. This conduct, often referred to as 'holdover usage,' is a common obstacle faced by franchisors at the conclusion of a franchise relationship.

Here is the typical scenario (using fictitious names): Frankie's Franks, a franchisor of hot dog stands, terminates its franchise relationship with cause when its franchisee, Main Street Franks, LLC, fails to maintain quality standards as called for in the franchise agreement. Under the terms of the contract, Main Street Franks has 14 days to 'de-identify' the stand by removing all trademarks, tradenames, and service marks that would identify the stand with the Frankie's Franks franchise system.

But well after the 14-day period has passed, Frankie's Franks gets a lengthy email from an angry customer, complaining about the lack of cleanliness and service at the restaurant. The customer also posts several negative reviews on various third-party websites, advising people to steer clear of all Frankie's Franks locations. On a post-termination site inspection, Frankie's Franks finds its signs are still being displayed, and the employees at the disenfranchised restaurant continue to answer phone calls with the Frankie's Franks name. Despite repeated requests by the franchisor and its attorneys, Main Street Franks, LLC refuses to cease and desist from its use of the Frankie's Franks trademarks.

A franchisor faced with this situation has little choice but to file a lawsuit coupled with an application for a preliminary injunction, since a court-ordered preliminary injunction is generally a franchisor's best remedy against additional harm.

Traditionally, in holdover usage cases—where an individual, group or organization continues to use a franchisor's federally registered trademark even after the franchise agreement has been terminated—obtaining a preliminary injunction was a relative certainty. But thanks to a series of recent decisions, a franchisor can no longer be assured of that outcome.

In the Third Circuit, a plaintiff must establish four elements before a district court will grant a preliminary injunction: 1) the plaintiff is likely to succeed on the merits of the case; 2) the plaintiff is likely to suffer irreparable harm in the absence of such preliminary relief; 3) the balance of equities tips in the plaintiff's favor; and 4) a preliminary injunction is in the public interest.[1]

A franchisor in a holdover usage case typically has little difficulty demonstrating it is likely to succeed on the merits of the case. Until recently, once a franchisor satisfied this prong, the second prong of irreparable harm was presumed. The Third Circuit has generally recognized that irreparable harm is caused if a holdover franchisee causes consumers to confuse a franchisor's high-quality brand with the former franchisee's inferior or defective brand.[2]

The Supreme Court Upset the Applecart with its *eBay* and *Winter* Rulings

The irreparable harm presumption was weakened by two decisions—*eBay Inc. v. MercExchange, L.L.C.*[3] and *Winter v. Natural Resources Defense Council, Inc.*[4] In *eBay*, a patent case, the U.S. Supreme Court ruled the traditional, four-factor test must be applied by courts when addressing permanent injunctions. While the *eBay* ruling did not specifically address the validity of the presumption of irreparable harm, it held that "traditional equitable principles" did not allow broad classifications similar to the presumption of irreparable harm.[5]

In *Winter*, the Supreme Court specifically addressed the irreparable harm standard in a preliminary injunction context. The Court held that "issuing a preliminary injunction based only on a possibility of irreparable harm" would no longer suffice.[6] Instead, the Court concluded an award of injunctive relief can only be made after an evaluation of the entire four-factor test.[7]

Following that decision, circuit courts began to use *Winter*, and the permanent injunction holding in *eBay*, to hold that the presumption of irreparable harm would no longer be valid in trademark infringement cases.

The Third Circuit followed suit, denying the validity of the presumption in *Ferring Pharmaceuticals*, where plaintiff Ferring filed a false advertising claim pursuant to the Lanham Act.[8] Ferring sought a preliminary injunction to prevent a competitor from continuing to assert demonstrably false statements about the superiority of its products. The district court denied relief, finding that Ferring was not entitled to a presumption of irreparable harm.[9]

In affirming the district court ruling, the court of appeals held that parties seeking preliminary injunctive relief under the Lanham Act are no longer entitled to a presumption of irreparable harm.[10] Unfortunately, *Ferring* did not provide much guidance for franchisors, or others seeking a preliminary injunction, on what was required to demonstrate irreparable harm.

The Third Circuit next confronted this issue in *Groupe SEB USA, Inc. v. Euro-Pro Operating, L.L.C.*[11] In *Groupe SEB*, Euro-Pro advertising claimed its products were better than those of Groupe SEB. But Groupe SEB used internal laboratory and independent testing to demonstrate its products were actually more powerful than those of Euro-Pro. Groupe SEB then sued Euro-Pro for false advertising under the Lanham Act, and requested a preliminary injunction to halt the false and harmful claims.

The district court granted the preliminary injunction, relying on scientific evidence provided by Groupe SEB, in addition to testimony from Groupe SEB that the advertising at issue was likely to harm their brand's reputation.[12] The Third Circuit upheld, noting that although *Ferring* barred a presumption of irreparable harm, the evidence presented by Groupe SEB created a reasonable inference that harm was likely.[13] The court specifically distinguished its finding of a likelihood of irreparable harm with the presumption of irreparable harm prohibited by *Ferring*. However, the *Groupe SEB* court noted that *Ferring* "does not bar drawing fair inferences from facts in the record," which it described as a critical aspect of fact finding.[14] This decision offers some direction for franchisors seeking to demonstrate irreparable harm.

The Third Circuit addressed the irreparable harm presumption most recently in *Arrowpoint Capital Corp. v. Arrowpoint Asset Management et al*.[15] In this case, trademark holder Arrowpoint Capital Corp., which provided insurance and investment-related financial services, brought an action for infringement of six trademarks against alleged infringers that included an investment management company and two private investment funds.

Arrowpoint Capital submitted evidence of 11 incidents of actual confusion. The district court denied its request for a preliminary injunction, ruling the confusion was among brokers and dealers, instead of "actual customer confusion." The district court thus determined that Arrowpoint Capital could not show a likelihood of success on the merits and did not analyze the three remaining factors for preliminary injunctive relief.

The Third Circuit remanded the case to the district court, noting the Lanham Act protects against "the use of trademarks which are likely to cause confusion, mistake, or deception of any kind, not merely of purchasers nor simply as to source of origin."[16]

While the Third Circuit did not have to discuss the irreparable harm element, it did address the recent rulings discussed above in a footnote. In response to Arrowpoint Capital's argument that a showing of actual confusion creates a presumption of irreparable harm, the court—citing *eBay*, *Winter*, and *Ferring*—stated "that a party bringing a claim under the Lanham Act is not entitled to a presumption of irreparable harm when seeking a preliminary injunction and must demonstrate that irreparable harm is likely."[17]

What Do These Rulings Mean for Franchisors?

While none of the Supreme Court or Third Circuit cases specifically address holdover usage by a franchisee, it seems clear that franchisor trademark holders seeking a preliminary injunction will likely have to take comprehensive, documented steps to prove a likelihood of irreparable harm, even in a straightforward holdover usage case. Until further guidance is provided, the *Groupe SEB* case provides the best roadmap for a franchisor: Specifically, in order to draw a reasonable inference of irreparable harm, a franchisor must testify regarding the likely harm it will suffer if the infringement is not prevented.

Franchisor counsel should advise clients that they can no longer assume they will secure a preliminary injunction based on the likely success on the merits of their case. Franchisor counsel should also prepare their clients to demonstrate actual and irreparable harm caused by the ongoing infringement. Counsel will need to document the harm their clients suffer from a holdover franchisee, and should—along with their client—take steps to collect evidence of such irreparable harm, including the loss of control of reputation, loss of trade, loss of goodwill, and the possibility of confusion.

Franchisor counsel and their clients should gather evidence regarding any customer complaints and service calls, as well as complaints by nearby franchisees who believe their franchised name is developing a bad reputation as a result of the behavior of the holdover franchisee. Franchisor counsel and their clients also should be prepared to document any negative customer reviews issued in connection with holdover franchisees, and to document the loss of customers resulting from the loss of goodwill.

Finally, to further bolster the claim of irreparable harm, franchisor counsel should prepare their clients to testify that once the holdover franchisee is out of the system, there is no way to monitor its service, even though the holdover continues to use the client's trademark and other identifying characteristics. ⚖

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ENDNOTES

1. *S&R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371, 374 (3d Cir. 1992).
2. *Id.* at 375 (burden of showing a likelihood of confusion met under Section 43(a) by demonstrating that the moving party and infringer are concurrently using moving party's trademarks after the termination of the franchise agreement).
3. *eBay, Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006).
4. *Winter v. Natural Resources Defenses Council, Inc.*, 555 U.S. 7 (2008).
5. *eBay*, 547 U.S. at 393.
6. *Winter*, 555 U.S. at 29.
7. *Id.* at 20.
8. *Ferring Pharmaceuticals v. Watson Pharmaceuticals, Inc.*, 765 F.3d 205 (3d Cir. 2014).
9. *Ferring Pharmaceuticals*, 765 F.3d at 209.
10. *Id.* at 216.
11. *Groupe SEB USA, Inc. v. Euro-Pro Operating, L.L.C.*, 774 F.3d 192 (3d Cir. 2014).
12. *Id.* at 196-197.
13. *Id.* at 205.
14. *Id.*
15. *Arrowpoint Capital Corp. v. Arrowpoint Asset Management, LLC*, 2015 WL 4366571.
16. *Id.* at *6 (*citing Kos Pharm., Inc. v. Andrx Corp.*, 369 F.3d 700, 711 (3d Cir. 2004).
17. *Id.* at *8, n15.