LICENSING THE USE OF INTELLECTUAL PROPERTY: THE TALE OF THE TWO FRANCHISING MARKET TYCOONS

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INTRODUCTION

Franchising agreements are contractual relationships, according to which the franchisor grants the franchisee the right to deal under his own trademark, use his "know-how," follow his business plan, in return for the

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agreed upon fees.[1] Accordingly, the essential elements of a franchise include licensing the use of intellectual property such as trademarks or service marks as well as the use of the confidential information. Intellectual property protection is typically the most important part of the franchise agreement; the core of franchising is the grant of a license to use the trademark owned by a business. No wonder, since a trademark of well-established reputation is usually a valuable business asset constituting goodwill that attracts franchisees, investors, and customers.[2]

The importance of licensing the use of intellectual property in a franchise has led some regulatory bodies to include a combination of intellectual property rights, covering trademarks, designs, copyright, and other manufacturing rights such as trade secrets and patents.[3] It seems that there are different types of intellectual property rights protected under each legal system. Ordinarily trademarks and confidentiality of undisclosed information are paramount. Unfair competitive practices also bear a close relationship with the use of intellectual property.

Generally speaking, the substantive issues related to licensing the use of intellectual property items in franchising agreements are regulated by contractual clauses among the

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[1] EUR. FRANCHISE FED., EUROPEAN CODE OF ETHICS FOR FRANCHISING, https://eff-franchise.com/code-of-ethics/ [https://perma.cc/BT4T-YR7S] (last visited Nov. 7, 2023); *see also Frequently Asked Questions About Franchising,* INT'L FRANCHISE ASS'N, https://www.franchise.org/faq [https://perma.cc/2T27-9AG3] (last visited Nov. 7, 2023).

[2] William A. Finkelstein, *Protecting Trademarks and Related Intellectual Property Rights*, *in* FUNDAMENTALS OF INTERNATIONAL FRANCHISING 62 (Richard M. Asbill & Steven M. Goldman, eds., 2001).

[3] MARTIN MENDELSOHN ET AL., FRANCHISING LAW 10 (Richmond Law & Tax ed., 2d ed. 2004) [hereinafter MENDELSOHN, FRANCHISING LAW] (citing the EC Commission Reg. No. 4087/88 on the application of Article 85(3) of the Treaty {establishing the European Economic Community} that was superseded by a Block Exemption Regulation for Vertical Agreements that came into force on 1 June 2000).

parties in their franchise agreements. Such agreements usually address different issues that guarantee the protection of the intellectual property element, the subject of question. Examples include, the determination of the intellectual property element licensed, property rights over the item licensed, conditions of use of the licensed element as per the operating manual, franchisors' rights, franchisors' rights to control the use and to develop the licensed intellectual property, infringement, sub-licensing, and the like.[4]

Besides, franchisors usually try to develop a training program to teach franchisees the proper method of displaying and using their intellectual property.[5]

However, the relevant regulatory issues such as registration of a trademark, assignment of a trademark, criminal protection of confidential information, unfair competition or mal-practices are usually regulated through general laws such as contract law or intellectual property law and not franchising laws directly.[6] This paper introduces franchising stakeholders to the main regulatory features concerning licensing, with the most relevant intellectual property items to the franchising industry being trademarks and confidential information. Some relevant aspects of unfair competition are discussed. This academic analysis is

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[4] INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW [UNIDROIT], GUIDE TO INTERNATIONAL MASTER FRANCHISE ARRANGEMENTS 11 (UNIDROIT ed., 2d ed. 2007); *see also* ANDREW J. SHERMAN, FRANCHISING AND LICENSING 141 (AMACOM ed., 3d ed. 2003).

[5] William A. Finkelstein & Christopher P. Bussert, *Trademark Law Fundamentals and Related Franchising Issues, in* FUNDAMENTALS OF FRANCHISING 42 (Ruper M. Barkoff & Andrew C. Selden eds., 2004).

[6] *See generally* Radwa Elsaman, *Disclosure and Registration Requirements in Franchising: Common Law or Civil Law Perspective?,* 58 Tulsa L. Rev. 279, 281 (2023). For instance, the issue of good faith and fairness requirements are dealt with in the Chinese Contract Law and not franchising law, see Contract Law of The People's Republic of China (promulgated by the Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999), at art. 6.

built based on a comparison of the legal systems adopting the largest franchise markets in the world, the U.S. and China. [7] The goal of the paper is to introduce franchising parties in both markets to an integrative analysis of relevant intellectual property aspects to their franchise transactions. Franchising parties, usually, prefer their agreements to be governed by a simple and unified set of rules rather than different rules, the application of which makes it complicated to negotiate and decide various issues arising from a franchise transaction. This is particularly relevant in a civil law country, where courts are more dependent on written statutes.

I. THE ASSOCIATED ASPECTS OF TRADEMARKS' LICENSING IN BOTH THE U.S. AND CHINA

In the United States both federal and state law regulate trademarks. Federal law provides protection for distinctive marks used in business,[8] regulates false designation of origin and false advertising disputes,[9] and provides registration as a method of protecting ownership and use of the mark[10] that results in incontestability.[11] The United States Patent and Trademark Office ("U.S. PTO")

[7] *See generally* Susan A. Grueneberg & Jonathan C. Solish, *Franchising 101 Key Issues in the Law of Franchising*, BUS. L. TODAY (Mar. 22, 2010), https://www.americanbar.org/groups/business_law/resources/business-law-today/2010-march/franchising-101-key-issues-in-the-law-of-franchising/ [https://perma.cc/QL5W-4J6T]; *China*, *in* THE WORLD FACT BOOK, https://www.cia.gov/the-world-factbook/countries/china/#introduction [https://perma.cc/6TWR-64ZG] (last visited Nov. 7, 2023).
[8] 15 U.S.C. § 1051 (Lanham Act).
[9] 15 U.S.C. § 1125(a).
[10] 15 U.S.C. § 1072.
[11] 15 U.S.C. § 1065.

reviews applications for registration.[12] State law provides the primary legal principles governing trademarks under unfair competition laws, model trademark laws, the Uniform Deceptive Trade Practices Act, state trademark protection statutes, and state dilution statutes.[13] The law regulating trademarks in China is the Trademark Law of the People's Republic of China ("Chinese Trademark Law").[14]

Though registration of a trademark is not mandatory in the United States to protect the trademark owner's rights, federal trademark registration with the U.S. PTO affords many benefits such as validity, ownership, and exclusive rights to use the mark.[15] Federal registration, on the basis of a good faith intention to use the mark, is not usually obtained until the applicant shows that the mark submitted for registration is in use in his business.[16]

The counterpart to federal registration in the U.S. is state registration.[17] State registration does not have the same advantages as federal registration as it rarely grants additional rights and covers only the state where registration takes place.[18] State registration is proof of the validity of the mark in the state where the mark is registered.[19] State registration also serves as an information system to those

[12] *See generally* UNITED STATES PATENTS AND TRADEMARK OFFICE, http://www.uspto.gov/ [https://perma.cc/E9Q2-FUPL] (last visited Nov. 7, 2023).
[13] *See generally* Steven John Olsen, *Mixed Signals in Trademark's "Likelihood of Confusion Law": Does Quality Matter?*, 44 VAL. U. L. REV. 659, 662–63 (2010).
[14] *See generally* Trademark Law (promulgated by the Standing Comm. of the Nat'l People's Cong., Aug. 23, 1982, amendments effective Dec. 1, 2001), CLI.1.37085(EN) (Lawinfochina).
[15] Finkelstein & Bussert, *supra note* 5, at 5.
[16] Francis J. Duffin & Bryan S. Watson, *Best Practices in Protecting and Enforcing Trademarks, Copyrights, and Other Intellectual Property Rights*, 28 FRANCHISE L.J. 132, 133 (2008).
[17] *Id.*
[18] *Id.*
[19] *Id.*

who search "the state register of the registrant's ownership interest."[20] After five years of state registration, the registration becomes incontestable.[21] Incontestability means that the owner of the mark can offensively claim the strength of the mark and defensively claim that it is beyond specific kinds of attack.[22] Aside from incontestability, registration works as a constructive notice by the mark's owner against any subsequent applications to register the same mark and such applications should be denied by the U.S. PTO if they cause confusion or deception.[23] It is also worth mentioning that in the U.S. the use of the mark is the key element to obtaining ownership rights as priority is determined according to the "first in time" principle with regard to use of the mark.[24] Judicial practice has provided that specific requirements be considered for granting rights over the trademark through use including requirements that the use be sufficient[25] and take place in good faith.[26]

The duration of a registered trademark, under U.S. trademark laws, is ten years, but is renewable.[27] There is no limit on the number of times a trademark can be renewed, with each renewal fee extending the duration for an additional ten years. The owner must simply continue using the mark and submit a Declaration of Continued Use application to the U.S. PTO, otherwise the registration will be cancelled.[28]

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[20] *Id.*
[21] 15 U.S.C. § 1115(b).
[22] SHELDON W. HALPERN, CRAIG ALLEN NARD & KENNETH L. PORT, FUNDAMENTALS OF UNITED STATES INTELLECTUAL PROPERTY LAW: COPYRIGHT, PATENT, TRADEMARK 352 (3d ed. 2011).
[23] 15 U.S.C. § 1072.
[24] 15 U.S.C. § 1051(a).
[25] Florida v. Real Juices, Inc., 330 F. Supp. 428 429, 431 (M.D. Fla. 1971).
[26] HALPERN, NARD & PORT, *supra* note 22, at 338.
[27] 15 U.S.C. § 1058(a).
[28] Duffin & Watson, *supra* note 16, at 134.

U.S. law does not provide a specific list of signs that cannot be registered as trademarks, rather it establishes specifications and requirements of what can be registered as a trademark. For example, names cannot be registered as trademarks except in specific cases where the name has a secondary meaning.[29] A good example of secondary meaning is found in *Emra Corp. v. Superclips, Ltd*, where Emra Corporation, a company with operation in California, brought a claim against Superclips Ltd., a company with operations in Canada and its franchisees in Canada and the United States.[30] Emra operated hair cutting shops and sold related products under the name "SUPERCUTS."[31] The defendant, James Tucker, contacted Emra to inquire about a franchise and was told that Emra was not currently seeking expansion.[32] The defendant and some partners then opened their own hair cutting shops under the name "SUPERCLIPS, Ltd.," and registered a trademark, "SUPERCLIPS."[33] Emra brought an action against SUPERCLIPS alleging that the defendant's trademark would cause confusion. The defendants cross-claimed that the plaintiff's trademark was a weak mark, that it had not acquired secondary meaning outside of California, and that accordingly, it was not eligible for trademark protection since it was simply descriptive.[34] The federal District Court for the Eastern District of Michigan held that:

> Emra is entitled . . . to injunctive . . . and other relief . . . against any unauthorized use in commerce of any reproduction, copy or colorable imitation of a registered mark in connection with the sale, offering

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[29] HALPERN, NARD, & PORT, *supra* note 22 at 319.
[30] Emra Corp. v. Superclips, Ltd., 559 F. Supp. 705 708, 709 (E.D. Mich. 1983).
[31] *Id.*
[32] *Id.* at 710.
[33] *Id.* at 710–11
[34] *Id.* at 713–14.

> for sale, distribution or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive. The legal standard governing the grant of injunctive relief under § 43(a) of the Lanham Act, is a showing of "likelihood of confusion.[35]

The court applied an eight-factor test to determine likelihood of confusion, examining: 1) the strength of the plaintiff's mark; 2) the relatedness of the goods; 3) the similarity of the marks; 4) evidence of actual confusion; 5) marketing channels used; 6) the likely degree of purchaser care; 7) the defendant's intent in selecting the mark; and 8) the likelihood of expansion of product lines.[36]

Concerning the first element, the court explained that trademarks fall into one of four categories: generic, descriptive, suggestive, or arbitrary or fanciful. Specifically, a mark is descriptive when it communicates to consumers the characteristics, functions, qualities, ingredients, properties, or uses of a product or service. A descriptive mark is a weak mark and is not protected unless it has a secondary meaning, for example, denoting goods or services provided only by a particular business.[37] The concept of secondary meaning was originally designed to limit the extent to which a manufacturer could monopolize through trademarks words and symbols that are useful in describing products.[38] The doctrine holds that a descriptive or geographical mark receives protection against copying only when consumers have come to associate it with a particular manufacturer or source. When a mark has acquired a secondary meaning, a second-comer is barred from using it because such use is virtually certain to create confusion in the public mind as to the source of the product. The court

[35] *Id.* at 714.
[36] *Id.*
[37] *Emra Corp.*, 556 F. Supp. 705 at 713–14.
[38] *Id.* at 713.

concluded that the Plaintiff's mark established a secondary meaning in this area of the industry.[39]

Examples of descriptive trademarks that have established secondary meanings in their industry include "Giant Hamburger" for burgers, "Pestway" for pest control services, "Beef & Brew" for restaurants, "Platinum" for home loan mortgage services, "Jewelry Repair Center" for jewelry repair.[40] In the same context, the Lanham Act specifies that using a reproduced, counterfeited, copied, or imitated mark that is likely to cause confusion or mistake, or to deceive others shall result in liability in a civil action brought by the registrant of the mark.[41] Remedies include damages, injunctive relief, court costs, and attorney fees.[42] For example, in *Howard Johnson Co. v. Khimani*, the court found that the termination compensation should cover all lost royalties.[43]

Another important issue when talking about trademarks is the assignment of a trademark. Assignment of a trademark is invalid until an application of the statement of use of the trademark is submitted by the assignor to the U.S.

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[39] *Id.* at 715.
[40] Finkelstein & Bussert, *supra* note 5, at 9–10.
[41] 15 U.S.C. § 1114(1).
[42] *Id.*
[43] *See generally* Howard Johnson Co. v. Khimani, 892 F.2d 1512, 1519–20 (11th Cir. 1990).

PTO.[44] Nevertheless, assignment of a trademark without goodwill is generally invalid in the United States.[45]

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[44] 15 U.S.C. § 1060 provides that:

> (1) A registered mark or a mark for which an application to register has been filed shall be assignable with the good will of the business in which the mark is used, or with that part of the good will of the business connected with the use of and symbolized by the mark. Notwithstanding the preceding sentence, no application to register a mark under section 1(b) shall be assignable prior to the filing of an amendment under section 1(c) to bring the application into conformity with section 1(a) or the filing of the verified statement of use under section 1(d), except for an assignment to a successor to the business of the applicant, or portion thereof, to which the mark pertains, if that business is ongoing and existing.
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> (2) In any assignment authorized by this section, it shall not be necessary to include the good will of the business connected with the use of and symbolized by any other mark used in the business or by the name or style under which the business is conducted.
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> (3) Assignments shall be by instruments in writing duly executed. Acknowledgment shall be prima facie evidence of the execution of an assignment, and when the prescribed information reporting the assignment is recorded in the United States Patent and Trademark Office, the record shall be prima facie evidence of execution.
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> (4) An assignment shall be void against any subsequent purchaser for valuable consideration without notice, unless the prescribed information reporting the assignment is recorded in the United States Patent and Trademark Office within 3 months after the date of the assignment or prior to the subsequent purchase.
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> (5) The United States Patent and Trademark Office shall maintain a record of information on assignments, in such form as may be prescribed by the Director.
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> (b) An assignee not domiciled in the United States may designate by a document filed in the United States Patent and Trademark Office the name and address of a person resident in the United States on whom may be served notices or process in proceedings affecting the mark. Such notices or process may be served upon the person so designated by leaving with that person or mailing to that person a copy thereof at the address specified in the last designation so filed. If the person so designated cannot be found at the address given in the last designation, or if the assignee does not designate by a document filed in the United States Patent and Trademark Office the name and address of a person resident in the United States on whom

Finally, U.S. law allows a licensor to maintain the right to control the quality of the products produced by the licensee. The "quality control" provision inserted in licensing agreements allows the franchisor to control the quality of the products.[46] Hence, if a licensor gives up quality control rights, this may result in a naked license. A naked license may be inferred if a trademark owner does not police the use of its mark and allows others to use it without providing oversight.[47] In either case, abandonment of the trademark will result and the trademark owner will lose all trademark rights.[48]

A case exemplifying the issue of quality control under the Lanham Act is *Dawn Donut Co. v. Hart's Food Stores*.[49] In that case, the Second Circuit Court of Appeals discussed the issue of cancellation of a trademark registration when the owner fails to exercise the quality control required by the Lanham Act over the nature and quality of the goods sold.[50] The court explained that the Lanham Act requires "the licensor of a registered trademark to take reasonable measures to detect and prevent misleading uses of his mark by his licensees or suffer cancellation of his federal registration."[51] The Lanham Act takes the position that, unlike naked licensing, controlled licensing helps to avoid abandonment of registration.[52] In other words, if

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> may be served notices or process in proceedings affecting the mark, such notices or process may be served upon the Director.

[45] HALPERN, NARD & PORT, *supra* note 22, at 350.
[46] *Id.*
[47] Yokum v. Covington, 216 U.S.P.Q. (BL) 210 (T.T.A.B. 1982).
[48] HALPERN, NARD, & PORT, *supra* note 22, at 350.
[49] *See* Dawn Donut Co. v. Harts Food Stores, Inc., 267 F.2d 358 (2d Cir. 1959).
[50] *Id.* at 360–61.
[51] *Id.* at 366.
[52] 15 U.S.C. § 1055 provides that:

> Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to

control is not required, the trademark owner's right to license the mark away from the business associated to it may result in differences in the quality of products bearing the same trademark.[53] The Act considers that the licensor's control of his licensee's actions reduces the risk that the public may be unwittingly deceived.[54]

In China, unlike in the United States, registration of a trademark is mandatory under Article 4 of the Chinese Trademark Law which requires trademarks to be registered with the State Trademark Office ("STO").[55] The Chinese Trademark Law further provides a list of signs that cannot be used or registered as trademarks.[56] The duration of a registered trademark, under the Chinese trademark laws is ten years, but, just like in the U.S., is renewable.[57]

Concerning the assignment of a trademark in China, if the trademark owner decides to assign ownership of the trademark, both the assignor and assignee must conclude an assignment agreement and submit a joint application to the STO.[58] The assignee may then enjoy the exclusive right to use the trademark from the date of publication.[59] The Chinese Trademark Law also provides licensors more rights

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> the benefit of the registrant or applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used in such manner as to deceive the public.

15 U.S.C.A. § 1127 defines 'related company' to mean "any person who legitimately controls or is controlled by the registrant or applicant for registration in respect to the nature and quality of the goods or services in connection with which the mark is used."

[53] *Dawn Donut Co.*, 267 F.2d at 367.

[54] *Id.*

[55] Trademark Law (promulgated by the Standing Comm. of the Nat'l People's Cong., Aug. 23, 1982, amendments effective Dec. 1, 2001), art. 4, CLI.1.37085(EN) (LawinfoChina).

[56] *Id.* at arts. 10–11.

[57] *Id.* at arts. 37–38

[58] *Id.* at art 39.

[59] *Id.*

than licensees. For instance, the Law explicitly provides for the licensor's right to supervise the quality of the goods for which the licensee uses the trademark and requires the licensee to guarantee the quality of the goods.[60]

Moreover, the Chinese Trademark Law defines the actions that are considered to be infringement to include use of a registered mark on counterfeit products or using marks identical to registered ones.[61] It provides a unique system to deal with infringement. First, it requires the disputing parties to try to resolve the problem through communication before making recourse to courts or asking the Administrative Authority for Industry and Commerce ("AAIC") to take action with regard to the infringement.[62] If consultations fail to produce an amenable result, then recourse can be sought from the AAIC. If the disputing party is not satisfied with the decision of the AAIC, it can file a claim in court.[63] The Chinese Trademark Law grants the AAIC the power to investigate, inspect, and handle infringement cases unless the infringement action constitutes a crime.[64] The Law also allows prompt precautionary measures by courts in the case of an infringement requiring immediate action.[65] The courts also handle cases of criminal infringement and those alleging an abuse of power by administrative agencies concerned with trademark issues.[66]

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[60] *Id.* at art. 40.
[61] Trademark Law (promulgated by the Standing Comm. of the Nat'l People's Cong., Aug. 23, 1982, amendments effective Dec. 1, 2001), art. 52, CLI.1.37085(EN) (LawinfoChina).
[62] *Id.* at 53.
[63] *Id.*
[64] *Id.* at arts. 54–55.
[65] *Id.* at arts. 57–58.
[66] *Id.* at arts. 60–62.

II. LEGAL RISKS AND BENEFITS CONCERNING LICENSING TRADE SECRETS IN THE U.S. VS. CHINA

In the United States, most states have adopted the Uniform Trade Secrets Act ("UTSA").[67] More information is given below on the definition of trade secrets, the information protected as trade secrets, and the remedies available in case of disclosure of protected trade secrets in the United States.

The definitions of trade secrets in the Restatement Third of Unfair Competition and the UTSA basically require that for information to be considered a trade secret it must be valuable, provide an advantage over competitors, be non-public, and be capable of being kept secret through reasonable efforts.[68] In *I Can't Believe It's Yogurt v. Gunn*, the franchisor terminated the franchise agreement when the franchisee failed to pay the agreed upon royalties, but the franchisee continued to sell the franchised products using the franchisor's layout after the termination.[69] As a result, the franchisor sued the franchisee for misappropriation of trade secrets, alleging that the operation manual included his business system, layouts, design, accounting procedures, know-how, and management information.[70] The U.S. District Court for the District of Colorado applied the following factors to determine whether information constitutes a trade secret:

> 1. The extent to which the information is known outside the business;

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[67] Duffin & Watson, *supra* note 16, at 178.
[68] UNIF. TRADE SECRETS ACT § 1(4) (NAT'L CONF. OF COMM'RS ON UNIF. STATE L. 1985); RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 39 (AM. L. INST. 1995).
[69] No. 94-OK-2109-TL, 1997 U.S. Dist. LEXIS 14480, at *27–29 (D. Colo. Apr. 15, 1997).
[70] *Id.* at *56.

> 2. The extent to which it is known to those inside the business, i.e., by the employees;
> 3. The precautions taken by the holder of the trade secret to guard the secrecy of the information;
> 4. The savings effected and the value to the holder in having the information as against competitors;
> 5. The amount of effort or money expended in obtaining and developing the information; and
> 6. The amount of time and expense it would take for others to acquire and duplicate the information.[71]

Based on the above-mentioned factors, the court concluded that the plaintiff failed to prove that the information in dispute should be treated as trade secrets since this information was disclosed to all people in Yogurt University and to the managers and employees who were required to sign neither the franchise agreement nor the confidentiality agreement.[72]

Furthermore, the court explained that for information to be protected as trade secrets, appropriate measures should be taken to prevent the secret from becoming available to people other than those who are allowed by the trade secret owner to have access to the information for the purpose of operating the business.[73] The court added that the fact that the franchisor disclosed the information to employees and managers who did not sign confidentiality agreements meant that the franchisor did not take proper measures to protect the confidentiality of the information as trade secrets.[74]

The Third Restatement of Unfair Competition considers the duty of confidentiality a duty of confidence that exists when there is an express commitment of confidentiality, or the person is supposed to know that

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[71] *Id.* at *57–58 (citing Network Telecommunications, Inc. v. Boor-Crepeau, 790 P.2d 901, 903 (Colo. App. 1990); Colorado Supply Company, Inc. v. Stewart, 797 P.2d 1303, 1306 (Colo. App. 1990)).
[72] *Id.* at *58–59 (D. Colo. Apr. 15, 1997).
[73] *Id.* at *57.
[74] *Id.* at *59.

disclosure is made in confidence while the disclosing party reasonably assumes an obligation of confidentiality.[75] The Restatement also establishes liability for misappropriation of a trade secret by any employee who discloses a trade secret in breach of a duty of confidence.[76]

Various types of business information can benefit from protection as trade secrets including business systems, business formats, processing, customer and supplier information, business plans, marketing information, recipes, product information, formulas, financial plans, inventories, and software.[77] In *Tan-Line Studios, Inc. v. Bradley*, Tan-Line claimed that Bradley misappropriated its trade secrets, including tanning studio operation methodologies, training programs, layouts, advertising and marketing methodologies, and accounting information that Bradley learned while working as a consultant to Tan-Line and subsequently used to operate a competing business.[78] Bradley alleged that the information he obtained from Tan-Line did not constitute trade secrets.[79] The law applied by the District Court for the Eastern District of Pennsylvania mirrored the definition of trade secrets contained in the Third Restatement of Unfair Competition.[80] The court declined Bradley's argument and decided that Bradley had

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[75] RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 41 (AM. L. INST. 1995).

[76] *Id.* at § 42.

[77] *See generally* Duffin & Watson, *supra* note 16, at 178–79.

[78] No. 84-5925, 1986 U.S. Dist. Lexis 27754, at *2–13, *16 (E.D. Pa. Mar. 25, 1986).

[79] *Id.* at *19.

[80] RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 39 COMMENT D (AM. L. INST. 1995) ("A trade secret can consist of a formula, pattern, compilation of data, computer program, device, method, technique, process or other form or embodiment of economically valuable information.").

misappropriated Tan-Line's trade secrets and found him liable for damages to Tan-Line.[81]

It is noteworthy that franchisees can also sue franchisors for misappropriation of the franchisees' trade secrets. In *Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp.*,[82] Camp Creek operated a Sheraton Inn franchise when the franchisor granted another Sheraton Inn franchise in the same area and made the new business appear to be operated by Camp Creek.[83] Camp Creek sued the franchisor asserting that the franchisor had hired a former manager of the franchisee, who had had access to the franchisee's confidential information.[84] The District Court for the Northern District of Georgia decided that there was no misappropriation of trade secrets but was subsequently reversed by the Eleventh Circuit.[85] The Court of Appeals held that the franchisee provided sufficient proof that the information used by the manager constituted trade secrets through expert testimony that the information used by the franchisor was specific in nature and used only in the hotel industry.[86] The court found that although the franchisee had disclosed this information voluntarily, Camp Creek had not disclosed this information except with the understanding that the franchisor would keep it confidential, which was supported by a note of confidentiality.[87] The 11th circuit remanded the case to determine if an injunction for Camp Creek is appropriate for preventing its competitor from misusing the confidential information.[88]

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[81] *Tan-Line Studios*, 1986 U.S. Dist. Lexis 27754, at *30.
[82] 139 F.3d 1396 (11th Cir. 1998).
[83] *Id.* at 1401.
[84] *Id.* at 1402.
[85] *Id.* at 1412.
[86] *Id.* at 1411.
[87] *Id.* at 1411–12
[88] *Camp Creek Hospitality Inns,* 139 F.3d at 1412.

Liability for breach of confidentiality usually attaches when an actor acquires or uses information he knows or should know is a trade secret in an "improper" way.[89] Improper means of acquiring another's trade secret under the Third Restatement of Unfair Competition Section 43 include "theft, fraud, unauthorized interception of communications, inducement of or knowing participation in a breach of confidence, and other means either wrongful in themselves or wrongful under the circumstances of the case.[90] Independent discovery and analysis of publicly available products or information are not improper means of acquisition."[91] When the misappropriation of trade secrets

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[89] RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 40 (AM. L. INST. 1995) provides that:

> One is subject to liability for the appropriation of another's trade secret if:
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> (a) the actor acquires by means that are improper under the rule stated in § 43 information that the actor knows or has reason to know is the other's trade secret; or
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> (b) the actor uses or discloses the other's trade secret without the other's consent and, at the time of the use or disclosure,
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> (1) the actor knows or has reason to know that the information is a trade secret that the actor acquired under circumstances creating a duty of confidence owed by the actor to the other under the rule stated in § 41; or
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> (2) the actor knows or has reason to know that the information is a trade secret that the actor acquired by means that are improper under the rule stated in § 43; or
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> (3) the actor knows or has reason to know that the information is a trade secret that the actor acquired from or through a person who acquired it by means that are improper under the rule stated in § 43 or whose disclosure of the trade secret constituted a breach of a duty of confidence owed to the other under the rule stated in § 41; or
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> (4) the actor knows or has reason to know that the information is a trade secret that the actor acquired through an accident or mistake, unless the acquisition was the result of the other's failure to take reasonable precautions to maintain the secrecy of the information.

[90] *Id.* at § 43.

[91] *Id.*

causes injury to the franchisor, the franchisor is usually entitled to injunctive relief.[92]

China also has an independent law that regulates trade secrets: the Anti-unfair Competition Law of the People's Republic of China[93] and its supplementary Provisions on Prohibiting Infringements upon Trade Secrets.[94] Generally speaking, the criminal law penalizes, with three years imprisonment and a fine, any encroachment upon commercial trade, such as: acquiring a rightful owner's commercial secrets via theft, lure by promise of gain, threat, or other improper means; disclosing, using, or allowing others to use a rightful owner's commercial secrets which are acquired through the aforementioned means.[95] The criminal law also defines a trade secret to include any technical and operating information that is unknown to the public, can bring economic profits, is functional, and is kept as a secret by its rightful owner.[96] According to the criminal law, users of trade secrets who have permission of the owner are deemed to be rightful owners of the secrets.[97] It is also worth mentioning that the prohibition on the illegal use of trade secrets is not restricted to direct infringers, but is

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[92] Deutsche Inv. Mgmt. Ams., Inc. v. Riverpoint Capital Mgmt., No. C-1-02-577, 2002 U.S. Dist. LEXIS 16147, at *9 (S.D. Ohio Aug. 22, 2002); *see also* Nelson v. Nat'l Fund Raising Consultants, Inc., 823 P.2d 1165 (Wash. Ct. App. 1992).

[93] *See generally* Anti-unfair Competition Law (promulgated by the Standing Comm. of the Nat'l People's Cong., Sept. 2, 1993, effective Dec. 1, 1993) CLI.1.6359(EN) (Lawinfochina).

[94] *See generally* Several Provisions on Prohibiting Infringements upon Trade Secrets (promulgated by the State Admin. for Indust. and Comm., Nov. 23, 1995, amended Dec. 3, 1998), CLI.4.23598(EN) (Lawinfochina).

[95] *See* Criminal Law (promulgated by the Nat'l People's Cong., July 1, 1979, amended Mar. 14, 1997, effective Oct. 1, 1997), arts. 219-20 CLI.1.17010(EN) (Lawinfochina).

[96] *Id.* at art. 219(3).

[97] *Id.*

applied to third parties who come across trade secrets indirectly in any way.[98]

Moreover, the Labor Contracts Law, supplementing and updating the Chinese Labor Law of 1995,[99] is the latest Chinese law to deal with protection of trade secrets and has promulgated rules on trade secrets and confidentiality issues.[100] The Labor Contract Law provides for the employer's right to include a confidentiality of trade secrets and intellectual property clause in the employment contract and if the employee breaches the covenant, that he is responsible for compensating the employer through liquidated damages as per the contract.[101]

Furthermore, under the Chinese Unfair Competition Law, trade secrets are defined as "the applied technology or business information unknown to the public and capable of bringing economic benefits to the right holder, for which the right holder has taken confidentiality measures."[102] The Supreme People's Court also issued the Interpretation on Some Issues Concerning the Application of Law in the Trial of Civil Cases of Unfair Competition,[103] according to which, the disclosure of trade secrets acquired through one's own

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[98] Robert Bejesky, *Investing in the Dragon: Managing The Patent versus Trade Secret Protection Decision for the Multinational Corporation in China*, 11 TULSA J. COMP. & INT'L L. 437, 459 (2003).

[99] *See* Labor Contract Law (promulgated by the Standing Comm. of the Nat'l Peoples' Cong., June 29, 2007, effective Jan. 1, 2008), art. 1 CLI.1.94833(EN) (Lawinfochina).

[100] Marisa Anne Pagnattaro, *Protecting Trade Secrets in China: Update on Employee Disclosures and the Limitations of the Law*, 45 AM. BUS. L.J. 399, 405 (2008).

[101] *Id.* at 404–05.

[102] Anti-unfair Competition Law (promulgated by Standing Comm'n of the Nat'l People's Cong., Sept. 2, 1993, effective Dec. 1, 1993), art. 10 CLI.1.6359 (Lawinfochina).

[103] Interpretation of the Supreme People's Court on Some Issues Concerning the Application of Law in the Trial of Civil Cases Involving Unfair Competition (promulgated by Supreme People's Court, Jan. 12, 2007, effective Feb. 1, 2007), CLI.3.83311 (Lawinfochina).

research or study is not considered a breach of the Unfair Competition Law.[104] Hence, infringement is deemed to take place when trade secrets have been obtained in an illegal way or when they are obtained through a bad faith breach of a confidentiality obligation.[105]

Nevertheless, specific conditions must be met for trade secrets to be protected in China. For instance, employers have to take serious measures to guarantee protection of their trade secrets, such as adopting a written policy to protect trade secrets that should be signed by employees and keeping records of all employees who go to any meeting where confidential information is disclosed.[106] Also, the plaintiff has to prove that the information is of "economic value and practical applicability."[107] The Chinese Supreme Court requires that the economic loss be at least CNY 500,000 if the infringement is committed by an individual and CNY 1,500,000 if infringement is committed by an entity.[108] One commentator argues that proving this amount of loss is not easy, particularly as political considerations affect the judicial process.[109]

The Supreme People's Court confirmed that the burden of proof for breach of confidentiality rests on the person alleging violation. This requires showing:

> (1) That it complied with the statutory requirements (e.g., detailed content and commercial value of the trade secret as well as specific confidentiality measures taken), (2) that the information used by the opposing party is identical or materially identical to its

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[104] *Id.*
[105] MAARTEN ROOS, CHINESE COMMERCIAL LAW A PRACTICAL GUIDE 285 (Kluwer L. Int'l ed., 2010).
[106] *Id.* at 83.
[107] *Id.*
[108] *Id.* at 285.
[109] *Id.*

> trade secret, and (3) that the opposing party obtained the information by improper means.[110]

Similarly, the Supreme People's Court provides guidelines for the courts to follow when deciding whether trade secret owners have followed sufficient confidentiality measures: "(1) restricting disclosure to relevant people, (2) "locking" or encrypting confidential information, (3) marking the information "confidential," (4) using passwords or codes on the confidential information, (5) entering into confidentiality agreements, (6) restricting access/visits to machines or sites with confidential information, and (7) other reasonable measures."[111]

The remedies provided under Article 25 of the Anti-Unfair Competition Law are injunctions and fines.[112] Chinese enforcement agencies may impose administrative sanctions on infringers directly without recourse to the courts.[113] Also, the Chinese Public Security Authority may impose administrative sanctions against minor infringements under the Regulations for the Administration and Punishment of Security Violations.[114] If an injured party is not satisfied with the remedies provided by the administrative process, it may appeal within fifteen days to "the competent authority at the next higher levels for reconsideration" within the control and inspection authority.[115] If the claimant is still not satisfied with the

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[110] Pagnattaro, *supra* note 100, at 407.
[111] *Id.* at 406.
[112] Anti-unfair Competition Law (promulgated by Standing Comm'n of the Nat'l People's Cong., Sept. 2, 1993, effective Dec. 1, 1993), art. 25 CLI.1.6359 (Lawinfochina).
[113] Nathan Greene, *Enforceability of The People's Republic of China's Trade Secret Law: Impact on Technology Transfer in The PRC and Preparing for Successful Licensing*, 44 IDEA 437, 445 (2004).
[114] *Id.*
[115] Bejesky, *supra* note 98, at 459–60.

administrative remedies, another appeal may be had to the competent People's Court.[116]

Because the protection of trade secrets in China is generally poor, particularly in terms of enforcement, trade secret owners must take practical steps to protect their information. Examples include conducting proper due diligence before concluding deals, utilizing confidentiality agreements, incorporating non-competition provisions, and providing for remedies in the case of breach.[117]

III. UNFAIR COMPETITION AND FRANCHISE TRANSACTIONS IN THE U.S. VS CHINA

In the United States, unfair competition is regulated at both the federal and state levels. At the federal level, the Lanham Act was intended to "mak[e] actionable the deceptive and misleading use of marks" and "to protect persons engaged in . . . commerce against unfair competition."[118] It basically prohibits commercial practices that cause confusion between the provider of goods or services and another, false advertisements pertaining to the origins of goods or services, and trademark infringement.[119]

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[116] *Id.* at 460.
[117] Greene, *supra* note 113, at 463–65.
[118] 15 U.S.C. § 1127.
[119] 15 U.S.C. § 1125(a) provides that:

> A. Civil Action:
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> (1) Any person who, on or in connection with any goods or services, or any container for goods, uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which—
>
> (A) is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person, or

Although the Lanham Act primarily concentrates on trademark and service mark infringement, Section 43(a) deals with unfair competition.[120] The Supreme Court, however, noted that Section 43(a) of the Lanham Act "does not have boundless application as a remedy for unfair competition" but rather "because of its inherently limited wording, section 43(a) can never be a federal codification of the overall law of unfair competition."[121] The Federal Trade Commission ("FTC") also has specific regulations concerning unfair competition.[122] The FTC acts in the interest of the public by issuing complaints, conducting hearings before administrative judges, and providing reviews and decisions that may be reviewed by federal courts.[123]

> (B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities, shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.
> (2) As used in this subsection, the term "any person" includes any State, instrumentality of a State or employee of a State or instrumentality of a State acting in his or her official capacity. Any State, and any such instrumentality, officer, or employee, shall be subject to the provisions of this chapter in the same manner and to the same extent as any nongovernmental entity.
> (3) In a civil action for trade dress infringement under this chapter for trade dress not registered on the principal register, the person who asserts trade dress protection has the burden of proving that the matter sought to be protected is not functional.

See also Section 43(a) of the Lanham Act.

[120] BUSINESS TORTS AND UNFAIR COMPETITION HANDBOOK 49 (ABA Section of Antitrust L. ed., 2d ed. 2006)

[121] Dastar Corp. v. Twentieth Century Fox Film Corp., 539 U.S. 23, 29 (2003) (quoting Alfred Dunhill, Ltd. v. Interstate Cigar Co., 499 F.2d 232, 237 (2d Cir. 1974)).

[122] 15 U.S.C. § 45.

[123] BUSINESS TORTS AND UNFAIR COMPETITION HANDBOOK, *supra* note 120, at 79.

Additionally, the Third Restatement of Unfair Competition emphasizes freedom of competition unless harm arises from deceptive marketing, infringement of trademarks, or appropriations of intangible trade values such as trade secrets.[124] Prohibitions against unfair competition include actions that interfere significantly with others' abilities to compete or that contradict public policy as recognized by statutory or common law.[125]

At the state level, legislation has been enacted dealing with various aspects of unfair competition. Alabama, for example, prohibits contracts restraining trade, such as agreements seeking to prevent someone from exercising a lawful trade or business, and expressly allows sellers to agree with their agents and employers to refrain from having a similar business to theirs through non-competition clauses.[126] California provides for a similar rule in its Business and Professions Code[127] and the Minnesota Franchise Act and South Dakota Franchise Act explicitly prohibit engagement in any unfair or inequitable practices.[128]

Likewise, court decisions have clearly dealt with unfair competition. For instance, in *Re/Max International, Inc. v. Trendsetter Realty, LLC*,[129] the Defendant, a former employee of a Re/Max franchise, claimed that the post-termination covenant not to compete was unreasonable as the provision was unlimited in scope, duration, and geographical area, and was unclear under the Texas Business

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[124] RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 38 COMMENT A (AM L. INST. 1995).
[125] BUSINESS TORTS AND UNFAIR COMPETITION HANDBOOK, *supra* note 120, at 48.
[126] ALA. CODE § 8-1-1 (2011).
[127] CAL. BUS. & PROF. CODE § 16600 (West 2012).
[128] MINN. STAT. § 80 C.14 (2012); S.D. CODIFIED LAWS § 37-5A-51 (2007).
[129] 655 F. Supp. 2d 679, 718 (S.D. Tex. 2009).

and Commerce Code.[130] The District Court for the Southern District of Texas explained that a non-competition clause does not need to explicitly prohibit competition, as long as the practical and economic reality of the provision prohibits competition.[131] The court also held that the clause was not a covenant not to compete, as it did not prevent the Defendant from competing with Re/Max clients, but rather aimed to protect Re/Max's goodwill by prohibiting previous employees from using its trademark to make consumers think that they were still employed by Re/Max.[132]

Moreover, in *Atlanta Bread Co. Int'l v. Lupton-Smith*, the franchisor, Atlanta Bread, concluded franchise agreements with the franchisee, Lupton-Smith, by which the franchisee was granted the right to operate five bakery stores in Atlanta.[133] All the agreements included a clause preventing the franchisee, without written permission from the franchisor, from engaging in any bakery business with similar operation methods to the franchisor's.[134] The franchisee started a P.J.'s Coffee & Lounge in Atlanta that caused the franchisor to terminate the franchise agreement, claiming that the franchisee's activity breached the covenant not to compete.[135] The Supreme Court of Georgia concluded that non-competition clauses included in franchise agreements need to be reasonable as to time, territory and scope.[136] Accordingly, the court decided that the restraint in this case was unreasonable because the territorial limitations were overly broad.[137]

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[130] *Id.* at 718.
[131] *Id.* at 718–19.
[132] *Id.* at 719.
[133] Atlanta Bread Co. Int'l v. Lupton-Smith, 679 S.E.2d 722, 723 *(*Ga. 2009*)*.
[134] *Id.*
[135] *Id.*
[136] *Id.* at 725 (citing Gandolfo's Deli Boys, LLC v. Holman, 490 F. Supp. 2d 1353, 1357–58 (N.D. Ga. 2007)).
[137] *Id.*

Other related state statutes also regulate unfair trade practices.[138] Colorado, Delaware, Hawaii, and Kansas, for example, have enacted legislation to deal with different aspects of unfair competition.[139] The Uniform Deceptive Trade Practices Act was drafted in 1964 and adopted by a number of states in 1966. It provides eleven deceptive trade practices among which are trademark infringement, passing off goods, bait and switch, disparagement, misrepresentation of standards, origins or quality of goods, and misleading price comparisons.[140] In addition, almost all states have adopted "Little FTC Acts" that are deemed to be essentially private versions of the Unfair Trade Practices Act and Consumer Protection Act.[141] These Acts basically provide exhaustive lists of unfair practices and allow consumers and sometimes other private parties to sue on grounds similar to those on which the FTC can sue.

In China, the applicable law to unfair competition practices is the Anti-unfair Competition Law, which should be distinguished from the Anti-Monopoly Law that deals with antitrust and monopolistic actions.[142] The Chinese

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[138] *See* CAL. BUS & PROF. CODE §§ 16700 et seq. (West 2012) (covering combinations on restraint of trade); *but see* CAL. FOOD & AGR. CODE §§ 54038-39 (West 2012) (stating that contracts between nonprofit cooperative marketing associations and their members are not a restraint on trade).

[139] *See* Mary W. Craig, *A Horse of a Different Color: A Study of Color Bias, Anti-trust, and Restraint of Trade Violations in the Equine Industry*, 22 ST. THOMAS L. REV. 433, 441 (2010).

[140] Marilyn B. Cane & Peter Ferola, *Back to the Future the States' Struggle to Re-Emerge as Defenders of Investors' Rights*, 5 U.C. DAVIS BUS. L.J. 15 (2005).

[141] BUSINESS TORTS AND UNFAIR COMPETITION HANDBOOK, *supra* note 120, at 80.

[142] *See generally* Anti-Monopoly Law (promulgated by Standing Commit. Of the Nat'l People's Cong., Aug. 30, 2007, amended June 24, 2022, effective Aug. 1, 2022) CLI.1.5128034(EN) (Lawinfochina); Anti-unfair Competition Law (promulgated by Standing Comm'n of the

Anti-unfair Competition Law provides for the promotion of fair competition and the interests of market players by requiring equality, fairness, honesty, credibility, and consideration of business ethics in trade by requiring the government to support and protect fair competition.[143] The Law prohibits many actions considered harmful to fair competition and free trade whether committed by private businesses or government-operated enterprises.

Examples of actions prohibited by private businesses include selling commodities for a lower price than their cost; tying sales or cartel arrangements; putting unreasonable conditions on sale transactions; conducting deceptive lottery sales; spreading false information to injure competitors; and the collusion of bidders to force bidding prices up or down.[144] Examples of actions prohibited by public enterprises include restricting purchasing to designated businesses, imposing limitations on the rightful activities of other businesses, and restricting commodities from entering local markets.[145] As for enforcement, the Chinese Anti-unfair Competition Law allows authorities charged with its execution to inspect, supervise, investigate, inquire, or interrogate businesses and their property to achieve the purpose of the law.[146] The Law also provides for financial penalties for any of the prohibited actions.[147]

Nat'l People's Cong., Sept. 2, 1993, effective Dec. 1, 1993), art. 25 CLI.1.6359 (Lawinfochina).

[143] Anti-unfair Competition Law (promulgated by Standing Comm'n of the Nat'l People's Cong., Sept. 2, 1993, effective Dec. 1, 1993), art. 1–4 CLI.1.6359 (Lawinfochina).

[144] *Id.* at arts. 5–15.

[145] *Id.* at arts. 6–7.

[146] *Id.* at arts 16–19.

[147] *Id.* at arts. 20–32.

IV. CONCLUSION

Relatively, three types of rules regulate franchising relationships in the various legal systems. Pre-sale disclosure rules that require disclosure of relevant information by the franchisor to enable the franchisee to decide upon the business opportunity.[148] Registration rules are usually associated to disclosure rules requiring the registration of franchising agreements.[149] Finally, relationship laws organizing the franchising parties' rights versus obligations.[150]

Nevertheless, the franchising relationship is a contractual one and, as a result, contract law governs the general framework of a franchise relationship.[151] Similarly, some other laws such as corporate and tax laws play a vital role in deciding whether to expand franchising through a branch or a subsidiary and the corporate form that best fits each franchise relationship.[152] Also, intellectual property law is closely connected to franchising, as use of trademarks or trade names is one of the most important elements of franchising.[153]

If franchising laws might have some similarities from a country to the other since franchise transactions usually reflect similar clauses, the other associated laws and rules governing issues such as intellectual property would vary from one jurisdiction to the other one. Accordingly, staying aware of those aspects of intellectual property law by franchising stakeholders is a must. Procedural aspects in

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[148] AMERICAN BAR ASSOCIATION FORUM ON FRANCHISING, FUNDAMENTAL OF FRANCHISING 96 (Rupert M. Barkoff, Joseph J. Fittante, Ronald K. Gardner, Andrew C. Selden eds., 2015).
[149] *Id.* at 143.
[150] *Id.* at 185.
[151] *Id.* at 223.
[152] *Id.* at 282–287.
[153] *Id.* at 287–288.

particular vary, such as registration procedures of a trademark, criminal protection in case of infringement or disclosure of undisclosed information and unfair competition. The American and Chinese laws do not only represent modules from the two legal systems; common and civil law systems, but also include the world's largest share of franchising industry. Staying aware of the associated aspects of licensing intellectual property in both countries is not only important for franchising parties in the two countries but also for other legal systems wishing to reach a working model law for their market.