wiley

NEWSLETTER

Recent Case Highlights Viability of Counterfeiting Claims Against Former Franchisees - Lessons for Franchisors

January 26, 2012

When a franchise agreement is terminated or expires, a franchisor may encounter an uncooperative franchisee that refuses to cease operation of the franchised business. Most franchisors are familiar with federal and state laws that may be invoked in such situations to address the holdover franchisee's trademark infringement. However, not all franchisors are aware that in this context, it also may be possible to assert a claim for counterfeiting against the holdover franchisee, and that such a claim could offer significant potential recovery for the franchisor. A recent decision by a federal district court in Indiana highlights the viability of counterfeiting claims in the franchise context, and the value of monetary remedies available under federal counterfeiting law.

In *Century 21 Real Estate, LLC v. Destiny Real Estate Properties et al.*, 2011 WL 6736060 (N.D. Ind., Dec. 19, 2011), the district court considered various claims asserted by franchisor Century 21 against Destiny Real Estate Properties and Daniel Sutton, a former franchisee and its owner. Century 21 had terminated the franchise agreement after Destiny failed to make the required payments thereunder, but Destiny continued to operate its real estate business under the Century 21 marks, including presentation of the marks in signage and Internet ads. Century 21 filed suit, asserting various causes of action based on Destiny's continued use of the Century 21 marks after termination of the franchise agreement, including federal trademark infringement, false designation of origin and dilution claims, as well as related state claims. Century 21 also included a claim for counterfeiting, asserting that Destiny's post-termination use of Century 21's exact mark constituted counterfeiting under § 34(d)(1)(B) of the Federal Trademark Act, 15 U.S.C. § 1116(d)(1)(B), and that such counterfeiting was willful, entitling Century 21 to treble damages and other monetary relief available where counterfeit marks are involved.

The district court found that "liability on the trademark claims [wa]s readily established," but engaged in a detailed analysis of Century 21's counterfeiting and damages claims. To prove counterfeiting under § 35(b) of the Federal Trademark Act, 15 U.S.C. § 1117(b), Century 21 was required to establish that: (1) the mark was "counterfeit"-a "spurious mark which is identical with, or substantially indistinguishable from, a registered mark"; (2) the mark was registered on the Principal Register for use on the same goods/services for which the defendant used the mark; (3) the defendant was not authorized to use the mark; and (4) the defendant acted with knowledge and intent-in other words, that the defendant intentionally used the mark knowing it was counterfeit. The district court's opinion specifically analyzed the first element, and considered whether the continued use of a formerly authorized mark by a holdover franchisee constituted the use of a "counterfeit" mark. In its analysis, the district court observed that courts have adopted different views regarding whether counterfeiting could be proven in such a context-with the Sixth Circuit and the Western District of Pennsylvania holding that counterfeiting could not be shown under such facts, and the Ninth Circuit holding that continued use of a certification mark following termination of a license constituted counterfeiting. Considering this precedent, and instructive case law from the Seventh Circuit, the district court reasoned that Destiny's actions could constitute counterfeiting under federal law because the ex-franchisee was selling a non-genuine service "wrapped in the 'package' stamped with the former franchisor's trademarks." The district court specifically noted that a former franchisee should not be permitted to escape liability for counterfeiting simply because it once had access to and a contractual right to use the franchisor's original marks and therefore did not need to *reproduce* an identical or substantially similar mark. Indeed, the district court found that the risk of confusion is even greater when a former franchisee uses a genuine mark instead of just a copy of the mark.

Based on that rationale, the district court held that Destiny's continued unlicensed use of Century 21's marks in connection with services that lacked connection with or approval from Century 21 constituted the use of counterfeit marks under federal law. The district court awarded Century 21 damages in the amount of $113,656 plus attorneys' fees of $5,419 and costs of $595, and issued a permanent injunction restraining the defendants from further use of the marks. The district court declined, however, to impose personal liability on Sutton as owner of the franchisee, finding that the complaint had not set forth sufficient facts to establish his personal involvement in the infringement.

Importance of Counterfeit Monetary Remedies

The Federal Trademark Act provides for special damages in counterfeiting cases. Specifically, § 35(b), 15 U.S.C. § 1117(b), specifies that, in cases of willful counterfeiting, the court should enter judgment for treble profits or damages (whichever amount is greater), together with reasonable attorneys' fees, unless there are some extenuating circumstances. Although "extenuating circumstances" are not defined in the Act and are determined on a case-by-case basis, such exception is narrow. Accordingly, a successful counterfeiting claim can result in a mandatory award of substantial value. In the alternative to these damages, § 35(c) of the Act, 15 U.S.C. § 1117(c), offers an option of statutory damages ranging between $500 and $100,000 per counterfeit mark per type of goods/services sold; or, if the court finds that the use of the counterfeit mark was willful, up to $1,000,000 per counterfeit mark per type of good/services sold. These remedies are of significant economic value, particularly in light of the fact that a judgment for willful infringement may not be dischargeable in bankruptcy. Further, the risk that such remedies will be imposed should generate significant settlement leverage in favor of the franchisor.

Practice Pointers

In light of the potential value of these counterfeiting monetary remedies, franchisors should keep such claims in mind when dealing with holdover franchisees. To bolster the viability of counterfeiting claims, franchisors might consider modifying franchise agreements to include an explicit acknowledgement by the franchisee that use of the franchisor's marks after termination or expiration of the agreement constitutes unauthorized use of an identically or virtually indistinguishable mark. In the event that the franchisee continues to use the franchisor's marks following termination or expiration of the franchise agreement, such acknowledgment could be used to support a claim that the franchisee is knowingly using a "counterfeit" mark, as defined in the Federal Trademark Act. The franchise agreement also could include language specifically noting, in the context of remedies available to the franchisor for unauthorized trademark use, that the franchisor may seek appropriate remedies under the counterfeiting provisions of the Federal Trademark Act.

In the event that a former franchisee continues to use the franchisor's marks without proper authorization, the franchisor should act decisively to stop such action. When demanding that such actions stop immediately, the franchisor should warn the franchisee that continued unauthorized use of the franchisor's marks constitutes both infringement and counterfeiting, with the latter imposing significant remedies. To the extent that the franchisor extends a temporary license to a terminated franchisee, or agrees to offer continued support and services, the franchisor should impose an express time limitation on such conditions, and reserve all rights to seek appropriate remedies under § 35(b). Finally, if a franchisor finds itself in the position where it must resort to judicial action to secure compliance from the holdover franchisee, counterfeiting claims should be pleaded in an effort to secure recovery of treble damages or treble profits as well as attorneys' fees.