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RECENT CASES

Here are some of the most recent judicial developments of interest to franchisors:

DAMAGES TO FRANCHISOR

RADISSON HOTELS ENTITLED TO LIQUIDATED DAMAGES UNDER CALIFORNIA LAW – CONTINUED VIABILITY OF PIP V. SEALY CALLED INTO QUESTION

In a case handled by Gray Plant Mooty attorneys, the U.S. District Court for the Central District of California recently granted Radisson Hotels International, Inc. summary judgment in the amount of $1,006,714.55 for past due fees and liquidated damages. In doing so, the court held that Radisson's contractual liquidated damages clause was reasonable and enforceable. The court also determined that California's leading case on a franchisor's ability to collect future lost profits in the context of a termination for cause, Postal Instant Press, Inc. v. Sealy, 43 Cal. App. 4th 1704 (1996), was inapplicable to the facts of the case and decided in error. This decision should provide franchisors with powerful ammunition in their efforts to overcome the negative influence of Sealy in obtaining lost future royalties when a franchisee commits a material breach resulting in termination.

In *Radisson Hotels International, Inc. v. Majestic Towers, Inc., et a*l., Case No. CV 06-4956 SVW (C.D. Cal. Jan. 25, 2007), Radisson terminated the franchisee's franchise rights after the franchisee refused to comply with its payment obligations under the parties' License Agreement. After termination, Radisson commenced a lawsuit seeking payment of past due fees and liquidated damages pursuant to a provision in the License Agreement that allowed Radisson to collect two years worth of royalties from a terminated franchisee. In support of its motion for summary judgment, Radisson argued that the liquidated damages amount was designed to estimate the revenue and future royalties that will be lost by Radisson while it searches for a replacement franchisee, which, on average, takes a period of two years to accomplish.

In response to Radisson's claim for liquidated damages, the franchisee argued that the provision was unenforceable because: (1) the two year loss of royalties estimate used by Radisson is unreasonable; (2) the provision constitutes an unenforceable penalty; and (3) Radisson's termination of the License Agreement due to the franchisee's failure to pay was not the proximate cause of Radisson's lost future royalties under the holding of PIP v. Sealy.

In rejecting the franchisee's arguments, the court ruled that the franchisee carried the burden of demonstrating that Radisson's two-year timeline for replacing terminated franchisees was unreasonable and that the franchisee failed to satisfy its burden. The court also dismissed the franchisee's argument that the liquidated damages provision constituted a penalty because (1) the license agreement was terminated within its first year; and (2) it is improper to use the revenues earned by the predecessor hotel operator in the calculation of lost future royalties. In rejecting this argument, the court held that the plain language of the liquidated damages clause did not support the franchisee's contention.

Finally, with respect to the franchisee's argument that Radisson's claim for lost future royalties is not allowed under the holding of PIP v. Sealy, the court determined that PIP v. Sealy was distinguishable from the facts of the case. The court noted that in Sealy, the franchise agreement contained a vague statement that the franchisor would be entitled to the "benefit of the bargain" in the event of franchisee's material breach, while in the present case, the parties included a specific contractual provision functionally requiring franchisee to indemnify Radisson for lost future profits in the event the contract is terminated due to franchisee's failure to pay royalties. Thus, the court found that the parties made a valid contractual agreement that renders Sealy's rule inapplicable to the facts of the case. In addition, the court noted that:

> Alternatively, this Court believes that the Sealy decision is mistaken. * * * * In this Court's view, the Sealy Court's holding that a franchisor has no remedy but to sue the franchisee over and over again as lost royalties accrue is

> simply untenable. * * * Similarly, the Court believes that where a franchisee breaches a contract and demonstrates that it is unable or unwilling to meet its obligations, lost future profits are a proximate result of the breach because the franchisee's actions are a substantial factor in bringing about that loss or damage.

The holding in this case clearly takes cases involving liquidated damages clauses outside of the scope of the Sealy decision, while at the same time providing franchisors with a strong argument against the application of Sealy whenever termination is the result of a franchisee's breach.

STATE FRANCHISE LAWS/VIOLATIONS/TERMINATIONS

COURT HOLDS THAT ADVERTISING FEES DUE UNDER AN EXCLUSIVE DISTRIBUTORSHIP AGREEMENT DO NOT CONSTITUTE A FRANCHISE FEE UNDER THE MINNESOTA FRANCHISE ACT

In *R&A Small Engine, Inc. v. Midwest Stihl, Inc*., 2006 WL 3758292 (D. Minn. Dec. 20, 2006), a Minnesota federal district court was asked to address whether advertising fees due under an exclusive distributorship agreement constitute a "franchise fee" under the Minnesota Franchise Act ("MFA"). The court held that the advertising fees were an "ordinary and reasonable business expense" and granted summary judgment dismissing the MFA claims.

R&A Small Engine ("R&A") was the exclusive distributor of handheld power equipment manufactured by Stihl, Inc. ("Stihl") in Minnesota. Under the excusive distributor agreement (the "Agreement"), Stihl implemented two advertising programs. The first program was a regional advertising program in which R&A paid an amount equal to 1% of the Stihl products that it purchased. Stihl derived no income or profit from its administration of the regional advertising program. The second program was a co-op advertising program in which Stihl gave an advertising budget to its distributors based on the prior year's sales for that distributor. Against that budget, Stihl would credit 50% of the distributor's individual advertising costs if the distributor used the proper advertising medium and adhered to certain advertising conditions and qualifications set by Stihl. R&A did not pay any funds into the co-op advertising program.

Just two months after the parties entered into the Agreement, R&A defaulted on its obligations to Stihl. Accordingly, R&A's distributor rights were terminated. After termination, R&A sought to re-characterize its relationship with Stihl as a franchise relationship governed by the MFA. R&A argued that the regional advertising fee constituted an indirect "franchise fee" under the MFA. Rejecting R&A's contention, the court noted it had previously determined in a prior case that this type of fee was not a "franchise fee." Further, based upon the following facts, the court concluded that the fee was an ordinary business expense:

1. The fee was not based on gross sales but on the amount of inventory purchased;
2. The fee went into a segregated account;
3. The fee's exclusive purpose was to benefit the retailers;
4. Stihl derived no income or profit from the fee; and
5. The advertising fund was not included in Stihl's operating revenues.

R&A also argued that a $10 catered lunch fee and the fee splitting arrangement it had with Stihl for yellow page listings constituted indirect franchise fees. Much like the advertising fees, the court held that these fees were ordinary business expenses and noted that the expenses had not been paid by R&A for the right to sell Stihl products. Because the regional advertising fees and other expenses were not indirect "franchise fees," no franchise relationship existed and R&A's MFA claims were dismissed.

VICARIOUS LIABILITY

FEDERAL COURT DENIES FRANCHISOR'S MOTION FOR SUMMARY JUDGMENT ON VICARIOUS LIABILITY CLAIM

In Roberts v. Bennett Enterprises, Inc., 2006 WL 38250567 (E.D. Mich. Dec. 26, 2006), a Michigan federal court denied a franchisor's motion for summary judgment with respect to a vicarious liability claim, concluding that under Michigan law the franchisor exercised control over the franchisee with respect to both room design and system standards. The case arose out of the tragic death of a ten-month old boy who, after being left unattended for a few minutes by his parents, climbed up the steps on the side of a jacuzzi in their room at a Holiday Inn Express and fell into scalding water, causing second degree burns over most of his body. The baby boy died several days later.

The boy's parents subsequently brought suit against Holiday Hospitality Franchising, Inc. (HHF), the franchisor for the Holiday Inn franchise system. They alleged, among other things, that HHF retained ownership of the Holiday Inn system and exercised complete control over the specifications for the design of the hotel and the standards under which it operated. Specifically, the boy's parents alleged that HHF failed to require that the franchisee install anti-scalding devices for the room and had approved the design of the tub, which allegedly did not contain adequate safeguards to prevent small children from gaining access to the tub. After the completion of discovery, HHF filed a motion for summary judgment, contending that it was not liable because it did not own or operate the premises, did not retain the right to control the day-to-day operations of the franchise, and had no on-site presence at the location.

The court found otherwise and concluded that where the issue surrounding the franchisor's liability involves the actual standards themselves and not how those standards are carried out on a day-to-day basis, the franchisor can be held directly liable. In this case, the court found that there was a material issue of fact as to whether HHF controlled the temperature of the hot water at the hotel because it mandated that hot water heaters could be set as high as 125 degrees Fahrenheit. As to the jacuzzi, the court noted that the room at issue was part of an addition to the hotel and that, under the Franchise Agreement, "every aspect of the plan" (including the design and layout of the tub and the lack of anti-scalding devices) was approved in advance by HHF. Thus, the court concluded, the question was not one of day-to-day operations of the franchise, but of the franchisor's building design and construction standards.

ARKANSAS FEDERAL COURT FINDS NO ACTUAL AGENCY RELATIONSHIP BETWEEN REAL ESTATE FRANCHISOR AND FRANCHISEE

In *Miles v. Century 21 Real Estate, LLC*, 2007 WL 92795 (E.D. Ark. 2007), an Arkansas federal court granted summary judgment for the franchisor, Century 21 Real Estate ("Century 21"), finding that no reasonable jury could conclude an actual agency relationship existed. The court went on, however, to deny Century 21's motion for summary judgment on the issue of apparent agency, finding that a jury could conclude the plaintiffs believed the franchisee real estate business was an agent or servant of Century 21.

The plaintiffs, Joseph Miles and LeWanda Lewis-Miles, an African-American couple, alleged that they were discriminated against on the basis of race by the franchisee's real estate agents while trying to rent a house in Arkansas. Plaintiffs brought an action alleging violations of federal and state anti-discrimination laws and named Century 21 as a defendant. Century 21 denied liability alleging that no actual or apparent agency relationship existed between the franchisor and the franchisee. The court found that because a franchisor may be held liable for an act of a franchisee when their relationship is that of principal and agent or master and servant, the primary inquiry was whether an actual or apparent agency relationship existed between Century 21 and the franchisee.

Even though Century 21 retained a right to inspect, receive performance reports, and enforce standards through probation and termination, the court determined that no actual agency relationship existed and granted Century 21 summary judgment on that issue. In support of its finding, the court noted that Century 21 did not have the right of control over the franchisee's employees or the manner in which the franchisee listed, sold, or leased properties.

With respect to the issue of apparent agency, however, the court determined that a reasonable jury could conclude an apparent agency relationship existed between Century 21 and the franchisee. Specifically, the court noted that Century 21's worldwide reputation, recognizable trademarks and brand name, the franchisee's payment of advertising fees to support national advertising, Century 21's requirement that its franchisees comply with its operations manual, the plaintiffs' failure to observe the disclaimer on the outside of the property that states each office is "independently owned and operated," and the plaintiffs' belief that they would receive quality service from any agent associated with the Century 21 name could lead a reasonable person to conclude that an apparent agency relationship existed.

ARBITRATION

EIGHTH CIRCUIT REJECTS PUBLIC POLICY CHALLENGE TO ARBITRATION AWARD

In *Twin Cities Galleries, LLC v. Media Arts Group*, 2007 WL 429551 (8th Cir. 2007), the operator of several Thomas Kinkade art galleries in Minnesota sued Media Arts, the exclusive manufacturer and distributor of Thomas Kinkade reproductions, claiming that the "dealer" arrangement between it and Media Arts was an unregistered franchise and that the operator was fraudulently induced into entering the relationship.

As required by the agreements governing the parties' relationship, the dispute went to binding arbitration under California law. The arbitration panel ruled in favor of Media Arts, finding that the relationship was not a "franchise" because the operator was not required to pay a franchise fee of any kind. The operator moved to vacate the arbitration award in federal district court in Minnesota. The court granted the operator's request to vacate the award on the grounds that application of California law violated Minnesota's public policy of protecting franchisees located in Minnesota, which policy is evidenced by the Minnesota Franchise Act.

On appeal, the Eighth Circuit rejected the operator's public policy argument and reinstated the original arbitration award. The appellate court held that, even "assuming for the sake of argument that a public policy of Minnesota may potentially override the arbitration panel's choice-of-law decision, the public policy exception will apply only if the application of California law is materially different from Minnesota law, such that the arbitrator's use of California law actually undermines the asserted Minnesota public policy." Finding no material difference between California and Minnesota's definition of a franchise fee (the central question in the case), the court of appeals concluded that Minnesota public policy had not been subverted by application of California law and reinstated the arbitration award.

NINTH CIRCUIT FINDS ARBITRATION CLAUSE IN FRANCHISE AGREEMENT UNCONSCIONABLE

In a decision that could have broad implications for franchisors, the United States Court of Appeals for the Ninth Circuit recently found an arbitration clause in a franchise agreement to be unconscionable, and thus refused to compel a franchisee to arbitrate its claims against the franchisor. In Nagrampa v. MailCoups, Inc., 469 F.3d 1257 (9th Cir. Dec. 4, 2006), Nagrampa entered into a franchise agreement with MailCoups that called for arbitration of disputes. Among other things, the arbitration clause provided that MailCoups, but not Nagrampa, could obtain injunctive relief from a district court pending the completion of an arbitration addressing any dispute between the parties. The clause also provided for arbitration in Boston, Massachusetts despite Nagrampa's California residency.

When a dispute arose, MailCoups filed a demand for arbitration with the hearing locale of Los Angeles. Nagrampa refused to participate and instead filed suit in California's state courts. MailCoups removed that action to federal court and moved to dismiss it, citing the parties' commitment to arbitrate. The United States District Court for the Northern District of California granted MailCoups' motion to dismiss, finding that the parties' arbitration clause was valid and must be given effect. On appeal, a Ninth Circuit panel originally affirmed that dismissal. After reconsidering the case en banc, however, the court of appeals reversed.

As a threshold matter, because Nagrampa had challenged the validity of just the arbitration clause, rather than the entire underlying contract, the challenge was held to be a matter for judicial decision. The Ninth Circuit then evaluated the arbitration clause to determine whether it was procedurally or substantively unconscionable. The clause was found to be both. It was procedurally unconscionable because it had been presented to Nagrampa on a "take it or leave it" basis. While MailCoups argued that Nagrampa could have chosen not to enter into the franchise relationship at all, the court found that argument insufficient to overcome the unconscionability associated with what it considered to be a contract of adhesion between parties of greatly disparate bargaining power.

The appellate court focused on two things in holding that the arbitration provision was unconscionable. First, the court was wary of the agreement to permit MailCoups to pursue judicial remedies while forcing Nagrampa to arbitrate all her claims. Second, the court of appeals held it was unconscionable to require arbitration in Boston. While acknowledging the general validity of forum selection clauses, the court still found that requiring arbitration in Boston is unduly oppressive because it would effectively deprive Nagrampa of a forum in which to resolve disputes. Further, the Ninth Circuit held that Nagrampa could not reasonably have expected MailCoups to insist on Boston as the location for an arbitration because MailCoups' Uniform Franchise Offering Circular ("UFOC") stated that its forum selection clause might not be enforceable under California law. In the view of the appellate court, the UFOC language suggested to prospective franchisees that

MailCoups would not enforce the strict language of the contract. Finally, the Ninth Circuit noted that MailCoups' own request that the matter be arbitrated in Los Angeles, rather than in Boston, supported its findings.

JURY TRIAL WAIVER

JURY TRIAL WAIVER IN FRANCHISE AGREEMENT UPHELD

A federal district court in Pennsylvania granted a franchisor's motion to strike a jury demand in Cottman Transmission Systems v. McEneany, 2007 WL 119956 (E.D. Pa. Jan. 4, 2007). Notwithstanding the franchise agreement they had signed that included a jury waiver provision, the franchisees sought a jury trial in response to the franchisor's lawsuit for money damages. The franchisor moved to strike the jury demand on the basis that the franchisees waived their right to a jury trial by signing the franchise agreement. In response, the franchisees alleged that the jury waiver clause was unenforceable because of the unequal bargaining power between the parties, the franchisees' lack of sophistication, and the franchisees' lack of opportunity to negotiate the jury waiver provision.

In striking the jury demand, the district court stated that federal law permits waiver of a civil jury trial if it is done "knowingly and voluntarily," under consideration of the following factors: (1) whether there was a gross disparity of bargaining power; (2) the sophistication of the party challenging the waiver; (3) whether the waiver provision was conspicuous; and (4) whether there was an opportunity to negotiate the waiver.

In analyzing these factors, the court found there was no gross disparity of bargaining power between the franchisor and franchisees. In so doing, the court noted that there was nothing in the record to indicate that the franchisees were prohibited from negotiating or bargaining for any terms in the franchise agreement or that the waiver provision was presented as a nonnegotiable term. To the contrary, the record demonstrated that the franchisees had an attorney review the agreement and that the franchisor had a history of negotiating and changing the terms of franchise agreements with other franchisees. As to whether the franchisees were sufficiently "sophisticated" to understand the waiver provision, the court noted that they were builders and contractors who had enough sophistication to incorporate and own a contracting business. Further, the court determined it was significant that the franchisees had explained in their own words the meaning of the waiver provision in a disclosure compliance interview with the franchisor. In addition, the court noted that the franchisees were represented by counsel in the transaction and that the waiver provision was plainly written and conspicuous. Finally, the court noted that the franchisees were not under any pressure to purchase the franchised business.

The court also added that, although specific allegations of fraud relating to a jury waiver provision might invalidate the provision, the franchisees' general allegations of fraud in no way suggested that their waiver of a jury trial was not knowingly or voluntarily done. Accordingly, the court granted the franchisor's motion to strike the franchisees' jury demand.

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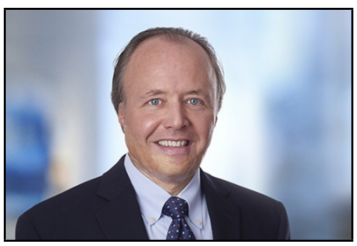

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