GRAY PLANT MOOTY

The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

FROM: GRAY PLANT MOOTY'S FRANCHISE AND DISTRIBUTION PRACTICE GROUP

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Below are summaries of recent legal developments of interest to franchisors.

TORTIOUS INTERFERENCE

NINTH CIRCUIT AFFIRMS DISMISSAL OF FRANCHISEE'S COMPLAINT FOR ALLEGED INTENTIONAL INTERFERENCE WITH ECONOMIC RELATIONS

The United States Court of Appeals for the Ninth Circuit has affirmed the dismissal of a franchisee's complaint alleging that franchisor Charter Practices International ("CPI") improperly refused to renew his franchise. *Robinson v. Charter Practices Int'l, LLC*, 2017 WL 2684122 (9th Cir. June 21, 2017). The franchisee had purchased a veterinary hospital from CPI and at the same time also owned and operated independent veterinary clinics that were not part of his CPI franchise. Initially, CPI had not enforced a noncompetition covenant contained in the parties' franchise agreement; however, when the term of the original franchise agreement ended and the franchisee tried to renew, CPI notified the franchisee of its intent to enforce the covenant in the renewal agreement going forward. The franchisee did not divest himself of his independent clinics, and the parties did not execute a renewal agreement. Instead, the franchisee sued CPI for breach of contract, breach of the covenant of good faith and fair dealing, and intentional interference with economic relations.

After affirming the dismissal of the franchisee's first two claims, the Ninth Circuit held that the franchisee had not adequately alleged that CPI intentionally interfered with economic relations. The court noted that conduct between business competitors is not improper if the conduct is in the defendant's competitive interest and not done for an improper purpose, such as spite or ill will. Because the franchisee had only alleged that CPI's actions in not renewing the franchise agreement were done to maximize potential profits, and because the franchisee did not otherwise allege improper means that were independently wrongful by reason of statutory or common law, the Ninth Circuit affirmed the district court's dismissal of his complaint.

FRAUD

SIXTH CIRCUIT AFFIRMS DISMISSAL OF KENTUCKY CONSUMER PROTECTION ACT CLAIM

Meanwhile, the Sixth Circuit recently affirmed the dismissal of a prospective franchisee's consumer fraud claims against a franchisor, holding that the plaintiff failed to state a claim upon which relief could be granted. *859 Boutique Fitness, LLC v. CycleBar Franchising, LLC*, 2017 WL 2731311 (6th Cir. June 26, 2017). The prospective franchisee, 859 Boutique Fitness, and the franchisor, CycleBar Franchising, participated in negotiations for a cycle-studio franchise. During a closing call, CycleBar executives indicated that the terms and conditions of the franchise agreement were agreeable, and Boutique Fitness signed the franchise agreement. CycleBar also informed Boutique Fitness that its executives "had executed the franchise agreement immediately." Following the call, Boutique Fitness immediately wired $59,500 in franchise and training fees to CycleBar. Two days later, CycleBar notified Boutique Fitness that it would no longer sell Boutique Fitness a franchise and that it would refund the entirety of the franchise fees. In response, Boutique Fitness brought suit against CycleBar, raising claims for violation of the Kentucky Consumer Protection Act ("KCPA") and negligent and fraudulent misrepresentation, among others.

The district court held that Boutique Fitness had failed to state a claim under the KCPA because the statute only provides a private right of action to an individual who purchases goods or services primarily for personal, family, or household purposes. On appeal, Boutique Fitness argued that another statute, Section 446.070, provided a cause of action for a violation of the KCPA because it allows "a person injured by the violation of any statute [to] recover from the offender such damages as he sustained by reason of the violation." The Sixth Circuit rejected that argument, reasoning that Section 446.070 was inapplicable because it only operates in situations where the statute that was allegedly violated provides no remedy for the aggrieved party, and in this case the KCPA prescribed the remedy for its violation. In addition, the court upheld the dismissal of the misrepresentation claims, finding that Boutique Fitness failed to show a nexus between the alleged misrepresentation that the franchise agreement had been executed and any specific injury, as the franchise and training fees paid by Boutique Fitness had already been refunded. Further, because Boutique Fitness pled a claim of misrepresentation that began on the day of the closing call, other amounts expended by Boutique Fitness in furtherance of its contractual relationship with CycleBar could not be considered.

DAMAGES

ADDENDUM REPLACING LIQUIDATED DAMAGES PROVISION PRECLUDES SUMMARY JUDGMENT ON FRANCHISOR'S BREACH OF CONTRACT CLAIMS

A South Dakota federal court granted in part and denied in part a franchisor's motion for summary judgment arising out of nonpayment of fees in *Days Inns Worldwide, Inc. v. Miller*, 2017 WL 2829810 (D.S.D. June 29, 2017). After the franchisee failed to pay fees required by the parties' franchise agreement, the franchisor terminated the agreement and filed suit for breach of contract. The franchise agreement contained a liquidated damages provision, but an addendum to the agreement replaced that provision with a provision making the franchisee responsible for "any and all damages" arising out of the franchisee's breach of the agreement, as well as "amounts which would otherwise be payable for and during the remainder" of the agreement. The franchisor moved for summary judgment both on its affirmative claims and on the franchisee's counterclaims arising out of an alleged promise by the franchisor to provide guests through its reservation system.

The court granted summary judgment against the franchisee on its counterclaims, noting that the integration clause in the franchise agreement precluded claims based on an alleged oral promise, and that the franchisor had a contractual right to suspend the franchisee's access to the reservation system as a result of the franchisee's nonpayment of required fees. On the franchisor's breach of contract claims, however, the court found that an issue of fact remained as to the amount of the franchisor's damages. While it was clear that a breach had occurred, the court found that the language in the addendum created an ambiguity as to whether the franchise agreement allowed recovery of expectation damages, an issue the parties did not brief. Further, the court noted that the franchisor's damages calculation exceeded the amount it could have claimed under the superseded liquidated damages provision, raising questions of unconscionability, another issue not briefed by the parties. Lastly, the court found the precise amount of damages unclear, in part because of inconsistencies in the proof submitted by the franchisor. The court directed the franchisor to submit further evidence supporting past damages, but denied summary judgment in favor of future damages "at this time."

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CLASS ACTIONS

FEDERAL COURT IN CALIFORNIA DENIES CLASS CERTIFICATION TO FRANCHISEES CLAIMING TO BE EMPLOYEES

The United States District Court for the Northern District of California recently denied class certification to a group of plaintiffs alleging that they were misclassified as franchisees rather than employees. *Soares v. Flowers Foods, Inc.*, 2017 WL 2793807 (N.D. Cal. June 28, 2017). The plaintiffs were all distributors who delivered, or hired their own subcontractors to deliver, baked goods for Flowers Foods and its network of subsidiaries. Flowers had classified the plaintiffs as franchisees rather than employees, as expressed in each plaintiff's distributor agreement. The plaintiffs alleged that Flowers had misclassified them as franchisees and asserted wage and hour claims based on that misclassification. The plaintiffs sought class certification under Federal Rule of Civil Procedure 23(b)(3), which requires the court to find "that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy."

The court found that the plaintiffs met the class certification threshold requirements of Rule 23(a) (numerosity, typicality, adequacy of representation, and commonality) primarily because the putative class members' claims were all based on a uniform distributor agreement. The court held, however, that class certification was inappropriate nonetheless because the plaintiffs did not satisfy the predominance or superiority requirements of Rule 23(b)(3). In reaching that conclusion, the court recognized that Flowers' right of control over the plaintiffs supported a finding of predominance, noting that the key inquiry is not the degree of control Flowers actually exercised but rather the degree of control Flowers retained the right to exercise. Yet, the court ultimately held that issues common to the class did not predominate over issues affecting individual class members, reasoning that "the nature of the [distributors'] businesses—namely, differences in their operations, such as whether they hired sub-drivers and whether they contracted with other companies—[would] require individual inquires." Additionally, the court held that a class action would not be superior to individual trials "because any classwide trial would be derailed by individualized inquiries into whether, when, and for how many hours each Distributor 'personally serviced' her route, making a class action no more efficient or convenient than numerous individual trials."

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PRELIMINARY INJUNCTIONS

FRANCHISEE DENIED INJUNCTION TO BLOCK SOFTWARE UPGRADE

A federal district court in New York denied a franchisee's motion for a preliminary injunction that would have prevented its franchisor from installing a new software system in its stores. *JDS Grp Ltd. v. Metal Supermarkets Franchising Am., Inc.*, 2017 WL 2643667 (W.D.N.Y. June 20, 2017). The dispute arose when the franchisor, Metal Supermarkets Franchising America ("MSFA"), developed and began installing an upgraded software platform in its franchise system. The franchisee, JDS Group, brought suit against MSFA, arguing that the requirement to utilize the new software constituted a violation of the Washington Franchise Investment Protection Act ("FIPA"), which prohibits "unfair or deceptive" practices. JDS sought a preliminary injunction to prevent MSFA from installing the new software platform in its stores. In support of its motion, JDS alleged that the new system was unreliable and inefficient and submitted the declarations of six other MSFA franchisees, all of whom reported that they had encountered serious problems while using the system.

Noting that federal courts have repeatedly held that it is permissible for a franchisor to require use of its proprietary computer systems, and finding no evidence of bad faith on the part of MSFA, the court found it unlikely that JDS would be successful on the merits of its FIPA claim. The court further held that JDS had not shown that it was likely to suffer irreparable harm if the software were installed because the majority of MSFA stores had already upgraded to the new software, and on average, those stores had actually seen an increase in sales after the conversion. Accordingly, the court concluded that the "extraordinary remedy" of an injunction was not appropriate and denied JDS's request.

ARBITRATION

NEW JERSEY APPELLATE COURT ENFORCES ARBITRATION AGREEMENT

The Superior Court of New Jersey, Appellate Division, has upheld a lower court's decision to enforce the arbitration provision in a franchise agreement between Angel Tips and its franchisee. *Glamorous Inc. v. Angel Tips, Inc.*, 2017 WL 2705412 (N.J. Super. Ct. App. Div. June 23, 2017). In doing so, the appellate court noted that the parties' franchise agreement called for arbitration of "all controversies disputes or claims between them," with only a few exceptions, including any claims made by the franchisor against the franchisee for money owed. The court held that a dispute between the parties relating to the franchisee's contractual obligation to renovate the premises of its franchised business did not fall within any of the arbitration provision's stated exceptions and, therefore, was subject to arbitration.

As part of its opinion, the appellate court dismissed the franchisee's claim that enforcement of the arbitration provision was contrary to New Jersey public policy, noting that the United States Supreme Court has repeatedly interpreted the Federal Arbitration Act to favor enforcement of arbitration provisions without regard for state law. The court also dismissed the franchisee's argument that the lower court "rewrote" the arbitration provision by not holding that the renovation requirement was really a demand for money owed to the franchisor and, therefore, not subject to arbitration.

CONTRACTS

CALIFORNIA COURT REVERSES FINDING THAT LANDLORD WAS NOT THE SUCCESSOR TO RIGHTS IN A RESTAURANT FRANCHISE

An appellate court in California recently reversed a grant of summary judgment to a franchisor, finding that the franchisor did not provide sufficient evidence to establish that a landlord was not assigned the rights to one of its restaurant franchises. *Cha La Mirada, LLC, v. Red Robin Int'l, Inc.*, 2017 WL 2691576 (Cal. Ct. App. June 22, 2017). The dispute involved a franchise agreement between Red Robin and La Mirada Restaurant Group ("LMRG") for the rights to operate a Red Robin restaurant in a hotel. Red Robin, LMRG, and the landlord for the property also signed a consent agreement that assigned to the landlord all of LMRG's rights in the franchise as partial security for LMRG's payment and performance under the applicable lease. The hotel was later sold to another company that then transferred the property to its subsidiary, Cha La Mirada ("CHA"). Several years later, LMRG vacated the restaurant premises after CHA served LMRG with a notice to pay rent or quit the premises. CHA then informed Red Robin that it expected Red Robin to recognize CHA as the franchisee of the restaurant. Instead, Red Robin terminated the franchise agreement for abandonment. LMRG sued CHA for breach of the lease, and CHA cross-complained against Red Robin for breach of the franchise agreement. The trial court granted Red Robin summary judgment on CHA's claims under the franchise agreement, finding that under a "no reassignment" provision in the consent agreement only the original landlord, not successor landlords, was entitled to exercise rights under the consent agreement.

The appellate court disagreed, finding that the consent agreement defined the landlord as the original landlord "and its successors and assigns." The court rejected Red Robin's argument that a no reassignment provision in the consent agreement meant that the landlord's rights could not be reassigned to CHA. The court held that a reasonable interpretation of the provision allowed for the reassignment of the franchise rights to CHA, but not for the reassignment of rights to third parties unrelated to the property or franchise.

DUTY OF GOOD FAITH AND FAIR DEALING

SETTLEMENT AGREEMENT DOES NOT GIVE RISE TO HEIGHTENED DUTIES OF LOYALTY AND GOOD FAITH

The Texas Court of Appeals recently held, in part, that a settlement agreement between a franchisor and franchisee containing "best efforts" and "reasonable assurances" clauses did not create heightened duties of candor, loyalty, and good faith in their subsequent dealings. *Whataburger, Inc. v. Whataburger of Alice, Ltd.*, 2017 WL 2664437 (Tex. App. June 21, 2017). The franchisor, Whataburger, and the franchisee, Whataburger of Alice ("WOA"), were parties to various franchise agreements. They later entered into a settlement agreement under which Whataburger purchased twenty-eight of WOA's franchised restaurants, and WOA was granted the exclusive right to construct, operate, and develop Whataburger restaurants in three counties in Texas. When WOA sought to open a new Whataburger restaurant at a specific location in its exclusive territory, Whataburger conditioned approval for the location on WOA modifying the royalty structure in the settlement agreement and its existing franchise agreements. WOA sued, and the parties moved for summary judgment.

Relying on "best efforts" and "reasonable assurances" clauses in the settlement agreement, WOA argued and the lower court found that Whataburger owed WOA a duty of candor, loyalty, and good faith, and that Whataburger was in breach of that duty in conditioning approval of WOA's new location on modifications to its existing agreements. Whataburger appealed, and the Texas Court of Appeals reversed. The appellate court reasoned that under Texas law the franchisor-franchisee relationship does not give rise to heightened duties, and the purpose of the "best efforts" and "reasonable assurances" clauses in the settlement agreement was to ensure that all obligations under the agreement were performed and the sale of assets was completed. Accordingly, Whataburger did not owe WOA heightened duties of candor, loyalty, and good faith.

Along with the attorneys indicated on the next page, summer associates Chelsey Enderle, Amy Fiecke, Hannah Holloran, Hannah Shirey, Abby Swanson Garney, and Maria de Sam Lazaro contributed to this issue.

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