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.

EMPLOYMENT

FRANCHISEE'S MISCLASSIFICATION CLAIM BARRED BY RES JUDICATA

The United States Court of Appeals for the First Circuit recently refused to allow a franchisee to pursue a claim that he was an employee of franchisor Jan-Pro on the grounds that the franchisee had already lost a similar case in a Georgia state court. *Depianti v. Jan-Pro Franchising Int'l, Inc.*, 2017 WL 4324323 (1st Cir. Sept. 29, 2017). Depianti, a unit franchisee of a third-party who was a Jan-Pro master franchisee, brought suit in the federal court in Massachusetts, where his franchise was located, arguing that he was an employee of Jan-Pro. At the same time, Jan-Pro filed a case in Georgia, where it is headquartered, seeking a declaratory judgment that it was not Depianti's employer. Ultimately, the Georgia Court of Appeals ruled in favor of Jan-Pro on the merits, finding that Jan-Pro satisfied the three-part test under Massachusetts law showing that the franchisee was not its employee. It found that the franchisee was free from the control and direction of Jan-Pro; the cleaning services performed by the franchisee were outside the usual course of Jan-Pro's business; and the franchisee was an independent business.

Meanwhile, the franchisee's case in federal district court in Massachusetts continued. The district court certified to the Massachusetts Supreme Judicial Court the question of whether Jan-Pro could be liable under the test for employee misclassification, even though it was not in a contract with Depianti. The Massachusetts Supreme Judicial Court concluded that it *could*, but declined to determine whether Jan-Pro was liable under the facts of the case. By that time, the Georgia appellate court had already determined that Depianti was not Jan-Pro's employee. Therefore, the federal district court, and subsequently the First Circuit, concluded that the determination of the Georgia court that the parties did not share an employer-employee relationship was a final judgment on the merits, and that the Massachusetts courts were bound by that decision under the doctrine of res judicata.

DISCRIMINATION

SEVENTH CIRCUIT INTERPRETS ANTI-DISCRIMINATION OBLIGATIONS UNDER INDIANA DECEPTIVE FRANCHISE PRACTICES ACT

In *Andy Mohr Truck Center, Inc. v. Volvo Trucks North America*, 2017 WL 3695355 (7th Cir. Aug. 28, 2017), the United States Court of Appeals for the Seventh Circuit reversed an Indiana district court's denial of Volvo Trucks of North America's motion for judgment as a matter law, finding that Volvo did not unfairly discriminate against its dealer, Mohr Truck Center, in violation of the Indiana Deceptive Franchise Practices Act ("IDFPA") and overturning a jury's finding of discrimination and a $6.5 million damages award. In support of its unfair discrimination claim, Mohr argued that Volvo violated the IDFPA by offering better prices and concessions to other franchisee-dealers located in various states than it offered to Mohr. At trial, Mohr identified thirteen transactions in which it received less favorable terms and concessions from Volvo than Volvo offered to other franchisee-dealers. On appeal, Volvo argued, among other things, that the trial evidence Mohr presented was insufficient to demonstrate "unfair discrimination" as the comparators were not similarly situated.

In reversing the district court's decision, the Seventh Circuit agreed with Volvo, finding that Mohr failed to prove that Volvo's treatment of Mohr when compared to other dealers was "unfair." The court noted that under the IDFPA, Mohr had the initial burden of proving that the difference in treatment amounted to "unfair discrimination." While the Seventh Circuit noted that Mohr presented evidence depicting different treatment amongst Volvo's various dealers, Mohr failed to establish that such differing treatment was unfair, especially since the franchise agreement between the parties expressly granted Volvo the right to grant different concessions for each transaction. Moreover, the court found that Mohr's evidence showed that at times Mohr received better terms and concessions, and at other times Mohr's competitors received better terms. The Seventh Circuit concluded that at most, Mohr's evidence showed that Volvo offered no reasoned explanation for providing differing concessions to different dealers, which, according to the court, was insufficient to show that such treatment was unfairly discriminatory.

CONTRACTS

A FEE CHARGED BY A FRANCHISOR TO A DESIGNATED SUPPLIER, WHICH IS PASSED ALONG BY THE SUPPLIER IN THE PRICE IT CHARGES FRANCHISEES FOR PRODUCTS, IS NOT A FEE IMPOSED BY THE FRANCHISOR ON FRANCHISEES

Baskin-Robbins charges its designated supplier a fee for the right to manufacture and sell Baskin's proprietary ice cream products to Baskin's franchisees. The supplier includes an amount equal to the fee in the price that it charges Baskin's franchisees for those products. In *Association of Independent BR Franchise Owners v. Baskin-Robbins Franchising, LLC*, 2017 WL 4314607 (D. Mass. Sept. 27, 2017), an association of Baskin-Robbins franchisees sought a declaration that the price component paid by its members that was attributable to the fee paid by the supplier to Baskin was, in fact, an unauthorized fee imposed by Baskin on its franchisees. Following a "case stated" proceeding—a proceeding tantamount to a bench trial on cross-motions for summary judgment and closing argument alone—the United States District Court for the District of Massachusetts entered judgment in favor of Baskin-Robbins, holding that the derivative price component was not an unauthorized fee. Gray Plant Mooty represented Baskin-Robbins in this case.

The court first found that Baskin's franchisees pay a "price" for products that they purchase, not a "fee." In reaching that finding, the court relied on the Black's Law Dictionary definitions of "fee" and "price" and the fact that Baskin franchisees pay a single amount to the supplier, not Baskin, for products. Next, the court considered whether Baskin's franchise agreement prohibited the supplier from including an amount equal to the fee that it must pay Baskin in the price that the supplier charges franchisees. The court found that the only relevant provisions of the franchise agreement required franchisees to purchase products from Baskin's designated supplier, at the supplier's price. The court further observed that "pass-through costs and charges along the supply chain is a standard industry practice." Finally, the court held that even if it were to find ambiguity in the language of the franchise agreement and extend its analysis beyond the agreement's four corners, the parties' course of dealing further demonstrated that the supplier's practice of passing along its cost to franchisees was not prohibited under the franchise agreement. Specifically, the court observed that the practice had been in place for many years with franchisees' knowledge and without their objection and that Baskin expressly advised franchisees in their disclosure documents that Baskin received revenue from franchisees' purchase of products from Baskin's designated supplier.

COVENANTS AGAINST COMPETITION

NONCOMPETE EXTENDED TO COVER FAMILIAL NONSIGNATORIES

In another case litigated by Gray Plant Mooty, the Chief Judge for the United States District Court for the District of Nebraska granted a preliminary injunction prohibiting former The Maids franchisees and their two daughters from operating a competing residential cleaning business in violation of the noncompete and nonsolicitation provisions contained in the applicable franchise agreements. *The Maids Int'l, Inc. v. Maids On Call, LLC*, 2017 WL 4277146 (D. Neb. Sept. 25, 2017). The Maids International ("TMI") terminated the franchise agreements because the franchisees were servicing customers outside of their territory, had failed to pay all of their required fees, and had abandoned their franchised businesses. Shortly thereafter, TMI learned that the former franchisees had transferred the assets of their franchises to a new, competing business operated by their daughters out of the same location and with the same employees. The defendants also failed to fully de-identify their formerly franchised businesses, leaving a sign reading The Maids outside their competing business until TMI filed its injunction action.

The defendants argued that the noncompete and nonsolication provisions of the franchise agreements could not apply to the daughters or their allegedly independent business because the daughters were not signatories to the franchise agreements. The court dismissed those arguments after the evidence demonstrated that the former franchisees and their daughters were working together to operate the new business and soliciting customers away from The Maids system. Among other things, the court noted that the former franchisees were involved in incorporating the new business and setting up the business's website. In addition, the former franchisees had sent a letter to their customers stating that their daughters were ready to "take over"; assuring the customers that "most everything will remain the same"; and urging the customers to "continue" with the competing business. As part of the letter, the former franchisees also repeatedly used the terms "we," "us," and "our" in describing the new business. Finally, one of the daughters admitted that "many of the customers" of the formerly franchised businesses were now patronizing the defendants' new business. Relying on another Nebraska federal court case litigated by Gray Plant Mooty, the court held that an apparent "continuity of operations" and the potential harm to TMI's goodwill warranted injunctive relief against all of the defendants.

FEDERAL COURT DENIES FRANCHISOR'S REQUEST FOR A PRELIMINARY INJUNCTION FINDING NO LIKELIHOOD OF IRREPARABLE HARM

Meanwhile, a federal court in Ohio denied a franchisor's motion for a preliminary injunction after finding that the franchisor did not show that it faced irreparable harm from a former franchisee who operated a competing business where the franchisor intended to open a new restaurant. *D.P. Dough Franchising, LLC v. Southworth*, 2017 WL 4315013 (S.D. Ohio Sept. 26, 2017). Franchisor D.P. Dough alleged a series of claims against Edward Southworth, a former franchisee, including breach of contract, misappropriation of trade secrets, copyright infringement, and trademark infringement. D.P. Dough also sought to enforce the nondiversion of business and noncompete clauses in the parties' franchise agreement in order to prevent Southworth from operating similar calzone restaurants in new D.P. Dough locations.

The court denied the injunction, noting that while there are public policy interests in enforcing reasonable restrictive covenants, any potential harm from Southworth operating competing restaurants would be the result of fair, normal competition. The court paid particular attention to the scope of the nondiversion and noncompete clauses in the franchise agreement, which restricted the franchisee from diverting or attempting to divert business from D.P. Dough for a period of three years after the termination of the franchise agreement. While the nondiversion clause was unlimited in geographic scope, the noncompete clause prohibited Southworth from operating a competing restaurant within a sixty-mile radius of any D.P. Dough restaurant. The court found that the clauses were ambiguous and held that they were only reasonable if they applied to D.P. Dough restaurants that were already operating at the time the franchise agreement was terminated. Because D.P. Dough did not attempt to open new restaurants until after Southworth had already set up his competing restaurants in new locations, the court refused to enforce the provision. The court also denied the franchisor's trademark and copyright claims, finding that Southworth was no longer using the franchisor's marks or other protective information at the time of the injunction hearing. Finally, the court denied D.P. Dough's trade secret claim because its recipes were generic and commonly known and therefore not entitled to protection.

FRANCHISE AGREEMENT'S POST-TERM NONCOMPETE WITHSTANDS FRANCHISEE'S MOTION TO DISMISS IN COLORADO DISTRICT COURT

In another case involving a post-term covenant against competition, the United States District Court for the District of Colorado declined to dismiss a franchisor's complaint seeking to enforce a noncompete provision contained in the parties' franchise agreement, despite the "strong public policy" against enforcement of such restrictions under Colorado law. *Homewatch Int'l, Inc. v. Navin*, 2017 WL 4163358 (D. Colo. Sept. 20, 2017). After expiration of the parties' franchise agreement, the franchisee's owner immediately commenced operating a competing business in violation of the agreement's noncompete covenant. When the franchisor sought to enforce the noncompete, the owner moved to dismiss the franchisor's claims, raising several challenges to the enforceability of the provision.

As a preliminary matter, the court found no merit to the owner's claim that she had only signed the franchise agreement in her capacity as an officer of the franchisee entity and that the noncompete provision therefore did not apply to her personally. The court observed that the personal guaranty the owner had signed stated expressly that the noncompete provision would apply to her. The court also held that the noncompete covenant was not automatically void under Colorado law, which governed the franchise agreement. Under a Colorado statute, any noncompete covenant that "restricts the right of any person to receive compensation for the performance of skilled or unskilled labor" is unenforceable unless it falls under one of the law's narrow exceptions. Contracts "for the purchase and sale of a business or the assets of a business" constitute one such exception. Although Colorado courts had not yet addressed this exception in the context of a franchise dispute, the court found that the franchisor had sufficiently alleged its applicability because the goodwill associated with the business was one of the things the franchisor had licensed to the franchisee under their franchise agreement. On that basis, the court permitted the franchisor's breach of contract, unjust enrichment, and injunctive relief claims to proceed.

VICARIOUS LIABILITY

COURT GRANTS FRANCHISOR'S MOTION FOR SUMMARY JUDGMENT ON VICARIOUS LIABILITY CLAIMS BROUGHT BY FRANCHISEE'S CUSTOMER

The United States District Court for the Northern District of Alabama has granted summary judgment in favor of franchisor Wintzell's Franchise Company on vicarious liability claims lodged against it by Jose Ruiz, a customer of franchisee Wintzell's Huntsville. *Ruiz v. Wintzell's Huntsville, LLC*, 2017 WL 4305004 (N.D. Ala. Sept. 28, 2017). Ruiz developed a severe infection after eating raw oysters at Wintzell's Oyster House, a restaurant owned and operated by Wintzell's Huntsville under a franchise agreement with Wintzell's Franchise. Ruiz claimed that Wintzell's Franchise was vicariously liable because it failed to implement adequate procedures for storing the raw oysters and for cataloging the date the oysters were harvested. Ruiz also argued that because Wintzell's Franchise was involved in the selection of oyster suppliers for its franchisees, it was liable to Ruiz for negligent selection of those suppliers.

In order to prevail against Wintzell's Franchise under a vicarious liability theory, Ruiz was required to show the existence of a franchise agreement, a reservation by Wintzell's Franchise of the right of control over the manner of its franchisee's performance, and some evidence of the exercise of that control. The court rejected Ruiz's vicarious liability argument because it determined that Wintzell's Franchise was not in control of Wintzell's Huntsville's operations and, therefore, owed Ruiz no duty to ensure that the franchisee's employees were fully trained in storing oysters. The court also rejected Ruiz's argument that Wintzell's Franchise was negligent in its selection of oyster suppliers because Ruiz failed to present any evidence that Wintzell's Franchise was involved in selecting a particular oyster harvester or that it was or should have been aware of any evidence of mishandling by that harvester.

ANTITRUST

FEDERAL COURT DISMISSES PRICE DISCRIMINATION AND UNLAWFUL TYING CLAIMS AGAINST FRANCHISOR

A franchisor of window replacement companies and its exclusive approved supplier of windows have successfully avoided claims that the windows sold to franchisees were sold at a discriminatory price under the Robinson-Patman Act and unlawfully tied to the franchisor's services under the Sherman Act. *Bendfeldt v. Window World, Inc.*, 2017 WL 4274191 (W.D.N.C. Sept. 26, 2017). The plaintiffs entered into a series of license agreements with Window World, Inc. ("WWI") in the 2000s. Although the plaintiffs were at first required to purchase windows and related materials from a small number of approved suppliers, by the end of the decade, WWI eventually announced that all franchisees would have to buy products from one exclusive supplier of windows. The plaintiffs brought suit under a variety of legal theories when they found out that the franchisor received significant kickbacks from its exclusive supplier.

The North Carolina federal court dismissed the plaintiffs' Robinson-Patman Act claim, focusing mostly on the plaintiffs' failure to sufficiently identify any competitor outside the franchise system that received a better price. Because a price discrimination claim requires a favored and disfavored customer that are in actual competition for "the same dollar," the plaintiffs did not plead a plausible claim by only alleging generally that other customers purchased windows from the supplier at lower prices somewhere "in the Midwest" or "throughout the United States." Next, the court dismissed the plaintiffs' allegation that, by naming an exclusive supplier, the franchisor had unlawfully tied the supplier's windows to the franchisor's license and business methods, thereby locking them into having to purchase windows at an unfair price. The court noted that the case law on tying arrangements in franchise relationships is "overwhelming" on this issue and that where the alleged market power flows from a contractual obligation in the franchise agreement, rather than the actual dominance of a product or service market, those claims are routinely dismissed. Because the plaintiffs were well aware of the fact that the franchisor had the contractual authority to limit their choice of window suppliers before they entered into a franchise, there was no unlawful tying and the claim was dismissed.

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CHOICE OF LAW/VENUE

ARIZONA FEDERAL COURT REFUSES TO ENFORCE FRANCHISE AGREEMENTS' CHOICE OF LAW AND FORUM SELECTION CLAUSES

An Arizona federal court declined to enforce choice of law and forum selection provisions in a suit brought by four Ohio franchisees of Zounds Hearing Franchising for violations of Ohio's Business Opportunity Purchasers Protection Act. *Zounds Hearing Franchising, LLC v. Bower*, 2017 WL 4399487 (D. Ariz. Sept. 19, 2017). The suit was initially filed in Ohio state court, and Arizona-based Zounds removed the case to federal court and moved to transfer it to Arizona pursuant to the forum selection clause in each franchise agreement, which included identical Arizona choice of law and venue clauses. The Ohio court transferred the case to the Arizona federal court, which then had to determine whether those clauses precluded application of Ohio's franchise laws, including the prohibition on out-of-Ohio venue provisions.

The Arizona court found in favor of the Zounds franchisees and held that the Ohio statute should apply, thereby invalidating the Arizona venue and choice of law clauses in the franchise agreements. Courts will generally apply the law chosen by the parties in their contract, unless the choice of law clause is contrary to a fundamental policy of the state with the most significant relationship to the transaction. Using this framework, the court found that Ohio had the most significant relationship to the parties because the franchisees were domiciled there and the franchises at issue were located there. Additionally, the court held that the parties could not circumvent by contract franchise laws designed to protect Ohio franchisees. Finally, the court determined that the Ohio franchise statute constituted a fundamental state policy of Ohio. Thus, the court held that Ohio law should govern, transferred the case back to Ohio, and awarded the franchisees attorneys' fees.

FRAUD

MICHIGAN COURT DISMISSES EARNINGS CLAIMS WITH PREJUDICE

A federal court in Michigan recently dismissed fraud claims brought against a provider of cryotherapy chambers for failure to state a cause of action. *Live Cryo, LLC v. CryoUSA Import & Sales, LLC*, 2017 WL 4098853 (E.D. Mich. Sept. 15, 2017). Live Cryo alleged that it had been fraudulently induced to enter into the parties' agreement, under which CryoUSA provided cryotherapy chambers to Live Cryo for use at its Michigan locations. Prior to signing the agreement, Live Cryo had received a booklet stating that some CryoUSA locations reached a 25-client-per-day mark fairly quickly, and that CryoUSA's Dallas location averaged about 50 clients per day. Live Cryo challenged the figures as predictions of its future performance and claimed that there was no factual basis for the prediction that it could service 25 clients per day or that it could replicate the success of the Dallas location. CryoUSA moved to dismiss on the grounds that the fraud claims were fatally deficient.

The court agreed that Live Cryo failed to state viable fraud claims. First, the court held that the fraud claims were deficient because Live Cryo engaged in impermissible "group pleading" and failed to specify the CryoUSA employees allegedly responsible for the misrepresentations and which statements they made. Second, the court held that to the extent that Live Cryo interpreted the figures as estimates of future profits, they were forward-looking projections, not statements of past or present facts, and thus were not actionable as fraud. Third, the court held that Live Cryo could not show reasonable reliance on any of the alleged misrepresentations because in signing the parties' written agreement it had agreed that no such promises had been made. Accordingly, the court dismissed the fraud claims with prejudice.

CLASS ACTIONS

FRANCHISOR'S MOTION TO DISMISS CLASS ACTION CLAIM GRANTED

A federal district court in California dismissed a class action suit initiated against Fitness Evolution Franchising LLC ("FEF"), the franchisor and successor to the Fitness 19 system, by members of the former Fitness 19 gyms in *Abrantes v. Fitness 19 LLC*, 2013 WL 4075576 (E.D. Cal. Sept. 14, 2017). The members' accounts were transferred from franchised Fitness 19 gyms to various franchised Fitness Evolution gyms in 2015 and 2016. Automatic debits of monthly membership fees were subsequently made from the members' bank accounts in accordance with the terms of the members' franchised Fitness 19 contracts, and the plaintiffs alleged that FEF's automatic debits of their monthly membership fees for Fitness Evolution franchised locations violated the Electronic Funds Transfer Act ("EFTA").

FEF moved to dismiss all claims against it on the grounds that the plaintiffs did not allege that FEF directly initiated the transactions at issue and that it therefore could not be held liable for any alleged EFTA violations. The plaintiffs argued that as the franchisor of the Fitness Evolution system, FEF provided its franchisees with an integrated billing system, and that it was reasonable to infer that FEF was responsible for the policies and procedures that led to the unauthorized deductions. The complaint included no allegation that FEF had any direct relationship with the plaintiffs, deducted the funds from the plaintiffs' accounts, or was a third-party payee. As a result, the court sided with FEF, noting that indirect involvement was not enough to state a claim for a violation of the EFTA. Further, because there is no liability for aiding and abetting EFTA violations, the court granted FEF's motion to dismiss.

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