The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

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

Maisa Jean Frank, Editor of *The GPMemorandum*

Julia C. Colarusso, Editor of *The GPMemorandum*

DATE: May 2, 2019—No. 241

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

TRADEMARKS

SIXTH CIRCUIT AFFIRMS GRANT OF SUMMARY JUDGMENT IN FAVOR OF FRANCHISOR ON MALICIOUS LITIGATION COUNTERCLAIM

The U.S. Court of Appeals for the Sixth Circuit recently affirmed a district court's grant of summary judgment dismissing multiple counterclaims brought by a former franchisee against the plaintiff-franchisor, Buffalo Wild Wings ("BWW"). *Buffalo Wild Wings, Inc. v. BW-3 of Akron, Inc.*, 2019 WL 994040 (6th Cir. Mar. 1, 2019). The parties had entered into a license agreement that authorized BW-3 to operate a Buffalo Wild Wings restaurant in Akron, Ohio. The agreement required BW-3 to operate the restaurant in conformance with the system developed by BWW and to maintain BWW's standards of quality and appearance. When BWW notified BW-3 that significant renovations were necessary to upgrade the restaurant to BWW's current design scheme, BW-3 refused to undertake the remodel. BWW then issued a notice of default and brought suit against BW-3, seeking treble damages for violation of the Lanham Act and a declaratory judgment that BWW could terminate the license agreement.

In response, BW-3 raised several counterclaims, including a claim for unfair competition through malicious litigation. To prevail, BW-3 needed to establish that BWW's lawsuit was objectively baseless and intended to injure BW-3's ability to be competitive. The court found that BWW's request for a declaratory judgment was not objectively baseless because it was intended to determine whether BW-3's obligations under the license agreement to operate the restaurant using the system developed by BWW and to maintain BWW's standards of quality and appearance included an obligation to remodel the location. In response to BWW's Lanham Act claim, BW-3 argued that a current licensee does not violate the Lanham Act by using a mark within the scope of its license. The court noted, however, that the question at issue was whether BW-3's use of BWW's marks was unauthorized because it did not comply with BWW's standards of quality and appearance, and therefore exceeded the scope authorized in the license agreement. As a result, the court determined that BWW's Lanham Act claim was not objectively baseless and affirmed the district court's grant of summary judgment in favor of BWW on the malicious litigation claim as well as the other counterclaims.

EMPLOYMENT

NINTH CIRCUIT VACATES JUDGMENT DISMISSING FRANCHISEES' MISCLASSIFICATION CLAIMS AND REQUEST FOR INJUNCTIVE RELIEF

The U.S. Court of Appeals for the Ninth Circuit vacated a judgment on the pleadings that had dismissed a claim by 7-Eleven franchisees that they had been misclassified as independent contractors rather than employees for purposes of federal and state labor laws. *Haitayan v. 7-Eleven, Inc*., 2019 WL 968927 (9th Cir. Feb. 27, 2019). In the same opinion, the Ninth Circuit vacated and remanded the lower court's denial in a related case of the franchisees' request for a preliminary injunction preventing 7-Eleven from refusing to renew their franchise agreements unless they released their labor law claims.

In vacating the judgment on the pleadings, the Ninth Circuit found that the district court incorrectly considered the persuasiveness of the franchisees' factual allegations, when it should only have analyzed the plausibility of their legal claims. It further observed that the lower court had failed to consider the franchisees' allegations regarding the actual control that 7-Eleven exerted over their businesses, and instead focused solely on the terms of the franchise agreements at issue. In vacating the lower court's refusal to preliminarily enjoin nonrenewal of the franchisees' agreements unless they signed a release, the Ninth Circuit found that the lower court had failed to consider California law that a wage and hour claim could not be waived by contract, and had failed to appropriately weigh the likelihood of irreparable harm, the balance of the equities, and the public interest in having the injunction entered.

DEPARTMENT OF LABOR PROPOSES A DIFFERENT JOINT EMPLOYER RULE

The U.S. Department of Labor has proposed a rule to revise and clarify when two entities will be considered joint employers for purposes of wage and hour liability under the Fair Labor Standards Act. The proposal contains specific limitations on joint employer status in the franchising context, and is intended to "ensure employers and joint employers clearly understand their responsibilities" under the FLSA. It is important to note that this proposal is distinct from, and different than, the proposed joint employer rule currently under consideration by the National Labor Relations Board. The DOL's proposed rule would not have any direct or immediate impact on the NLRB's proposed rule, which applies in different contexts for different purposes.

The heart of the new DOL proposal is a "clear, four-factor test—based on well-established precedent." This new test would consider whether the potential joint employer *actually exercises* the power to: (i) hire or fire the employee; (ii) supervise and control the employee's work schedules or conditions of employment; (iii) determine the employee's rate and method of payment; and (iv) maintain the employee's employment records. The proposal also includes guidance of particular interest to franchisors, such as the following:

1. "Only actions taken" on employment terms and conditions, and *not merely a theoretical power* under a contract, are relevant to joint employer status.

2. A franchisor's "providing a sample employee handbook or other forms to an employer as part of a franchise arrangement" does not make joint employer liability more or less likely. Similarly, requiring a franchisee employer to institute workplace safety measures, wage floors, or sexual harassment policies does not itself create a joint employer relationship between the franchisor and the franchisee.

3. Separate franchisees do not become joint employers simply by employing the same person during different hours, where the franchisees "are not associated in any meaningful way with respect to the individual's employment. The fact that both restaurants are part of the same nationwide franchise, [is] not relevant to the joint employer analysis."

The DOL's Notice of Proposed Rulemaking indicates that interested parties may submit comments on the proposal, identified by Regulatory Information Number 1235-AA26, at www.regulations.gov. Comments are due by June 10, 2019.

POST-TERMINATION INJUNCTIONS: NONCOMPETE COVENANTS

SANCTIONS REISSUED AGAINST FRANCHISEE FOR BREACH OF CONSENT INJUNCTION AFTER THIRD CIRCUIT REMAND

A franchisor's years-long battle to enforce a consent injunction against a terminated franchisee finally ended after a New Jersey federal court reissued sanctions for the franchisee's breach of the injunction's covenant against competition. *Lawn Doctor, Inc. v. Rizzo*, 2019 WL 1299671 (D.N.J. Mar. 21, 2019). As previously reported in *The GPMemorandum*, this matter began in 2012, when the Rizzos, former franchisees of the Lawn Doctor system, failed to adhere to the terms of their franchise agreement's noncompete provision. The district court ultimately entered a consent injunction outlining the Rizzos' obligations not to compete with Lawn Doctor. After finding that the Rizzos had violated the injunction, the district court issued a sanction in favor of Lawn Doctor equal to the fair market value of the Lawn Doctor customer list that the Rizzos had allegedly transferred to a third-party buyer of their business. The Third Circuit vacated the sanctions award, finding it was error to place the burden on the Rizzos to prove that the list had not been transferred, and remanded for further proceedings. On remand, after permitting limited discovery, the district court determined that Lawn Doctor put forth sufficient evidence to establish that the Rizzos sold Lawn Doctor's customer list to the third-party buyer. As a civil contempt sanction for violating the consent injunction, the court required the Rizzos to pay Lawn Doctor the established fair market value of the customer list — $178,800.

CONTRACTS

COURT GRANTS SUMMARY JUDGMENT ON BREACH OF CONTRACT CLAIM AFTER FINDING NO CONTRACT

A federal court in South Carolina has granted summary judgment to a franchisor after finding no material question of fact regarding whether a contract ever existed between the parties. *Theo's Pizza, LLC v. Integrity Brands, LLC*, 2019 WL 1282325 (D.S.C. Mar. 20, 2019). Ted and Marcia Contos began communicating with Integrity Brands, LLC ("IBL") with the hope of developing an Uncle Maddio's Pizza Joint franchised restaurant. The Contoses created two limited liability companies: (i) Thea and Theo, LLC to develop the premises for the restaurant, and (ii) Theo's Pizza, LLC to serve as the franchisee. Thea and Theo, LLC entered into a market development agreement with IBL to govern the Contoses' relationship with IBL until the opening of the restaurant. Although that agreement required Thea and Theo, LLC to sign IBL's franchise agreement within 10 days after IBL approved the location for the restaurant, the parties never actually signed such an agreement. In 2013, after having spent over $600,000 in developing the restaurant, the Contoses opened their first location for business. Between 2013 and 2016, the Contoses never turned a profit on the restaurant.

Theo's Pizza filed suit against IBL seeking a declaratory judgment regarding the parties' relationship and alleged that IBL had violated the South Carolina Business Opportunity and Sales Act and the South Carolina Unfair Trade Practices Act. In the alternative, Theo's Pizza argued that IBL had committed a breach of contract. IBL moved for summary judgment on all claims. The court had already ruled in a prior decision that there was no enforceable arbitration provision between the parties because there was no evidence that they had entered into a binding agreement. The court noted that the parties had not presented any additional evidence or arguments regarding the existence of a written contract or an oral contract that would satisfy the statute of frauds. Accordingly, the court granted IBL's motion for summary judgment on the breach of contract claim because there was no dispute of fact, and the court had previously held that there was no agreement between the parties. Because disputes of material fact remained for the statutory claims, the court denied summary judgment on those issues.

PRELIMINARY INJUNCTIONS

INJUNCTION REQUIRING COMPLIANCE WITH SYSTEM STANDARDS UPHELD

The Court of Appeals of Texas recently affirmed a trial court's decision to grant Eskimo Hut Worldwide's request for a preliminary injunction against one of its franchisees due to the franchisee's failure to comply with systemwide standards. *South Plains Sno, Inc. v. Eskimo Hut Worldwide, Ltd.*, 2019 WL 1591994 (Tex. App. Apr. 12, 2019). Worldwide franchises Eskimo Hut convenience stores that sell frozen beverages to consumers and provides franchisees with a "base mix" and particular instructions on how to use that mix. When South Plains sued Worldwide for alleged violations of the franchise agreement, Worldwide raised a counterclaim for breach of contract and sought a preliminary injunction to bar South Plains from selling or using any recipe for frozen beverages other than Worldwide's at stores in the Worldwide franchise system. Worldwide presented evidence to the trial court that South Plains did not use the required base mix of ingredients in accordance with the recipe dictated by Worldwide, and the trial court granted Worldwide's requested relief. South Plains appealed.

The appellate court affirmed the trial court on the grounds that Worldwide had demonstrated both a probable right to recovery as well as irreparable injury that would result without a preliminary injunction. The franchise agreement between Worldwide and South Plains required South Plains to use the recipe prescribed by Worldwide to make its frozen drinks, and South Plains deviated from the precise recipe. The court recognized the importance of systemwide uniformity based upon specific language contained within the franchise agreement. Additionally, the franchise agreement contained an extraordinary relief clause, which stated that a violation of the uniformity provision would result in irreparable and incalculable harm. Importantly, the court noted that the harm to Worldwide was not just the lost profits, which were calculable, but the damage to Worldwide's reputation and brand from the lack of uniform product across the system.

GRAY PLANT MOOTY

DAMAGES TO FRANCHISOR

GEORGIA COURT OF APPEALS REVERSES TRIAL COURT'S DENIAL OF FRANCHISOR'S MOTION FOR DIRECTED VERDICT ON ADVERTISING FEES CLAIM

The Georgia Court of Appeals has ruled that a trial court erred in denying a motion for directed verdict on a claim for unpaid advertising fees. *Legacy Acad., Inc. v. PACU Enters., Inc.*, 2019 WL 1146664 (Ga. Ct. App. Mar. 13, 2019). PACU had been a Legacy Academy franchisee since 2002. In addition to royalties, PACU's franchise agreement required it to pay advertising fees of one percent of PACU's gross monthly revenue. In December 2010, PACU abandoned its franchised daycare and stopped paying fees. Legacy filed suit, seeking past and future royalties and advertising fees. The case went to trial. At the close of evidence, Legacy moved for a directed verdict, but the trial court denied the motion and submitted the case to the jury. The jury awarded $275,000 in royalties and attorneys' fees, but no advertising fees. Legacy appealed on its advertising fees claim.

On appeal, Legacy argued that the trial court should have granted its motion for directed verdict on the advertising fees claim. While PACU did not file an appellate brief, at the trial court level it defended against the advertising fees claims by alleging that Legacy had failed to mitigate damages, because Legacy could have "replenish[ed] the lost revenue stream by installing a new franchisee in what was formerly protected territory." The court of appeals disagreed with PACU's argument. Under Georgia law, mitigation of damages is not a defense to a claim based on an "absolute promise to pay." Because PACU's obligation to pay advertising fees was fixed and absolute, its mitigation defense did not apply. The court of appeals therefore reversed the denial of Legacy's motion for directed verdict, and directed the trial court to add advertising fees to the verdict.

ANTITRUST

WASHINGTON NO-POACHING CASES SETTLE FOLLOWING AMICUS BRIEFS

Three parallel anti-poaching cases brought by private parties in the U.S. District Court for the Eastern District of Washington have settled following the filing of statements of interest by the U.S. Department of Justice and amicus briefs by the Washington State Attorney General's Office. As reported in Issue 238 of *The GPMemorandum*, the DOJ had announced its intent to file a statement of interest in each of the three putative class action lawsuits. All three cases involved challenges to no-poaching provisions included in franchise agreements, provisions which restricted the ability of franchisees to hire employees away from other franchisees in the system and/or the franchisor. The cases are: *Stigar v. Dough Dough, Inc.*, No. 2:18-cv-00244 [Auntie Anne's]; *Richmond v. Bergey Pullman, Inc.*, No. 2:18-cv-246 [Arby's]; and *Harris v. CJ Star LLC*, No. 2:18-cv-00247 [Carl's Jr.].

The DOJ filed its statement of interest, which addressed federal antitrust law, on March 7, 2019, arguing that franchise agreements are "usually vertical" agreements and thus "assessed under the rule of reason." A franchise agreement is vertical because franchisor and franchisee "normally conduct business at different levels of the market structure." Because of the vertical nature of the agreement, a "typical no-hire or no-solicitation agreement between a franchisor and a franchisee" is to be assessed under the rule of reason. The question under such analysis would be whether the interbrand procompetitive effects of such agreements outweigh the intrabrand limitation on competition. On March 11, the Washington AG filed its amicus brief arguing that, under Washington antitrust law, a franchise no-poaching agreement would be subject to per se analysis, unless the parties could show that it was "reasonably necessary" to a separate, legitimate business transaction or collaboration. The Washington AG argued that franchisors cannot satisfy that standard because many franchisors do not use such provisions, and others have removed them in response to the Washington AG's investigations. Because federal antitrust law guides, but does not bind, the interpretation of Washington antitrust law, the two can be subject to different standards.

Days after these statements were filed, the parties requested that the court cancel a scheduled hearing on the defendants' motions to dismiss. By March 18, the parties informed the court that they had reached a settlement. A stipulation of dismissal was entered in each case in mid-April.

STATE FRANCHISE LAWS

ALABAMA INTRODUCES COMPREHENSIVE FRANCHISE RELATIONSHIP BILL

The Alabama Legislature recently introduced two companion bills in the House of Representatives (HB134) and State Senate (SB129) to create "The Protect Alabama Small Businesses Act," the first major state franchise relationship bill to be seriously considered this year. The bill, which purports to promote fair business relationships between franchisors and franchisees, contains some of the most expansive relationship law requirements seen in recent legislation. It requires good cause for termination and nonrenewal, and governs sales, transfers, or assignment of franchised businesses, the repurchase by a franchisor of a franchised business or an interest in a franchised business, and the mandatory repurchase of certain assets upon termination, nonrenewal, or expiration of a franchise agreement. Under the bill, franchise agreements are perpetual despite any stated contractual term of years, unless termination of the franchise agreement is authorized under the law or the franchisor completely withdraws from distributing its products or services in the geographic market then being served by the franchisee.

Except for certain enumerated exceptions, the bill defines "good cause" as the failure of the franchisee to substantially comply with a provision of the franchise agreement, which is both "reasonable and of material significance to the franchise," after receiving written notice of the failure to comply and being given at least 90 days to cure the failure. If the franchise agreement expires or is terminated without good cause, subject to specific exceptions, a franchisor must repurchase at fair market value the inventory, supplies, goods, fixtures, equipment, and furnishings of the franchised business. The franchisor must also purchase the "goodwill" of the franchised business or waive any post-term noncompete obligations of the franchisee so that the franchisee, at its option, may continue in business. A franchisee is entitled to receive from the franchisor the fair market value of the franchised business and assets in addition to other damages for terminations or nonrenewals that violate the proposed law.

If enacted into law in its current form, the law would apply broadly to both new and existing franchise agreements, would render void any franchise agreement provision restricting the applicable governing law or venue for disputes to jurisdictions outside of Alabama, and would afford aggrieved franchisees the right to bring a private action in state or federal court.

WASHINGTON STATE TO ENACT LAW REGULATING NONCOMPETES

The Washington Legislature recently passed HB1450, a bill that will codify certain limits on the enforceability of noncompetition agreements and outlaw anti-poaching agreements in Washington. It is anticipated that Governor Jay Inslee will sign the bill into law soon, and once enacted, it will take effect on January 1, 2020. HB1450 applies to any noncompetition agreement by which an employee or independent contractor is prohibited or restrained from engaging in a lawful profession, trade, or business of any kind. It does not include: (i) non-solicitation agreements; (ii) confidentiality agreements; (iii) covenants prohibiting the use or disclosure of trade secrets or inventions; (iv) covenants entered into by a person purchasing or selling the goodwill of a business or otherwise acquiring or disposing of an ownership interest; or (v) a covenant entered into by a franchisee when the franchise sale complies with the Washington Franchise Investment Protection Act ("WFIPA"). While the bill appears on its face not to apply to noncompetition covenants in franchise agreements, franchisors should note that franchises not granted in compliance with WFIPA would likely fall under the law's reach. Standard noncompetition covenants in franchise agreements that extend to the franchisees' owners and managers, and which require their owners or managers to enter into a separate form of noncompetition agreement with the franchisee could be interpreted to undermine the franchise exemption in the new law.

Under HB1450, employers may not enter into or enforce a noncompetition agreement unless an employee's yearly earnings exceed $100,000 as adjusted annually for inflation. If the restriction applies to an independent contractor, the income threshold is $250,000, which will also be adjusted for inflation. Noncompetition agreement terms exceeding 18 months are presumed to be unreasonable and unenforceable, but even if the noncompetition agreement complies with the law in all other respects, the agreement must still comply with existing common law standards regarding reasonableness in duration, scope, and geographic area. The scope of the forum selection and choice of law aspects of the bill are also unclear. The law would apply to Washington-based employees and independent contractors and invalidate provisions that select forums outside of Washington and deprive restricted persons of the "benefits of Washington law." Subject to certain exceptions, restricted persons may bring a private cause of action if such person's noncompetition agreement violates the law. Once enacted, the law will apply retroactively to existing noncompetition agreements.

Minneapolis, MN Office

Elizabeth S. Dillon, co-chair (612.632.3284)
Megan L. Anderson (612.632.3004)
Eli M. Bensignor (612.632.3438)
* Sandy Y. Bodeau (612.632.3211)
Phillip W. Bohl (612.632.3019)
Jennifer C. Debrow (612.632.3357)
Ashley Bennett Ewald (612.632.3449)
John W. Fitzgerald (612.632.3064)
* Hannah H. Fotsch (612.632.3340)
* Olivia Garber (612.632.3473)
Michael R. Gray (612.632.3078)
* Karli B. Hussey (612.632.3278)
Gaylen L. Knack (612.632.3217)

Kirk W. Reilly, co-chair (612.632.3305)
* Raymond J. Konz (612.632.3018)
* Richard C. Landon (612.632.3429)
* Mark S. Mathison (612.632.3247)
Craig P. Miller (612.632.3258)
Bruce W. Mooty (612.632.3333)
Ryan R. Palmer (612.632.3013)
Max J. Schott II (612.632.3327)
Michael P. Sullivan, Jr. (612.632.3350)
James A. Wahl (612.632.3425)
Lori L. Wiese-Parks (612.632.3375)
Quentin R. Wittrock (612.632.3382)

Washington, D.C. Office

Mark A. Kirsch, co-chair (202.295.2229)
* Samuel A. Butler (202.295.2246)
* Julia C. Colarusso (202.295.2217)
* Maisa Jean Frank (202.295.2209)
* Jan S. Gilbert (202.295.2230)
* Peter J. Klarfeld (202.295.2226)
Sheldon H. Klein (202.295.2215)
* Thomas A. Pacheco (202.295.2240)
* Justin L. Sallis (202.295.2223)

Frank J. Sciremammano (202.295.2232)
* Michael L. Sturm (202.295.2241)
* Erica L. Tokar (202.295.2239)
Stephen J. Vaughan (202.295.2208)
* Diana V. Vilmenay (202.295.2203)
Eric L. Yaffe (202.295.2222)
Robert L. Zisk (202.295.2202)
* Carl E. Zwisler (202.295.2225)

**** Wrote or edited articles for this issue.***

For more information on our Franchise and Distribution practice and for recent back issues of this publication, visit the **Franchise and Distribution** Practice Group at http://www.gpmlaw.com/Practices/Franchise-Distribution.

Follow us on Twitter: @GPM_Franchise

GRAY PLANT MOOTY

80 South Eighth Street
500 IDS Center
Minneapolis, MN 55402-3796
Phone: 612.632.3000

600 New Hampshire Avenue N.W.
The Watergate – Suite 700
Washington, D.C. 20037-1905
Phone: 202.295.2200

franchise@gpmlaw.com

The GPMemorandum is a periodic publication of Gray, Plant, Mooty, Mooty & Bennett, P.A., and should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult your own franchise lawyer concerning your own situation and any specific legal questions you may have.