The GPMemorandum

TO: **OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS**

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

Quentin R. Wittrock, Editor of *The GPMemorandum*

Maisa Jean Frank, Editor of *The GPMemorandum*

Julia C. Colarusso, Editor of *The GPMemorandum*

DATE: **September 13, 2018—No. 233**

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

DAMAGES

FOURTH CIRCUIT VACATES FRANCHISEE'S AWARD OF LOST PROFITS DUE TO LACK OF CONSIDERATION

The United States Court of Appeals for the Fourth Circuit vacated part of a district court's order that had awarded lost profits to a franchisee in connection with his attempt to repurchase his franchised businesses. *JTH Tax, Inc. v. Aime*, 2018 WL 3770028 (4th Cir. Aug. 8, 2018). The franchisee, Aime, operated nine tax preparation businesses pursuant to franchise agreements with JTH. When the IRS suspended Aime's electronic filing number, JTH purchased and assumed control over the businesses. The purchase agreement included an option for Aime to buy back the franchises if he could obtain a new filing number by a certain date.

Aime was not able to obtain a new filing number by the buyback deadline, so JTH offered to extend the deadline. Aime continued to pay certain expenses of the businesses after the original deadline passed and while he was trying to obtain a new filing number. Soon after, the parties' relationship deteriorated, and they sued each other for breach of contract before the expiration of the extended deadline and before Aime obtained a new number. After a bench trial, the trial court awarded Aime over two million dollars, including the profits Aime lost because he was unable to repurchase his franchised businesses. Critical to the judgment was the trial court's holding that Aime could enforce JTH's promise to extend the buyback deadline.

On appeal, the Fourth Circuit held that JTH's offer to extend the deadline was, in effect, a gratuitous promise that was unenforceable. While JTH agreed to extend the deadline, there was no corresponding consideration by Aime. The appellate court held that even though it was foreseeable that Aime would continue to pay expenses of the franchised businesses after the original buyback deadline had passed, and JTH knew Aime would be induced to do so, the foreseeable inducement did not constitute consideration. As a result, the Fourth Circuit vacated the trial court's judgment to the extent it relied on the validity of the extended deadline.

JOINT EMPLOYER

WENDY'S MAY BE LIABLE UNDER TITLE VII AS JOINT EMPLOYER

Wendy's could be liable as a joint employer under Title VII, a federal court recently held, allowing the plaintiff to proceed with her hostile work environment claims against Wendy's and one of its franchisees. *A.H. v. Wendy's Co.*, 2018 WL 4002856 (M.D. Pa. Aug. 22, 2018). The plaintiff, a former employee of the franchisee, filed suit alleging that she was sexually harassed by a supervisor and that Wendy's was jointly liable for the hostile work environment under either a joint employer or agency theory. Wendy's moved to dismiss, arguing that the plaintiff failed to plead facts to show that it exercised sufficient control over the franchisee to establish liability under either theory.

In analyzing the joint employer theory, the court first examined whether the plaintiff sufficiently alleged that Wendy's had authority over the conditions of her employment. The plaintiff alleged that she was required to sign a conduct policy that identified activities that Wendy's considered to be "a business abuse or contrary to acceptable business practice." She also had to sign several additional policies identified as Wendy's rules and regulations. According to the court, language in the applicable franchise agreement requiring the franchisee to operate its restaurant in strict conformity with methods prescribed by Wendy's in its manual further supported the plaintiff's allegations that Wendy's had authority over certain employment conditions. While these allegations did not establish that Wendy's had control over hiring and firing decisions, they were sufficient to show Wendy's had authority to set conditions of employment and workplace rules.

The court then turned to the second factor, finding that the plaintiff plausibly alleged Wendy's had control over day-to-day supervision. Specifically, the plaintiff alleged that at the start of her employment, she was required to undergo a series of computerized training courses authored by Wendy's. Moreover, Wendy's provided continual in-service employee training. As with the first factor, the court also found support in the franchise agreement, which authorized Wendy's to conduct periodic inspections and to provide "as it deems advisable, periodic and continuing advisory assistance to Franchisee as to the operation, merchandising, and promotion of the Restaurant." Finally, the court determined that the plaintiff had sufficiently alleged that Wendy's exercised control over employee records given that the franchise agreement required Wendy's to provide the franchisee with certain reporting forms and Wendy's had the right to examine the franchisee's "books, records, and tax returns." The plaintiff's claims against Wendy's under an agency theory of liability also survived the motion to dismiss for similar reasons.

ALJ REJECTS PROPOSED SETTLEMENT IN MCDONALD'S JOINT EMPLOYER LITIGATION

An administrative law judge has denied motions to approve proposed "informal" settlements in the National Labor Relations Board joint employer litigation against the franchisor of the McDonald's system. *McDonald's USA, LLC & Fast Food Workers Comm.*, N.L.R.B. Case Nos. 02-CA-093893 (July 17, 2018). The litigation arose out of alleged retaliation against franchisees' employees who participated in Fight for $15 demonstrations demanding higher pay for fast food workers. The litigation was commenced under the Obama Administration for the stated purpose of obtaining "a finding that McDonald's USA, LLC was jointly and severally liable for all of the alleged unfair labor practices . . . because of its status as a Joint Employer of the affected workers." When Republicans took control of the NLRB, new General Counsel Peter Robb sought to retreat from this objective and settle the claims against McDonald's. After 150 days of hearing, near the close of the proceedings, McDonald's and the General Counsel presented the proposed settlement terms to the ALJ, over the strenuous objection of the Charging Parties.

The proposed settlements would have resulted in payments to certain allegedly affected employees. They would have also established a limited-time Settlement Fund (funded by the Franchisee Respondents) that would compensate employees for future instances of some, but not all, of the retaliatory actions alleged in the consolidated complaint. The proposal also provided a process allowing the General Counsel to reassert joint employer claims against McDonald's in the event the settlement agreements were breached, but only if both the Franchisee Respondents and McDonald's failed to perform their obligations under the agreements. McDonald's obligations would be limited to mailing out a Special Notice if a Franchisee Respondent failed to remedy a violation of the agreements, and to collecting the money comprising the Settlement Fund. The proposed settlements did not include any admission regarding McDonald's alleged joint employer status.

The ALJ recognized the NLRB's longstanding policy of encouraging amicable settlements. Nevertheless, Judge Esposito decided that the proposed settlements failed to satisfy the so-called *Independent Stave* test, finding that the proposal was not reasonable in light of the nature of the violations alleged, the risks inherent in the litigation, and the state of the litigation. Among the ALJ's reasons were contradictory statements made by McDonald's counsel and the NLRB General Counsel regarding McDonald's responsibilities under the proposal. Finding that there was no meeting of the minds, the ALJ suggested that the settlement would not conclusively end the litigation, particularly in light of the parties' contentious relationship throughout the litigation. Further, the ALJ suggested that the risks of proceeding with the litigation did not warrant the General Counsel's acquiescence to settlement terms so favorable to McDonald's. The proceedings were almost finished, and while the ALJ did not decide McDonald's was a joint employer, she described "a significant quantum of evidence" suggesting that McDonald's was more than a mere bystander. Given McDonald's potential liability, the proposed settlements would "not in any way approximate the remedial effect of a finding of joint employer status."

In denying the motions to approve the settlements, the ALJ directed the parties to either request permission to appeal or prepare for an additional 12 days of hearing in October 2018. McDonald's has already requested permission to appeal.

PRELIMINARY INJUNCTIONS

MAINE FEDERAL COURT DENIES FRANCHISOR'S MOTION FOR TRO

The U.S. District Court for the District of Maine recently denied a franchisor's motion for a temporary restraining order to stop its former franchisee from operating a new business following the expiration of the parties' franchise agreement. *Toddle Inn Franchising, LLC v. KPJ Assocs. LLC*, 2018 WL 3676826 (D. Me. Aug. 2, 2018). The parties had entered into a franchise agreement that permitted KPJ to open and operate a Toddle Inn childcare center. When the franchise agreement expired in July 2016, the parties did not renew the contract. Nonetheless, KPJ continued to operate as a Toddle Inn location, paid royalties, and abided by some of the other terms of the franchise agreement until July 2018, when KPJ told Toddle Inn that it planned to close and reopen as Kennebunk Children's Academy. Toddle Inn then sued KPJ and sought a TRO to enforce the agreement's two-year post-termination noncompete provision.

The court determined that Toddle Inn failed to establish a likelihood of success on the merits because it could not prove that the franchise agreement remained in effect after July 2016 and that the parties had implicitly agreed to extend the noncompete provision. Among other things, statements made by Toddle Inn's CEO indicated that KPJ was operating "at will" and was "not eligible to renew" the franchise agreement until it complied with the agreement's terms. The court also held that Toddle Inn failed to identify a hardship comparable to the hardship KPJ would suffer if Kennebunk Children's Academy were forced to close. Further, because families who brought their children to Kennebunk's Children Academy would suffer as a result of any TRO, the public interest weighed against granting the motion.

ANTITRUST

EMPLOYEE'S SHERMAN ACT CLAIM BASED ON ANTI-POACHING AGREEMENT ALLOWED TO CONTINUE AGAINST JIMMY JOHN'S

A federal court in Illinois has allowed a former Jimmy John's employee to proceed with antitrust claims targeted at an anti-poaching requirement in Jimmy John's franchise agreements. *Butler v. Jimmy John's Franchise, LLC*, 2018 WL 3631577 (S.D. Ill. July 31, 2018). Jimmy John's had included in its franchise agreements a prohibition on franchisees recruiting or hiring any employee that has worked at another Jimmy John's in the prior year. According to the plaintiff, this requirement was enforced by franchisees through noncompete provisions in their employment agreements, and could also be enforced by one franchisee against another for a known breach. The plaintiff filed suit against Jimmy John's under the Sherman Act, arguing that Jimmy John's was per se liable under federal antitrust laws for facilitating a horizontal agreement in restraint of trade between its competing franchisees that unfairly precluded him from supplementing his work at other Jimmy John's shops.

Jimmy John's moved to dismiss, arguing that its agreements with franchisees are vertical in nature—not agreements between competitors—and therefore subject to a "rule of reason" analysis that requires detailed allegations about market power. Although Jimmy John's relationship with its franchisees is vertical, the court concluded that the plaintiff had sufficiently pled details that could support a "hub-and-spoke" conspiracy by which Jimmy John's individual agreements with franchisees were used to orchestrate a "horizontal wheel" connecting each franchisee, even without individual horizontal agreements among the franchisees themselves.

The plaintiff also sufficiently pled an alternative theory that required a "quick look" analysis—a standard more rigorous than the "rule of reason"—that is applied when the agreements in question may be vertical, but still require a certain degree of cooperation between competitors. In particular, the court noted that the plaintiff alleged that all franchisees were designated as third-party beneficiaries to the anti-poaching provision and were expressly able to enforce the requirement against other franchisees who violated it.

CONTRACTS

WYOMING SUPREME COURT UPHOLDS TERMINATION OF FRANCHISE EXECUTIVES FOR PURSUIT OF ANOTHER FRANCHISE OPPORTUNITY

The Wyoming Supreme Court affirmed a lower-court decision approving the termination of two executives following their pursuit of a franchise opportunity with another system. *James v. Taco John's Int'l, Inc.*, 2018 WL 4011633 (Wyo. Aug. 22, 2018). In 2013, Taco John's International (TJI) hired a new Chief Development Officer and a Vice President of Operations at the behest of its recently hired President and CEO. The pair's employment agreements required them to "devote all of [their] time, attention, knowledge, and skills solely to the business and interest of Employer." In 2016, the three executives became interested in a franchise opportunity with another system and took several steps toward acquiring the franchise. When TJI's compensation committee found out about the venture, the board of directors terminated the CDO and VP of Operations.

The two terminated executives sued for breaches of their employment agreements. In affirming the lower court's grant of summary judgment against them, the Supreme Court first rejected the executives' argument that their employment agreements were ambiguous. The executives argued that they could not be required to devote "all" of their time to their jobs, as they were permitted to have private lives. The court found the term "all" clearly to refer to "all" of the executives' working time, by virtue of the word's location in a section of the contract labeled "Other Employment." The court next found immaterial the facts that the executives never acquired the franchise, that they did not neglect the duties of their employment, and that the President's contract permitted other business activities. Finally, the court rejected the executives' argument that TJI authorized their actions through the alleged apparent authority of the President.

STATE TAX LAWS

COLLECTION OF ROYALTY FEES UNDER FRANCHISE AGREEMENT SUBJECT TO GROSS RECEIPTS TAX IN NEW MEXICO

The New Mexico Court of Appeals affirmed a decision by an administrative hearing officer that a franchisor's receipt of royalty fees under a franchise agreement were subject to gross receipts tax pursuant to New Mexico's Gross Receipts and Compensating Tax Act. *A&W Rests., Inc. v. Taxation & Revenue Dep't*, 2018 WL 4024741 (N.M. Ct. App. Aug. 22, 2018). In 2007, the state legislature amended the Act so that the definition of taxable "gross receipts" included the amount of money received "from granting a right to use a franchise employed in New Mexico," and so that the definition of "property" included "licenses other than the licenses of . . . trademarks." Following an audit in 2013, the New Mexico Taxation and Revenue Department assessed gross receipts tax on the royalty fees A&W collected under its franchise agreements. A&W protested the Department's decision, arguing that the royalty fees were exempt from gross receipts tax because trademarks are not considered "property" under the Act.

The critical issue in the case was whether the royalty fees under the franchise agreement were received from the grant of a franchise or from the licensing of the trademark. The court concluded that the legislature's change to the definition of gross receipts evidenced the state's intent to subject money received from the grant of a franchise, such as royalties, to gross receipts tax. Because a franchise is viewed as a "bundled form of property" that includes a limited trademark license along with additional rights and obligations, the court held that it should be treated differently from a standalone trademark license agreement, which is exempt from gross receipts tax.

PRACTICE OF FRANCHISE LAW

NASAA PROPOSES NEW STATE COVER SHEETS TO FDDS

On June 12, 2018, the Franchise Project Group of the North American Securities Administrators Association, Inc. (NASAA) sought public comments on a proposal (the "Proposal") to revise instructions in its 2008 Franchise Registration and Disclosure Guidelines ("NASAA Guidelines") regarding the information provided in the state cover sheets to franchise disclosure documents (FDDs). If the Proposal is adopted as currently written, three new state cover sheets titled "How to Use this Franchise Disclosure Document," "What You Need to Know About Franchising, *Generally*," and "Special Risk(s) to Consider about *This* Franchise" will replace the current state FDD cover sheet. As part of the Proposal, NASAA seeks to make the FDD a more user-friendly tool for prospective franchisees by, among thing things, (i) providing prospective franchisees clearer directions about how to use the FDD, (ii) highlighting general information about franchising that prospective franchisees may not understand until after the franchisee has entered into the franchise relationship, and (iii) changing the format of the information presented in the state cover sheets, including requiring that all state-required risk factors be written in lower case text instead of all capital letters, and providing new instructions and procedures for the inclusion of state-required, nonuniform risk factors.

Gray Plant Mooty submitted comments to the Proposal to help improve the utility of the state cover sheets. Our comment letter is linked here. The comment period ended on July 13, 2018. We anticipate that NASAA will review the public comments over the next few months and will issue the revised NASAA Guidelines shortly thereafter. The Proposal, including instructions and a sample of the proposed "State Cover Sheets" and "State Effective Dates Page," can be found at http://www.nasaa.org/regulatory-activity/nasaa-proposals/.

Along with the attorneys indicated on the next page, David C. Bahls, a principal in the Corporate & Business practice group, contributed to this issue.

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)
* Olivia Garber (612.632.3473)
* Michael R. Gray (612.632.3078)
Karli B. Hussey (612.632.3278)
Gaylen L. Knack (612.632.3217)
* Raymond J. Konz (612.632.3018)

Kirk W. Reilly, co-chair (612.632.3305)
* Richard C. Landon (612.632.3429)
Christine A. Longe (612.632.3424)
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)
Iris F. Rosario (202.295.2204)
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