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

JURY FINDS FRANCHISOR NOT LIABLE FOR TORTIOUS INTERFERENCE BY TERMINATION OF A FRANCHISEE'S DEVELOPMENT AGREEMENT

Following a two-week jury trial in federal court in Philadelphia on a real estate developer's tortious interference claim, a jury recently returned a complete defense verdict in favor of Dunkin' Donuts. *Selzer v. Dunkin' Donuts Inc.*, No. 2:09-cv-05484-GP (E.D. Pa.). Gray Plant Mooty represented the franchisor in this case, which involved a Pennsylvania real estate developer who had entered into an agreement with a Dunkin' Donuts franchisee to develop his stores in York, Pennsylvania. The franchisee had entered into a store development agreement with Dunkin', giving him the exclusive right to develop ten stores during a certain time frame. The franchisee developed three stores. The real estate developer constructed the stores for him and then acted as the franchisee's landlord.

The franchisee was unable to develop the remaining seven stores, and eventually Dunkin' terminated the store development agreement. The real estate developer sued Dunkin' for tortious interference with contractual relations, seeking several million dollars, representing monies it contended it would have received had Dunkin' fulfilled its obligations under the development agreement. The real estate developer asserted that Dunkin' had unlawfully failed to approve the franchisee's fourth location for development and then wrongfully terminated the development agreement. It further contended that, absent Dunkin's wrongful conduct, it would have received profits from the construction of the remaining seven shops as well as substantial rental income from each shop. Numerous witnesses testified, including damages experts for the developer and Dunkin' Donuts. The jury found that Dunkin' was not liable and awarded no damages.

TRADEMARKS

SUPREME COURT HOLDS THAT TTAB RULINGS ON LIKELIHOOD OF CONFUSION MAY BIND A COURT IN A LATER PROCEEDING

The U.S. Supreme Court recently held that, under certain circumstances, rulings by the Trademark Trial and Appeal Board (TTAB) of the United States Patent and Trademark Office on the core issue of "likelihood of confusion" in contested trademark registration (opposition or cancellation) proceedings can be binding on a court considering the same issue in infringement litigation. *B&B Hardware, Inc. v. Hargis Indus., Inc.*, 135 S. Ct. 1293 (March 24, 2015). The TTAB had held, in an opposition proceeding, that there was a likelihood of confusion between B&B's senior registered mark SEALTIGHT for metal fasteners in the aerospace industry and Hargis's mark SEALTITE for metal fasteners in the construction industry. This resulted in a denial of Hargis's application to register its mark. In a concurrent trademark infringement jury trial between the parties in federal district court, B&B asked the judge to hold that Hargis could no longer contest likelihood of confusion because the TTAB decision was binding under the doctrine of issue preclusion or collateral estoppel. The judge refused, B&B lost the case, and the Eighth Circuit affirmed. Reversing the district court and the Eighth Circuit, the Supreme Court, in a 7-2 decision, held that the TTAB had considered essentially the same material facts and applied the same legal standard that the district court was required to consider and apply in the infringement case. Therefore, the Board's finding of likelihood of confusion was binding on the district court.

The court indicated that issue preclusion should apply in only a limited number of cases, where the ordinary elements of the doctrine (including the actual litigation of an essential issue of fact or law and its determination by a final judgment) are met, and "when the [trademark] usages adjudicated by the TTAB are materially the same as those before the district court." For example, the TTAB often does not fully consider, but a court does consider, the effect of marketplace conditions on likelihood of confusion. In many cases, however, it will be difficult to predict whether preclusion will apply—*especially* in the early stages of either the TTAB case or the court case. This presents a significant challenge to trademark litigants and their counsel. TTAB proceedings are likely to become longer and more expensive, and settle less frequently. Decisions will probably be appealed more often. The lower courts will need to refine and apply the court's "materially the same" standard on a case-by-case basis. Ultimately, as the court indicated, preclusion may not apply in many cases, but trademark disputants should err on the side of caution. Since courts can issue injunctions and award damages and the TTAB cannot, many may decide to bypass the TTAB and litigate their disputes in the courts, which are also empowered to rule on trademark registration. Franchisors, as owners of many of the world's most famous brands, will unquestionably be impacted by *B&B Hardware, Inc. v. Hargis Industries.*

FEDERAL COURT DISMISSES TRADEMARK INFRINGEMENT CLAIM BASED UPON FRANCHISEE'S SALE OF GENUINE PRODUCTS AT A COMPETING STORE

In a recent case a federal court in New Jersey granted a franchisee's motion to dismiss trademark infringement claims brought by the franchisor, but granted the franchisor leave to amend its claim. *7 Eleven, Inc. v. Maia Inv. Co.*, 2015 U.S. Dist. LEXIS 50753 (D.N.J. Apr. 17, 2015). 7-Eleven brought suit against its franchisee, Maia, after discovering that it had sold 7-Eleven branded products at a competing convenience store. Specifically, 7-Eleven alleged that Maia had sold various 7-Eleven proprietary products, such as Cheeseburger Bites and BIG BITE hot dogs, at its own store that it called "24-7 Foodmart."

The court dismissed 7-Eleven's trademark infringement claim by applying the "first sale doctrine." That doctrine provides that the mere resale of trademarked goods purchased from the trademark owner, as occurred in this case, does not constitute infringement. The court noted, however, that 7-Eleven may have other viable theories of trademark infringement, and granted 7-Eleven leave to amend its complaint. It declined to dismiss 7-Eleven's claim that the franchisee breached the franchise agreement by independently selling 7-Eleven products and by failing to accurately report sales of those products. The court dismissed 7-Eleven's fraud claim by applying the "economic loss rule," reasoning that the claim was based on the same conduct as the breach of contract claim, and it dismissed 7-Eleven's conspiracy claim because it was based upon the same alleged fraud.

TERMINATIONS

SECOND CIRCUIT AFFIRMS GRANT OF SUMMARY JUDGMENT TO HOTEL FRANCHISOR AND ENFORCES LIQUIDATED DAMAGES PROVISION

The Second Circuit affirmed a grant of summary judgment in favor of hotel franchisor HLT Existing Franchise Holding LLC, dismissing a former franchisee's claim that HLT improperly terminated the franchise agreement and permitting HLT to recover liquidated damages. *HLT Existing Franchise Holding LLC v. Worcester Hospitality Grp., LLC*, 2015 U.S. App. LEXIS (2d Cir. Apr. 9, 2015). The terminated Hampton Inn franchisee, Worcester Hospitality Group, LLC (WHG), argued that the district court erred in three respects, contending that: (1) HLT had violated the covenant of good faith and fair dealing by conducting on-site inspections of the hotel in an arbitrary or irrational manner; (2) the district court should have excluded guest surveys that reflected customer dissatisfaction as inadmissible hearsay; and (3) the contractual liquidated damages term—which awarded HLT three years' worth of estimated future royalties if HLT terminated the agreement due to WHG's breach—was unreasonable based on record evidence that HLT could construct a new Hampton Inn in less than one year.

The Second Circuit affirmed. It held that the application of the covenant of good faith and fair dealing was inapposite because the allegedly arbitrary or irrational inspections were not HLT's sole basis for terminating the agreement. Because WHG also received failing scores on guest surveys, HLT had an independent, contractually-permitted reason for termination. The guest surveys were not hearsay because they were not admitted to show the truth of the matter asserted. Rather, they were admissible evidence that HLT reasonably believed that guests were dissatisfied. The surveys were also exempted from hearsay as records of a regularly conducted business activity. Finally, the court found that evidence regarding the timeframe for constructing a new Hampton Inn was irrelevant to the reasonableness of the liquidated damages. Instead, the parties' assessment of how quickly HLT could replace WHG as a franchisee and reopen the existing Hampton Inn was the appropriate measure for calculating liquidated damages. Thus, HLT was entitled to contractual liquidated damages.

THIRD CIRCUIT AFFIRMS DISMISSAL OF FRANCHISEE'S CLAIMS THAT FRANCHISOR MISREPRESENTED STARTUP COSTS AND CONSTRUCTIVELY TERMINATED FRANCHISE

The Third Circuit recently affirmed a federal district court's dismissal of a lawsuit against the franchisor of the Doctors Express franchise system. In *Fabbro v. DRX Urgent Care, LLC*, 2015 WL 1453537 (3d Cir. Apr. 1, 2015), the franchisee alleged that Doctors Express breached its contract, breached the duty of good faith, and fraudulently misrepresented the actual startup costs the franchisee would expend after entering into the franchise agreement. It claimed that its actual costs exceeded the estimates by a substantial margin, and it argued that overly restrictive requirements and changes in the Doctors Express business model had effectively rendered the franchise inoperable, constituting constructive termination in violation of New Jersey's franchise act.

The court first rejected the franchisee's argument that the startup estimates in the Doctors Express disclosure documents had somehow constituted a breach of contract or of the duty of good faith and fair dealing. The court noted that the complaint had not identified a single provision of the franchise agreement that had been breached by these disclosures, since they were expressly identified as estimates that did not account for local economic and market conditions. The good faith and fair dealing claim was not permitted where there was no evidence or allegation of bad motive or intent to create an economic disadvantage. Next, the court rejected the franchisee's fraud claim because the estimates were nothing more than a prediction as to the future course of events, and there was no showing that the initial estimates were inaccurate at the time they were made or known to be false by the franchisor. Finally, the court concluded that there could be no constructive termination because the franchisee had failed to identify any facts that would demonstrate Doctors Express wanted to cease doing business with it or otherwise undermine its business. To the contrary, the court observed that Doctors Express would continue to profit from the continued business of the franchisee, which was otherwise still in "good standing" with Doctors Express.

CLASS ACTIONS

PENNSYLVANIA FEDERAL COURT CERTIFIES CLASS OF FRANCHISEES, ALLOWING CONTRACTOR MISCLASSIFICATION AND STATE WAGE CLAIMS TO PROCEED

A Pennsylvania federal court has granted class certification to a group of Jani-King® franchisees, allowing their lawsuit alleging contractor misclassification and wage claims under Pennsylvania's Wage Payment and Collection Law ("WPCL") to proceed. *Myers v. Jani-King of Phila.*, 2015 U.S. Dist. LEXIS 29566 (E.D. Pa. Mar. 10, 2015). The action considered whether Texas-based franchisor Jani-King, a franchisor of commercial cleaning businesses, exercised so much control that its franchisees were employees, rather than independent business owners, and whether the franchisees were subject to improper wage deductions under the WPCL.

In granting the franchisees' certification motion, the court held that the plaintiffs met the numerosity, commonality, typicality, adequacy, and predominance class certification requirements under Federal Rule of Civil Procedure 23(a) and (b). While the franchisees were required to incorporate a business and had the right to elect to personally perform cleaning services or do so through employees they selected and managed, the court found that other uniformly applied Jani-King policies and practices evidenced control. For example, Jani-King obtained customer contracts for its franchisees, established and quoted contract prices to customers, guaranteed franchisees a certain level of gross sales, trained franchisees on required cleaning methods, required certain levels and types of customer interactions by franchisees, resolved customer complaints involving franchisees, and handled invoicing and accounting functions for franchisees. Importantly, in certifying the plaintiff class the court declined to adopt the reasoning used by a California federal court in a separate case against Jani-King, *Juarez v. Jani-King,* 273 F.R.D. 571 (N.D. Cal. 2011). In that action, the court refused to consider control evidence showing merely the "common hallmarks of a franchise." The Pennsylvania court held that, unlike in some other states, Pennsylvania wage law does not distinguish between controls that are put in place to preserve a franchisor's intellectual property and goodwill and controls for other reasons.

GRAY PLANT MOOTY

CONTRACTS

FRANCHISOR PROPERLY PLED BREACH OF CONTRACT CLAIM AGAINST FRANCHISEES OPERATING COMPETING BUSINESS

A federal district court in Michigan recently denied a franchisee's motion to dismiss its franchisor's counterclaims for breach of contract and a declaratory judgment. *AKB Wireless, Inc. v. Wireless Toyz Franchise LLC*, 2015 U.S. Dist. LEXIS 48005 (E.D. Mich. Apr. 13, 2015). The franchisor, Wireless Toyz, alleged that AKB had breached its franchise agreement by, among other things, violating the agreement's covenant not to compete and confidentiality provisions. AKB argued that the franchise agreement's noncompetition and confidentiality provisions only applied upon termination or expiration of the franchise agreement. Since they were still operating their franchise at the time they formed a competing business, they claimed those provisions did not apply to them.

The court found, however, that another provision of the agreement prohibited AKB from engaging in competitive activity during the term of the agreement. The court also rejected AKB's argument that Wireless Toyz failed to state a claim for declaratory relief because it had an adequate remedy at law, pointing out that Federal Rule of Civil Procedure 57 expressly provides that the existence of another remedy does not preclude an otherwise appropriate action for a declaratory judgment. Finally, the court refused to consider whether Wireless Toyz's other breach of contract claims should be dismissed, holding that the adequacy of one of its allegations of breach was sufficient to deny the motion.

NEBRASKA COURT REFUSES TO INVOKE BLUE PENCIL RULE AND DEEMS POST-TERM NONCOMPETE UNENFORCEABLE

In *Unlimited Opportunity, Inc. v. Waadah*, 2015 Neb. LEXIS 71 (Neb. Apr. 10, 2015), the Supreme Court of Nebraska affirmed a district court's ruling that the post-term non-compete covenant contained within the parties' franchise agreement was unreasonable, and therefore unenforceable. Unlimited Opportunity, d/b/a Jani-King of Omaha, ("Jani-King") is a subfranchisor of professional cleaning and maintenance services. In 2008, Jani-King granted Waadah a franchise in the Omaha, Nebraska area, which franchise later was terminated. The parties' franchise agreement contained a post-term non-compete clause which restricted participation in a competitive business within: (i) the territory granted to Waadah under the franchise agreement for a period of two years; *and (ii) the territory of any other Jani-King® franchisee for a period of one year.* Jani-King terminated the franchise agreement in 2010 because Waadah attempted to divert Jani-King® customers to his own janitorial business. Waadah subsequently formed a competing business in his former franchised territory, and Jani-King filed suit. Although

Jani-King's claims relied on the two-year portion of the provision, the district court concluded that the geographic scope of the one-year covenant was unreasonable because it restricted competition outside Waadah's franchised territory, and therefore held the entire noncompete clause unenforceable.

On appeal, the Nebraska Supreme Court echoed the district court's analysis and decision. The enforceability of a noncompete covenant under Nebraska law is based in part on whether the covenant is reasonable in space and time. As a result, such covenants must be limited in geographic scope. The court agreed that because Jani-King® franchisees operate across the globe, the one-year covenant not to compete in any franchisee's territory was similar to having no geographic restriction at all. Although Jani-King's claims relied on the two-year, geographically-limited restraint, the district court refused to sever the broader one-year restraint and deemed the entire noncompete provision unenforceable. The high court affirmed the district court's dismissal of Jani-King's claims, noting that Nebraska precedent has consistently declined to apply the "blue pencil rule," which enables courts to reform covenants to make them enforceable.

This case is a frightening reminder for franchisors of a court's unwillingness to reform noncompete provisions, even when franchisee activity is egregious. Franchisors subject to Nebraska law need to carefully draft noncompete provisions in light of prevailing Nebraska law as to what is deemed "reasonable."

PRACTICE OF FRANCHISE LAW

FRANCHISEE'S ATTORNEY DISQUALIFIED FOR PAYING A FACT WITNESS

In *Patel v. 7-Eleven, Inc.*, Bus. Franchise Guide (CCH) ¶ 15,492 (C.D. Cal. Apr. 14, 2015), a former franchisee alleged that 7-Eleven unlawfully terminated its franchise. While preparing to file the case, Patel's counsel was contacted by a disgruntled employee in 7-Eleven's Asset Protection Department, Kurt McCord, who offered his services as a "Loss Prevention Consultant." Patel hired McCord. He drafted a document specifying how 7-Eleven's Asset Protection Department operated, a summary of proper interview techniques, and an analysis of 7-Eleven's loss prevention interview with Patel. From that document, Patel's counsel drafted a "Certification of Kurt McCord," which was later signed by McCord and filed in the case.

7-Eleven argued that Patel's counsel, Gerard Marks of Marks & Klein, LLP, improperly paid McCord for fact testimony and moved to disqualify him. The court agreed and granted 7-Eleven's motion. It found that Patel's counsel violated California Rule of Professional Conduct 5-310, which states that an attorney shall not "directly or indirectly pay . . . compensation to a witness contingent upon the content of the witness's testimony." The court rejected Patel's argument that McCord was an expert witness. McCord did not have significant experience in the industry, his purported certifications were never explained, and the bulk of his testimony concerned 7-Eleven's specific interactions with Patel, which was fact testimony and not expert testimony. The court also found that the payment was not acceptable compensation for "preparation time" because McCord was paid a flat fee. Even if McCord's testimony were truthful, that would not be a defense to the rule violation. McCord indicated the sort of factual testimony he could provide, for a fee, and Patel's counsel hired him to provide that testimony. That arrangement was deemed a quid pro quo payment for testimony that the ethical rules prohibit. Because it found that no lesser sanction would be effective, the court disqualified Patel's counsel.

DAMAGES TO FRANCHISEE

GEORGIA SUPREME COURT REVERSES FAVORABLE FRANCHISEE AWARD OF RESCISSION AND DAMAGES

In a case involving claims for rescission of the franchise agreement and damages related to a franchisee's purchase of a day care franchise, the Georgia Supreme Court recently reversed the franchisee's favorable jury verdict and remanded the case for a new trial. *Legacy Acad., Inc., v. Mamilove, LLC*, 2015 Ga. LEXIS 233 (Ga. Apr. 20, 2015). Mamilove and its owners alleged that the franchisor, Legacy Academy, made improper earnings claims, and that they were fraudulently induced to sign the franchise agreement with false information from historical earnings of existing franchisees. Evidence at trial revealed that Legacy Academy first made the earnings claims and then later delivered the FDD and the franchise agreement on the day the franchisee signed them. The franchisee signed the documents without reading them. The jury awarded the franchisee $750,000 in compensatory damages, $375,000 in additional Georgia RICO statute damages, and $30,000 in costs of litigation.

Legacy Academy claimed that the trial court erred in denying its motion for a directed verdict on Mamilove's claims for rescission, fraud, negligent misrepresentation, and violation of Georgia RICO statute, and the court of appeals erred in affirming this denial. The Georgia Supreme Court agreed, indicating that a party who has the capacity and opportunity to read a written contract cannot later claim fraud in the procurement of his or her signature to the contract based on differing extra-contractual representations. The court determined that because the precontractual earnings claim upon which Mamilove and its owners allege they relied expressly contradicted the disclaimer and acknowledgment provisions of the franchise agreement, Mamilove's reliance on the earnings claims was unreasonable as a matter of law. Absent any evidence of fraud that prevented Mamilove from reading the agreement, the franchisor should have prevailed on the rescission claim. In addition, the RICO claims, which depended on allegations of precontractual representations, should have been barred by the merger clause.

VICARIOUS LIABILITY

TEXAS COURT OF APPEALS REVERSES JURY VERDICT THAT HAD FOUND FRANCHISOR VICARIOUSLY LIABLE FOR DELIVERY DRIVER ACCIDENT

The Texas Court of Appeals recently overturned a jury verdict that had found the Domino's franchisor vicariously liable for a death and serious injuries resulting from an accident caused by the defective vehicle of a delivery driver. *Domino's Pizza, LLC v. Reddy*, 2015 Tex. App. LEXIS 2578 (Tex. Ct. App. Mar. 19, 2015). The court observed that whether a franchisor may be held vicariously liable for the acts of its franchisees depends on whether the franchisor had the right to the control the injury causing conduct. Reddy, a representative of the victims, argued that Domino's controls virtually all aspects of its franchisees' conduct, including pizza delivery. In support of that argument, Reddy noted that Domino's prescribes and controls the specifications, standards and operating procedures of its franchises—requiring, for instance, the periodic inspection of delivery driver vehicles—and retains the right to terminate franchisees for failing to meet system requirements.

The Texas Court of Appeals rejected Reddy's arguments, concluding that insufficient evidence existed for a jury to conclude that Domino's controlled the aspects of the franchisee's conduct giving rise to the accident. Specifically, the court held that the establishment of system procedures and rules and the reservation of the right to monitor compliance with those rules and to terminate in the event of noncompliance, does not by itself evidence a right to control. Rather, the court noted, Domino's procedures and rules represented minimum standards for which the franchisee was free to implement its own "means, methods, and details" to satisfy. Thus, requiring franchisees to comply with general safety practices did not evidence sufficient control where the franchisee was left to implement the means with which those practices were complied. The court also placed significant weight on the franchise agreement's designation of the franchisee as an independent contractor.

CLARIFICATION

The Northern District of Georgia case, *Massey, Inc. v. Moe's Southwest Grill, LLC*, reported in Issue 191, was brought against the founder and prior owner of the Moe's Southwest Grill brand and related parties. All references to "Moe's" and "Moe's CEO" in the article actually refer to the prior owner and prior CEO. The Moe's Southwest Grill brand was purchased in 2007 and has been operated by a new franchisor entity since that time. The current franchisor entity was not a party to the dispute.

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