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.

CONTRACTS

COURT HOLDS SALES AGREEMENT WITH INDEFINITE DURATION IS NOT TERMINABLE AT WILL IF ITS TERMS PROVIDE OTHERWISE

The United States Court of Appeals for the Seventh Circuit recently reversed a lower court’s judgment that a sales agreement was of indefinite duration and therefore terminable at will. Burford v. Accounting Practice Sales, Inc., 2015 U.S. App. LEXIS 7894 (7th Cir. May 13, 2015). The parties had entered into an agreement whereby Burford facilitated the purchase and sale of accounting practices in a designated territory on behalf of Accounting Practice Sales (“APS”). The agreement had an initial term of twelve months and provided that it would renew automatically for another twelve-month period each year thereafter. It stated that “APS cannot terminate [the] agreement unless it is violated by Burford.” When APS terminated the parties’ relationship, Burford brought suit for breach of contract. The district court granted summary judgment to APS on the theory that the sales agreement was perpetual, and as with any contract of indefinite duration, it could be terminated at will by either party. Burford appealed the grant of summary judgment and argued that APS could only terminate the contract for cause.

The Seventh Circuit held that the lower court erred in granting summary judgment for APS because the plain language of the sales agreement and the context in which it was signed showed that APS could not terminate the
contract at will. Applying Illinois law, the court recognized that the sales agreement was of indefinite duration and that, as a general rule, such contracts are presumed to be terminable at will by either party. However, the court reasoned that parties can avoid this presumption if they agree to place limits on when termination may take place. The sales agreement included an express provision that it could be terminated by APS only if Burford violated its terms. The court inferred that this provision was intended to protect Burford from the risk that APS would wait until he had built up his territory and then reassign it to someone else. Absent APS’s ability to terminate the agreement at will, the contract claim survived summary judgment.

COURT DENIES FRANCHISOR’S MOTION FOR SUMMARY JUDGMENT ON BREACH OF FRANCHISE AGREEMENT CLAIMS DUE TO COMANAGEMENT OF FRANCHISES

A federal court in Florida recently denied a franchisor’s motion for summary judgment, finding that issues of fact remained as to whether the franchisor or the franchisee was responsible for alleged breaches of the franchise agreement. Creative Am. Educ., LLC v. The Learning Experience Sys., LLC, 2015 U.S. Dist. LEXIS 60138 (S.D. Fla. May 7, 2015).

Pursuant to a management agreement between the parties, the franchisor (“TLE”) assumed initial management responsibilities for the two franchises at issue, then transitioned responsibility to the franchisee (“CAE”). At some point, the franchises were cited for failing to comply with state licensing and childcare regulations. They also experienced staffing issues. As a result, a representative from CAE wrote to TLE proposing the immediate closure of one of the franchises. TLE responded by assuming complete managerial control of both franchises. CAE sued TLE, and TLE asserted counterclaims alleging that CAE had breached the franchise agreement, and other agreements between the parties, by failing to comply with: (i) state laws and regulations and contractual staffing requirements; (ii) provisions prohibiting the abandonment of the franchises; and (iii) other contractual requirements after TLE’s managerial take-over (e.g., the obligation to fund the franchises). TLE moved for summary judgment on its counterclaims.

The court denied TLE’s motion for summary judgment, finding that issues of fact remained as to each of the counterclaims. First, the court found that it was unclear from the record whether the regulatory violations and staffing issues arose during, or resulted from, TLE’s or CAE’s management of the franchises. The court further held that issues of fact remained as to whether CAE’s proposed closure of a franchise implicated a cessation of operations in violation of the franchise agreements, or a short-term closure to remedy regulatory violations. Whether CAE’s “proposed” closure was sufficiently clear and definite to warrant preemptive action by TLE also remained an issue of unresolved fact. Finally, the court concluded that it could not determine, at summary judgment, whether TLE’s managerial take-over of the franchises constituted a termination and, therefore, whether CAE had any continuing obligations under the
franchise agreements. In support of CAE’s theory that the agreements had been terminated, the court noted that TLE had, among other things, assumed complete managerial control without CAE’s consent and banned CAE representatives from the franchise premises. In support of TLE’s theory that the agreements had not been terminated, the court noted that TLE had not issued a notice of termination and that TLE alleged that CAE consented to its assumption of managerial control.

ARBITRATION

SECOND CIRCUIT RULES THAT DISTRICT COURT COULD NOT ENJOIN LICENSEE FROM MAKING MERIT-BASED ARGUMENTS TO ARBITRATION PANEL

The Second Circuit has affirmed in part and reversed in part a district court’s injunction in aid of arbitration in a license agreement dispute. Benihana, Inc. v. Benihana of Tokyo, LLC, 2015 WL 1903587 (2nd Cir. Apr. 28, 2015). For many years, Benihana of Tokyo had been operating a restaurant in Hawaii pursuant to a license agreement with Benihana, Inc. (“Benihana America”). Despite provisions in the license agreement that prohibited Benihana of Tokyo from serving unapproved menu items, the restaurant began serving hamburgers without approval. After Benihana America terminated the license agreement, Benihana of Tokyo filed an arbitration demand seeking a declaration that it had not defaulted under the license agreement. Alternatively, if the arbitration panel concluded that it had defaulted, Benihana of Tokyo requested time to cure the alleged defaults. While the arbitration was pending, Benihana America petitioned a New York federal court for injunctive relief in aid of arbitration, specifically asking the court to enjoin Benihana of Tokyo from selling hamburgers, using unapproved advertisements, and from arguing to the arbitration panel that it be provided additional time to cure any defaults. The district court granted the requested injunctive relief.

On appeal, the Second Circuit concluded that the district court was within its discretion to enjoin Benihana of Tokyo from selling hamburgers and from using unapproved advertisements while the arbitration was pending because the normal injunction factors all weighed in favor of the request. The appellate court, however, reversed the part of the order that enjoined Benihana of Tokyo from making certain arguments to the arbitration panel. Although the district court had concluded nothing in the license agreement gave an arbitrator the authority to extend a cure period, the Second Circuit noted this conclusion went to the merits and was not a jurisdictional question for the district court to decide. Because the dispute had been properly submitted to an arbitrator, any decision on the merits was to be made by the arbitrator.
FEDERAL COURT COMPELS ARBITRATION, FINDING EMPLOYEE EXEMPTION OF FEDERAL ARBITRATION ACT DID NOT APPLY TO A FRANCHISE AGREEMENT

The United States District Court for the Southern District of Georgia granted a franchisor’s motion to compel arbitration, concluding that a franchisee and its employee were not transportation employees of the franchisor, and thus not exempt from the Federal Arbitration Act. *Morning Star Assocs., Inc. v. Unishippers Global Logistics, LLC*, 2015 U.S. Dist. LEXIS 66042 (S.D. Ga. May 20, 2015). The case arose out of three franchise agreements between Morning Star and Unishippers and a noncompetition agreement between Morning Star and one of its employees. Each of the franchise agreements and the noncompetition agreement included an arbitration provision requiring the parties to arbitrate certain disputes and delegating all arbitrability questions to the arbitrator. Despite the arbitration provisions, Morning Star filed an action against Unishippers in federal court in Georgia raising claims of fraud, breach of contract, conversion, unjust enrichment, and unfair competition. In opposing Unishippers’ motion to compel arbitration, Morning Star argued, among other things, that the franchise agreements and noncompetition agreement were employment contracts with transportation workers and therefore exempt from the FAA.

Section 1 of the Act expressly exempts “contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.” The court, however, rejected Morning Star’s claims that the franchise agreements and noncompetition agreement constituted employment contracts, noting that the controls outlined in the franchise agreements were the types of controls typically retained by franchisors to ensure system standards and to protect the franchisor’s brand. The court observed that Unishippers did not have any control over Morning Star’s labor relations and there was no indication that Unishippers oversaw Morning Star’s hiring, interviewing, wage rates, or benefits decisions. Therefore, the court granted Unishippers’ motion to compel and concluded that merely reserving the right to control certain quality standards in order to protect a franchisor’s brand was a practice common in the franchise industry and insufficient to convert an independent contractor relationship into a contract of employment.

NONSIGNATORY FRANCHISOR COMPELS SUBFRANCHISEES TO ARBITRATE

The Massachusetts Supreme Judicial Court found that a franchisor could compel subfranchisees to arbitrate their disputes under arbitration clauses in the subfranchise agreements, even if the franchisor was not a signatory to such agreements. *Machado v. System4 LLC*, 2015 Mass. Lexis 163 (Mass. Apr. 13, 2015). The plaintiff franchisees of a System4 subfranchisor filed a complaint against the subfranchisor and System4 alleging breach of contract and violations of the Massachusetts Wage Act. The subfranchisor and System4 filed a motion to stay proceedings pending arbitration, which was denied with
respect to System4 on the grounds that it was not a party to the subfranchise agreements. System4 appealed and the subfranchisees filed an application for direct appellate review, which was granted by the Massachusetts Supreme Judicial Court.

The court found that because the subfranchisees agreed to arbitrate virtually all claims arising out of the subfranchise agreements, they were equitably estopped from avoiding arbitration of their breach of contract and other claims against System4 on the grounds that System4 was not a signatory to the subfranchise agreements. The court noted that equitable estoppel typically allows a nonsignatory to compel arbitration when a signatory must rely on the terms of the written agreement in asserting claims against the nonsignatory, or a signatory raises allegations of “interdependent and concerted” misconduct by a signatory and nonsignatory. Because the subfranchisees’ claims were so “intimately founded in and closely related” to the subfranchise agreements which mandated arbitration, and because the subfranchisees failed to distinguish between System4 and the subfranchisor in their complaint, the court found that System4 could compel arbitration.

**ILLINOIS COURT UPHOLDS ARBITRATOR’S AWARD AGAINST INDIVIDUAL WHO TRIED TO ACT AS BOTH FRANCHISOR AND FRANCHISEE**

The Illinois Court of Appeals held that an arbitrator did not make a gross error of law in concluding that the exemption to the Illinois Franchise Disclosure Act’s disclosure requirements did not apply where the franchisor and franchisee were controlled by the same individual and they entered into a franchise agreement when that individual was already in negotiations to sell the franchise to another party. *McGill v. Wortham*, 2015 III. App. Unpub. LEXIS 1052 (Ill. App. Ct. May 15, 2015). The arbitrator found that the franchisees, McGill, were entitled to rescission of the franchise agreement based on franchisor Wortham’s failure to comply with the Franchise Disclosure Act’s requirements. In reaching this decision, the arbitrator specifically rejected Wortham’s argument that the sale fell within an exclusion applicable to transfers of existing franchises by franchisees if the sale “is not effected by or through the franchisor.”

McGill purchased a pizza franchise from Wortham, who acted as both the franchisor and an existing franchisee of the location at issue. McGill’s franchise went out of business after it discovered that Wortham had misrepresented sales and labor costs, and that some of the restaurant’s equipment was not in working order. McGill commenced an arbitration action for fraudulent inducement and violations of the Illinois Franchise Disclosure Act. The arbitrator found that the Act’s exclusion for sales not effected by the franchisor did not apply for two reasons. First, the exclusion was only meant to cover arms-length transactions between parties not affiliated with the franchisor, rather than transactions where an individual improperly uses multiple entities to act as both franchisor and franchisee. Second, the arbitrator noted that Wortham admitted in his
testimony that there was no franchise agreement in effect when the sale to McGill took place. The trial court confirmed the award, and the appellate court affirmed, rejecting Wortham’s arguments that a recent amendment to the Uniform Arbitration Act expands the scope of judicial review and that the arbitrator’s conclusion was erroneous and unsupported by the evidence.

TRADEMARKS

FEDERAL COURT Imposes PERMANENT INJUNCTION ProHIBITING COMPETITOR FROM USING SIMILAR TRADEMARKS IN ITS ADVERTISING

The federal district court in Minnesota granted a franchisor’s motion for summary judgment against a competitor who used variations of its trademark in online advertisements and when interacting with customers. Zerorez v. Distinctive Cleaning, Inc. 2015 U.S. Dist. LEXIS 58635 (D. Minn. May 5, 2015). Zerorez Franchising System, a carpet cleaning franchisor, brought suit against Distinctive Cleaning, a competing carpet cleaning business located in the same area, and its owner and day-to-day manager after discovering online advertisements for “Zero Rez Carpet Cleaning” with links to Distinctive’s website. These ads were discovered after doing Google searches for “Zerorez,” “twin cities carpet cleaning,” and other related phrases. Zerorez filed suit alleging violations of the Lanham Act and Minnesota consumer protection statutes. The parties entered into a stipulated order forbidding Distinctive from using the trademark ZEROREZ or similar phrases in connection with any advertising. Zerorez later discovered that Distinctive was violating the court order by using similar phrases and brought an action for trademark infringement, false designation of origin, and other related state law claims. Zerorez then moved for summary judgment.

The court granted Zerorez’s motion on its trademark infringement and false designation claims, but denied the related Lanham Act and state claims as duplicative. The court found that five of the six “likelihood of confusion” factors weighed in favor of Zerorez and that no material factual disputes existed. The violation of the stipulated order, evidence of actual consumer confusion, and the advice of counsel served as important evidence in the court’s analysis. The court also held that Zerorez was entitled to summary judgment on trademark counterfeiting claims because Distinctive continued to use “Zero Rez” and “Zero Res” in advertisements in violation of the stipulated order and against the advice of its own attorney. The owner was held personally liable for infringement of the ZEROREZ mark. The court entered a permanent injunction against Distinctive’s use of ZEROREZ and other similar marks and awarded Zerorez attorneys’ fees because the infringement was “willful, deliberate, and blatant.”
FEDERAL COURT DENIES FRANCHISEE REQUEST TO STAY INJUNCTION MOTION

The United States District Court for the Eastern District of California recently denied a franchisee’s request to stay the franchisor’s motion for a preliminary injunction so the franchisee could take expedited discovery. *TGI Friday’s Inc. v. Stripes Rests., Inc.*, 2015 U.S. Dist. LEXIS 62885 (E.D. Cal. May 13, 2015). TGI Friday’s had terminated the franchise agreements after Stripes failed to pay amounts owed. TGI Friday’s sued and moved for a preliminary injunction after Stripes continued to operate the TGI Friday’s restaurants using TGI Friday’s trademarks. Stripes filed an ex parte request to stay the injunction hearing to take expedited discovery. The court denied the request.

The franchisee sought certain documents and to take several depositions of TGI Friday’s employees and corporate representatives to show that TGI Friday’s had breached its duties under the franchise agreements and had caused Stripes to breach its agreements. It contended that TGI Friday’s had interfered with its attempt to sell the franchises. The court found that there was no good cause to take expedited discovery and the request was overbroad and not sufficiently related to the preliminary injunction motion. Stripes offered vague defenses to the complaint and injunction motion, and did not make it clear how the alleged interference excused Stripes’ payment of the fees owed under the franchise agreements. The court therefore denied Stripes’ request.

STATE FRANCHISE LAWS

TEXAS COURT GRANTS MOTION TO DISMISS FRANCHISEE’S WFIL CLAIMS

A franchisor recently prevailed on a motion to dismiss an amended complaint filed by a former franchisee, which alleged the franchisor had violated the Wisconsin Franchise Investment Law during the franchise sales process. *Braatz, LLC v. Red Mango FC, LLC*, 2015 U.S. Dist. LEXIS 54885 (N.D. Tex. Apr. 27, 2015). On November 4, 2011, Red Mango provided Braatz with its current FDD, which included a form franchise agreement. On December 28, 2011, Red Mango provided Braatz with an official franchise agreement to sign, which was executed and returned by Braatz with a check on January 5, 2012. At the same time, Braatz completed a mandatory franchisee questionnaire, indicating that Red Mango had provided financial projections that were not provided in the FDD. Upon receipt of the questionnaire, Red Mango resent a blank questionnaire and asked Braatz to modify its response, which it did. Braatz eventually closed its franchise due to financial hardship, and then filed for rescission of the franchise agreement on the basis that Red Mango failed to provide an additional 14 days before submitting the revised questionnaire, which constituted a material violation of the franchise law. Red Mango filed a motion to dismiss.
The court sided with Red Mango, finding that Braatz’s actions upon receipt of the second questionnaire demonstrated the immateriality of the alleged violation. The court noted that Braatz promptly submitted the new questionnaire, with answers revised to conform to the acknowledgments or representations in the franchise agreement, confirming that Braatz had not relied on any representations made by Red Mango concerning actual or potential revenues, expenses, or profits. Also, promptly following the submission of the revised questionnaire, Braatz provided Red Mango with another check to cover the remainder of the development fee owed. The court found that Red Mango’s request that Braatz revise its answers in the questionnaire was necessary to ensure consistency with the representation to which Braatz had already agreed. Because the request did not present any new requirements for franchise ownership, the court found that the failure to provide an additional 14 days to complete the questionnaire could not be considered a material violation of the franchise law. The court granted the motion to dismiss but gave Braatz leave to file and serve a second amended complaint.

**COURT IN TEXAS CONFIRMS THAT “FRANCHISE RULE” CONTAINS NO PRIVATE RIGHT OF ACTION AND DISMISSES FRANCHISEE’S CLAIMS**

The U.S. District Court for the Northern District of Texas confirmed that the FTC’s Franchise Disclosure Rules do not confer a private right of action. In *Yumilicious Franchise, LLC v. Barrie*, 2015 U.S. Dist. LEXIS 64407 (N.D. Tex. May 18, 2015), Yumilicious had filed breach of contract claims against a franchisee, Barrie, which had failed to make required payments and closed its franchised frozen yogurt store without consent. Barrie responded with counterclaims alleging violations of the Texas Deceptive Trade Practices Act (“DTPA”), the Franchise Rule, and the Texas and South Carolina Business Opportunities Acts. In an earlier decision, the court dismissed Barrie’s DTPA counterclaim, finding that the alleged misconduct—Yumilicious’ speculation that it “could go national,” financial performance representations outside of the FDD, unanticipated start-up costs, and failure to provide an up-to-date FDD—were at most “technical violations” of disclosure rules. Absent evidence of a knowing omission or misrepresentation that caused detrimental reliance by the franchisee, the court found no DTPA violation. The court similarly held that the franchisee failed to establish damages required for a fraud or negligent misrepresentation claim. The court therefore granted Yumilicious’ summary judgment motion and awarded damages.

Because Yumilicious neglected to move for summary judgment with respect to the Franchise Rule claim, the court raised the issue *sua sponte*. The court concluded that Barrie had no private right of action to raise a stand-alone claim. Although violations of the Franchise Rule that also contravene state law are actionable, the court had already dismissed Barrie’s state law claims on other grounds. Thus, it dismissed the alleged Franchise Rule violation as well.
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