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. At the end of this issue, we also have included an analysis of a proposed rule currently under consideration by the Consumer Financial Protection Bureau related to the use of mandatory arbitration clauses and a summary of newly enacted federal legislation aimed at the protection of trade secrets.

PRACTICE OF FRANCHISE LAW

SUPREME COURT WILL NOT HEAR CHALLENGE TO SEATTLE’S $15 MINIMUM WAGE LAW

The United States Supreme Court has denied a petition for a writ of certiorari filed by the International Franchise Association (“IFA”) in International Franchise Ass’n v. Seattle, 2016 WL 1723297 (S. Ct. May 2, 2016). In its petition, the IFA asked the Court to consider whether a state or local law that discriminates against certain in-state businesses based solely on their ties to interstate commerce violates the Commerce Clause of the United States Constitution. In the underlying case, the United States Court of Appeals for the Ninth Circuit had upheld a lower court’s denial of the IFA’s request for a preliminary injunction to prevent the City of Seattle from implementing part of its recently enacted minimum wage ordinance. The IFA had challenged the portion of the ordinance that classifies small franchisees of franchise systems that have at least 500 employees nationwide as large employers and therefore requires those franchisees to phase in the ordinance’s $15 per hour...
minimum wage requirement at a more accelerated pace than similarly situated independent small businesses. In denying the injunction, the Ninth Circuit concluded that the IFA failed to show that the ordinance had a discriminatory purpose or resulted in discriminatory effects on out-of-state companies or interstate commerce, instead finding that the IFA established only that the ordinance burdened in-state franchisees. The court also held that even if the ordinance had a disparate impact on national chains, the IFA had presented insufficient evidence to establish that interstate franchise networks would face higher costs or would decrease their operations or investments in Seattle or that franchisors would suffer adverse effects. The Supreme Court’s denial of certiorari means that the Ninth Circuit’s ruling will stand.

VICARIOUS LIABILITY

COURT DENIES FRANCHISOR’S MOTION TO DISMISS LABOR LAW CLAIMS PREMISED ON JOINT EMPLOYER THEORY

A federal district court in Pennsylvania recently denied a motion to dismiss filed by the franchisor of Friendly’s restaurants in which Friendly’s argued that a putative class of restaurant employees asserting violations of the Fair Labor Standards Act (“FLSA”) and other state labor and wage laws had failed to plead facts sufficient to establish that Friendly’s and its franchisees were joint employers. Reed v. Friendly’s Ice Cream, LLC, 2016 WL 2736049 (M.D. Pa. May 11, 2016). To determine whether Friendly’s could be considered a joint employer under the FLSA, the court applied the multi-factor Enterprise test, which includes considerations of whether the alleged joint employer had: “(1) authority to hire and fire relevant employees; (2) authority to promulgate work rules and assignments and to set conditions of employment . . . ; (3) involvement in day-to-day employee supervision . . . ; and (4) control of employee records . . . .” The court held that the employees had alleged enough facts in support of their joint employer theory to survive a motion to dismiss. Specifically, the employees had alleged that Friendly’s was actively engaged in the day-to-day operations of all restaurants; set policies related to hiring, training, hours, overtime, timekeeping, and compensation; provided ongoing operations support; had the authority to inspect, supervise, hire, and fire employees through restaurant inspections; and used the same payroll system at all restaurants. The court also rejected what it perceived to be a premature attack by Friendly’s on class certification as well as other substantive attacks on the employees’ claims.

FRANCHISOR NOT LIABLE FOR WORKERS’ COMPENSATION CLAIM BROUGHT BY FRANCHISEE’S EMPLOYEE

Meanwhile, the Kentucky Supreme Court recently held that the franchisor of the Quizno’s system, QFA Royalties, LLC (“QFA”), did not have up-the-ladder liability for a
workers’ compensation claim brought by an employee of one of its franchisees. *Uninsured Employers’ Fund v. Crowder*, 2016 WL 2605624 (Ky. May 5, 2016). The injured worker was employed by a Quizno’s franchisee whose workers’ compensation insurance had lapsed. The state’s Uninsured Employers’ Fund paid the employee’s benefits and sought reimbursement from QFA under a Kentucky statute that imposes workers’ compensation liability on entities deemed to be contractors.

The court affirmed an earlier ruling that QFA did not meet the statutory definition of “contractor” and therefore was not responsible for paying the employee’s benefits. Under the statute at issue, a contractor is one who subcontracts “[t]o have work performed of a kind which is a regular or recurrent part” of its business. QFA argued – and the court agreed – that “making and selling sandwiches” was not a regular and recurrent part of QFA’s business. Noting that up-the-ladder liability decisions must be made on a case-by-case basis, the court found that QFA’s work was limited to “granting and overseeing franchisee agreements,” not operating individual restaurants. The court noted that while QFA’s franchise agreement and operating manual provided detailed instructions on how to manage Quizno’s restaurants on a day-to-day basis, those guidelines were only intended to protect the brand that QFA sold.

**FRAUD**

**COURT GRANTS FRANCHISOR’S MOTION TO DISMISS CLAIMS FOR BREACH OF CONTRACT, PROMISSORY ESTOPPEL, AND MISREPRESENTATION**

The United States District Court for the Eastern District of Kentucky has dismissed a complaint raising claims for breach of contract, promissory estoppel, and misrepresentation in connection with a franchisor’s refusal to grant a franchise. *859 Boutique Fitness LLC v. CycleBar Franchising, LLC*, 2016 WL 2599112 (E.D. Ky. May 5, 2016). Following negotiations between the parties about a ten-year franchise, Boutique Fitness signed a franchise agreement during a closing call with CycleBar’s representatives. Two days after Boutique Fitness signed the agreement, however, CycleBar’s general counsel informed Boutique Fitness that CycleBar had decided not to grant Boutique Fitness a franchise, offered to refund Boutique Fitness’s initial franchise fee, and attached a voided copy of the franchise agreement signed only by Boutique Fitness’s members. Although CycleBar never countersigned the franchise agreement, Boutique Fitness alleged that CycleBar’s representatives had represented during the closing call that the agreement had been executed by its directors.

The court granted CycleBar’s motion to dismiss Boutique Fitness’s claims. First, the court held that the contract claim was barred by the Kentucky statute of frauds because the franchise agreement, which was to be carried out over a period of time greater than one year, was never signed by CycleBar. Based on precedent from the Kentucky
Supreme Court, the court further held that a promissory estoppel claim could not be used as an alternative means to enforce an agreement that was otherwise barred by the statute of frauds. Finally, the court held that Boutique Fitness failed to allege with reasonable particularity a nexus between the alleged misrepresentation and any injury it suffered as required by Federal Rule of Civil Procedure 9(b). The only act that Boutique Fitness claimed it was induced to take as the result of CycleBar’s alleged misrepresentation was to wire an initial franchise fee to CycleBar. However, Boutique Fitness also alleged that CycleBar immediately offered to refund that fee, which eliminated any nexus between the alleged misrepresentation and the harm Boutique Fitness claimed to have suffered.

JURISDICTION AND PROCEDURE

TEXAS-BASED FRANCHISOR ESTABLISHES SPECIFIC PERSONAL JURISDICTION OVER EUROPEAN DEFENDANTS ON APPEAL

The Texas Court of Appeals recently held that Falco Franchising, a Belgian entity, and its related principals had sufficient contacts with Texas to subject them to personal jurisdiction in the state. Jani-King Franchising, Inc. v. Falco Franchising, S.A., 2016 WL 2609314 (Tex. App. May 5, 2016). Jani-King, a Texas entity, had granted Falco the right to operate a commercial-cleaning franchise in Belgium pursuant to a franchise agreement governed by Texas law. Falco later defaulted on its reporting and payment obligations to Jani-King and gave notice to Jani-King that it intended to terminate the franchise agreement. Jani-King then filed suit in Texas after allegedly discovering that Falco and its principals had secretly formed a competing business and had misused Jani-King’s confidential information.

The trial court held that it could not exercise personal jurisdiction over Falco’s principals, and Jani-King appealed, arguing that specific jurisdiction over Falco’s principals was proper based on their commission of a tort in Texas. Specifically, Jani-King claimed that Falco’s principals: (i) personally misrepresented the causes for Falco’s poor performance, (ii) led Jani-King to believe that Falco was dedicated to the franchise relationship when it was not, and (iii) concealed the fact that Falcos was operating a competing business. Overturning the decision of the trial court, the appeals court noted that the liability of the defendants in this matter, if any, would arise from the type and scope of information that Falco’s principals provided to and withheld from Jani-King in Texas. The court concluded that specific personal jurisdiction over Falco’s principals was established given that their contacts with Texas were purposeful, Jani-King’s claims arose from or related to such contacts, and the exercise of jurisdiction in this case comported with traditional notions of fair play and substantial justice.
A federal court in Connecticut denied thirty-five franchisees’ collective motion for a preliminary injunction against their franchisor in *Family Wireless #1, LLC v. Automotive Technologies, Inc.*, No. 3:15-cv-01310 (D. Conn. May 4, 2016). The franchisees sought to enjoin their franchisor, Automotive Technologies, Inc. (“ATI”), from withholding a five percent royalty on certain funds paid to the franchisees by Verizon Wireless. As subagents of Verizon, the franchisees sold wireless devices and service plans at their stores and were compensated for those sales in the form of “commissions” that Verizon paid directly to ATI, and which ATI then passed through to the franchisees. Although ATI had not previously collected royalties on the commissions, in January 2015 it began to withhold a five percent royalty on each payment, which it contended it had a right to do under the relevant franchise agreements. The franchisees argued that the commissions were “reimbursement payments” that were not subject to royalty charges and filed suit for breach of contract, unjust enrichment, and unfair trade practices. They then moved for a preliminary injunction to stop ATI from applying the royalty charges.

The court denied the franchisees’ motion, focusing its analysis on the factor of irreparable harm. The court noted that a franchisee may establish irreparable harm when it demonstrates that, absent preliminary relief, it will face a “threat to the continued existence of its business.” Here, the alleged losses at issue for each of the thirty-five franchisees consisted of less than five percent of their total revenues, which the court concluded did not threaten the franchisees with an imminent risk of losing their businesses. Because the franchisees could not establish irreparable harm, the court did not consider their likelihood of succeeding on the merits of their claims and denied the requested injunction.

**ARBITRATION**

**CONSUMER FINANCIAL PROTECTION BUREAU PROPOSES RULE BANNING ARBITRATION CLAUSES THAT PREVENT CLASS ACTION LAWSUITS**

On May 5, 2016, the Consumer Financial Protection Bureau (“CFPB”) issued a proposed rule that would prohibit the use of mandatory arbitration clauses in consumer financial services contracts that waive class action lawsuits. Although the proposed rule is aimed at regulating providers of consumer financial services, a number of commentators have highlighted the broad scope of the rule and its applicability to banks, credit unions, consumer lenders, payday lenders, certain auto lenders, loan servicers, debt settlement firms, installment lenders, money transfer services, certain payment processors, and
others. Thus, while the proposed rule appears to be aimed at the relationship between individual consumers and core financial service providers, and not at the franchisee-franchisor relationship, franchisors who offer financing to their franchisees will want to monitor the proposed rule’s progress. The rule would also require covered entities to submit certain information to the CFPB, including claims filed and awards issued in arbitration.

If the proposed rule were to go into effect, providers of consumer financial services could face significant exposure to class action suits, which are often particularly problematic for franchisors. The rule presents a significant legal shift because arbitration clauses containing class action waivers have generally been upheld since the Supreme Court’s decision in AT&T Mobility LLC v. Concepcion, 563 U.S. 333 (2011).

Although the proposed rule will likely see implementation in 2017, the final form of the rule is subject to change after a public comment period, and even then, the contours of the rule are sure to be tested through litigation. The CFPB published the proposed rule in the Federal Register on May 24, 2016, which officially opened the 90-day comment period, with all comments due no later than August 22, 2016. The full text of the rule can be found here. Gray Plant Mooty will track the status of the proposed rule and continue to provide updates regarding any developments impacting franchisors.

LEGISLATION

NEW LEGISLATION PROVIDES FEDERAL PROTECTION FOR TRADE SECRETS

After several years of consideration, the United States Congress has enacted the Defend Trade Secrets Act (“DTSA”), the first federal law designed to protect companies’ trade secrets. The DTSA passed with strong bipartisan support, and it was signed into law on May 11, 2016.

Prior to the enactment of the DTSA, businesses seeking to hold someone accountable for the misappropriation of their trade secrets had to rely on the Uniform Trade Secrets Act (“UTSA”), a version of which has been adopted in forty-eight states. Although there is significant overlap between most states’ version of the UTSA, some differences do exist, and courts in certain states are more receptive than others to claims under that statute. The DTSA does not preempt or eliminate state law remedies for the misappropriation of trade secrets, and claims now will exist under both federal law and state law (except for New York and Massachusetts, the only two UTSA hold-outs). The enactment of a federal law is predicted to create two significant benefits: (1) consistent, uniform outcomes across the country, particularly for companies with national operations and employees in multiple states; and (2) a guaranteed path to federal court, which may sometimes be preferable to commencing litigation in state court.
Another significant aspect of the DTSA is its authorization of seizure orders. Specifically, the DTSA includes a provision allowing, under certain circumstances, a suing party to obtain an *ex parte* order authorizing the civil seizure of property wrongfully possessed by the party accused of misappropriating trade secrets. This provision is intended to apply in very rare circumstances where the more conventional approach of seeking an injunction from a court may create significant risk for dissemination of the trade secrets at issue. Injunctions are also available under the DTSA, as is the case with the UTSA, but in the DTSA Congress expressed the clear intention that injunctions under the new law are not intended to be available as “backdoor” noncompete agreements. Other remedies that may be available under both the DTSA and the UTSA include: (1) monetary damages caused by the misappropriation; (2) exemplary damages; and (3) attorneys’ fees.

Moving forward, companies interested in fully protecting their trade secrets should be mindful of the DTSA’s requirements. In particular, in order to recover attorneys’ fees or exemplary damages, the law requires that all employee agreements setting out any obligations or restrictions regarding trade secrets or confidential information must provide notice of the statute’s whistleblower provisions. In addition, it remains important for businesses to specifically and meaningfully identify their trade secrets and to take concrete steps to protect that information, including but not limited to labeling of trade secrets and limitation of access to that information.

Along with the attorneys indicated on the next page, Dean A. LeDoux, a principal in the Labor, Employment, & Higher Education practice group, and summer associates Richard Bennett, Dion Farganis, Amy Erickson, Olivia Garber, and Amanda McAllister all contributed to this issue.
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