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 updates relating to the Iranian Sanctions Program and a summary of new franchise legislation enacted in France.

CLASS ACTIONS

FRANCHISEES MAY PURSUE MISCLASSIFICATION CLAIMS AGAINST COMMERCIAL CLEANING FRANCHISOR ON CLASS-WIDE BASIS

The United States Court of Appeals for the Third Circuit recently held that a trial court did not abuse its discretion when it allowed an employment-classification dispute between a group of franchisees and a franchisor to proceed on a class-wide basis. In *Williams v. Jani-King of Philadelphia Inc.*, 2016 WL 5111920 (3d Cir. Sept. 21, 2016), two franchisees sued Jani-King, the world's largest commercial cleaning franchisor, on behalf of a class of Jani-King franchisees in the Philadelphia area. The franchisees claimed that they were misclassified by Jani-King as independent contractors when they should have been classified as employees.

Under Pennsylvania law, the employment classification test involves a multifactor analysis, with the right to control the manner in which the work is accomplished being the primary factor. The specific issue on appeal was the preliminary question of whether the lawsuit involved common issues of law or fact among the class members that predominated over issues affecting individual class members. The Third Circuit held that the Jani-King franchise agreement, policies manual, and training manual were common to the class and described the level of Jani-King's right to control its franchisees. On that basis, the court held that the plaintiffs could proceed against Jani-King as a class. The court was careful to note, however, that Jani-King may ultimately be correct that the franchise agreement and manual do not contain sufficient controls over the day-to-day work of its franchisees to make them employees under Pennsylvania law, and stated that it expressed no opinion on that matter.

Notably, among other arguments, Jani-King and the International Franchise Association (as an amicus) argued that franchises are inherently different from other types of business relationships and that franchise system controls should be categorically excluded from consideration when determining whether an employment relationship exists. The court disagreed, holding that under Pennsylvania law, no special treatment is accorded to the franchise relationship and that a franchisee may be an employee or an independent contractor depending on the nature of the franchise system controls. The dissent offered a harsh rebuke, theorizing that the court's decision could threaten the viability of franchising.

NEW YORK COURT DECLINES TO FIND LIABILITY FOR FRANCHISOR IN CLASS ACTION SALES TAX COLLECTION DISPUTE

A federal court in New York held that it lacked subject matter jurisdiction to hear claims that Dunkin' Donuts franchises assessed an unlawful surcharge, under the guise of a sales tax, in *Estler v. Dunkin' Brands, Inc.*, 2016 WL 5720814 (S.D.N.Y. Oct. 3, 2016). Gray Plant Mooty represented the franchisor in this case. The plaintiffs alleged that various franchisees in New York City had improperly assessed sales tax on prepackaged coffee, which is exempt from sales tax under New York law. The plaintiffs brought claims against the franchisor, Dunkin' Brands, and several franchisees alleging, among other things, that the franchisor assisted the franchisees in the setting of prices and the collection of sales tax.

The district court determined that it lacked subject matter jurisdiction to hear the plaintiffs' claims, in part because the New York tax laws at issue provide exclusive administrative remedies for the refund of sales taxes believed to be erroneously, illegally, or unconstitutionally collected. According to the court, the plaintiffs' attempt to recast the taxes as "surcharges" did nothing to change the exclusive nature of the remedy. Therefore, the court held that it lacked jurisdiction to hear the case and that the plaintiffs' only recourse was to follow the refund procedure set forth in the statutes.

The court also found that the plaintiffs' New York General Business Law § 349 claim, which alleged that the defendants engaged in deceptive business practices, was misplaced because § 349 is a consumer protection statute that does not cover the ministerial act of the collection of sales tax.

TERMINATIONS

TENTH CIRCUIT AFFIRMS TERMINATION FOLLOWING FRANCHISEE'S REFUSAL TO USE MANDATORY MEAL PRICING

The United States Court of Appeals for the Tenth Circuit has affirmed the district court's grant of summary judgment in favor of a fast food franchisor in a case where the franchisee refused to sell and promote the franchisor's mandatory menu plan. *Steak N Shake Enter., Inc. v. Globex Co., LLC*, 2016 WL 4743685 (10th Cir. Sept. 12, 2016). The dispute arose when Steak n Shake expanded its "$4 Menu" promotion, which offered a combination of items for a price of $4 – less than what customers would pay if each item was purchased separately. The franchisee refused to adopt the new $4 Menu and instead implemented its own "à la carte" plan, in which items were all sold at their higher, separate prices unless customers specifically requested the $4 Menu pricing. The franchisee also removed all references to the $4 Menu from its restaurants. After investigating the franchisee's practices, Steak n Shake terminated the parties' franchise agreements without providing an opportunity to cure and filed suit for breach of contract, and the district court entered summary judgment in its favor.

On appeal, the franchisee argued that a question of material fact existed as to whether it had materially breached the franchise agreements and contended that it was entitled to receive notice and a thirty-day opportunity to cure. The court of appeals disagreed, finding that reasonable minds could not dispute that the franchisee had knowingly failed to offer the mandatory $4 Menu promotion and exceeded the franchisor's maximum pricing standards by charging higher total prices for the same meals. Accordingly, the court of appeals concluded that Steak n Shake properly terminated the franchise agreements.

JOINT EMPLOYER

NEW YORK DISTRICT COURT DECLINES TO DISMISS EMPLOYMENT CLAIMS AGAINST FRANCHISOR

A district court in the Southern District of New York recently denied a franchisor's motion to dismiss federal and state law employment claims brought against it by employees of one of its franchisees. *Ocampo v. 455 Hospitality LLC*, 2016 WL 4926204 (Sept. 15, 2016). Several employees of a Doubletree hotel franchise sued the franchisee and the franchisor of the Doubletree system alleging violations of the Fair Labor Standards Act ("FLSA") and the New York Labor Law. Doubletree moved to dismiss the claims against it on the grounds that the employees had failed to allege facts from which it could be inferred that Doubletree was a joint employer of the franchisee's employees for the purposes of the two statutes.

In determining whether an employer-employee relationship could exist between Doubletree and its franchisee's employees, the court considered two multi-factored tests that it noted provided "a nonexclusive and overlapping set of factors" ultimately focusing on the degree to which Doubletree possessed and exercised control over the franchisee's employees. The court found the following allegations, taken together, sufficiently alleged an employer-employee relationship between Doubletree and its franchisee's employees: Doubletree (1) imposed mandatory training programs for hotel employees; (2) maintained the right to inspect the hotel at any time; (3) imposed mandatory recordkeeping requirements; (4) established standards and specifications for hotel construction, furnishing, and operation; (5) required the franchisee to use a particular business software; (6) retained the right to make changes to the manner in which the hotel operated; (7) performed audits of the hotel to check the franchisees' compliance with recordkeeping requirements and operational standards; (8) maintained the right to terminate the franchise, which would result in the termination of the employees' employment; and (9) was aware of but failed to stop the franchisee's unlawful wage practices.

In making its ruling, the court was not persuaded by language in the franchise agreement stating that the franchisee was an "independent contractor" of the franchisor. The court observed that "economic realities, not contractual labels, determine employment status" for FLSA purposes. Of course, the court's ruling was limited to a determination that the employees had pled enough facts to survive a motion to dismiss. The court noted that the employees may ultimately fail to prove on the merits that Doubletree was a joint employer of the employees. Nonetheless, the court's ruling is troubling precedent from the perspective of franchisors. With the exception of the last item listed (failure to stop known wage violations), the allegations relied upon by the plaintiffs and the court could all be made against the vast majority of franchisors in operation today. Gray Plant Mooty will continue to monitor the progression of this case and report material updates in future issues of *The GPMemorandum.*

POST-TERMINATION INJUNCTIONS

FRANCHISOR AWARDED PERMANENT INJUNCTION BUT NOT FUTURE ROYALTIES

A New Jersey federal district court granted a permanent injunction to Mister Softee against a former franchisee but declined to award lost future royalties based on the terminated franchise agreements. *Mister Softee, Inc. v. Amanollahi*, 2016 WL 5745105 (D.N.J. Sept. 30, 2016). Reza Amanollahi ("Amano") entered into twenty-two franchise agreements pursuant to which he was permitted to operate Mister Softee ice cream trucks, provided that he park the trucks only at a specified location. Through an installment sale, Amano sold his franchises to four individuals (the "Transferees") whereby Amano's name remained on the franchise agreements and the Transferees' royalty payments passed through Amano. After the Transferees moved the trucks to an unapproved location in violation of the franchise agreements, Mister Softee terminated the agreements and reminded Amano of his post-termination obligations. When Amano and the Transferees continued to operate the Mister Softee trucks, Mister Softee filed suit and eventually brought a motion for summary judgment asking the court to (1) permanently enjoin Amano from using Mister Softee's trademarks, (2) permanently enjoin him from violating the non-compete provisions of the franchise agreements, and (3) award Mister Softee lost future royalties.

The court ruled in favor of Mister Softee on the requested injunctive relief but declined to award the lost future royalties that Mister Softee would have received under the terminated franchise agreements. The court held that, under New York law, Mister Softee could either terminate the agreements or continue to operate under the agreements and sue for the ongoing unpaid royalties, but not both. Because it chose the former option, Mister Softee was not entitled to lost future royalties under the agreements. The court did, however, award Mister Softee attorneys' fees, as the contractual language contemplated. Finally, the court also dismissed Amano's two counterclaims that the franchise agreements should be rescinded due to Mister Softee's alleged failure to provide an offering prospectus and that Mister Softee breached the agreements by failing to provide training and a safe warehouse environment. In doing so, the court held there was no evidence to suggest that any failure by Mister Softee to provide a prospectus was willful or material, and that Amano was precluded from bringing any claim for damages because he did not give Mister Softee thirty days' written notice as required by the franchise agreements.

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PRACTICE OF FRANCHISE LAW

OFAC CLARIFIES THAT IRANIAN SANCTIONS PROGRAM REMAINS IN PLACE

Franchisors seeking to do business in Iran will continue to face challenges because Iranian sanctions will remain substantially in place for most industries. On October 7, 2016, the United States Department of Treasury's Office of Foreign Assets Control ("OFAC") updated the FAQs related to the Iranian Sanctions Program to provide further clarity regarding the scope of the sanctions lifting that occurred as part of the Joint Comprehensive Plan of Action ("JCPOA") reached in 2015.

In July 2015, the U.S. and other countries entered into the JCPOA to ensure that Iran's nuclear program will be exclusively peaceful. As part of the JCPOA, the U.S. agreed to lift certain sanctions against Iran as of January 16, 2016. Despite widespread press suggesting that a substantial portion of the sanctions against Iran were removed, the opposite is true. The U.S. agreed to permit trade in certain specific industries, allowed U.S. companies to seek special licenses in other areas, removed a number of individuals and entities from the SDN list (prohibited persons), and removed certain nuclear-related secondary sanctions involving U.S. owned or controlled foreign entities. OFAC has clarified in its FAQs that, with the exception of specific restrictions that have been lifted or modified, OFAC's Iranian Sanctions Program will remain in place and will generally maintain the trade embargo against Iran (OFAC FAQ A.3). Because many franchised businesses do not fit within any of the special industries impacted by the JCPOA (e.g., aviation, humanitarian foodstuffs, energy, etc.), franchisors wishing to conduct business in Iran will generally need to seek assistance from another source of permitted activity. The JCPOA does indicate, however, that the U.S. will review the Iranian Sanctions Program in 2023 and possibly remove additional restrictions at that time.

LEGISLATION

FRENCH PARLIAMENT PASSES LABOR LAW REQUIRING FRANCHISORS TO ESTABLISH A DIALOGUE FORUM FOR LABOR ISSUES PERTAINING TO ALL EMPLOYEES IN THE FRANCHISE SYSTEM

After review by the French Constitutional Court, the French Parliament recently passed a controversial labor law commonly referred to as the "El Khomri" law (the "Law"). Article 64 of the Law contains provisions governing certain franchises. It is triggered if: (1) a franchise network contains at least 300 employees in France, inclusive of the employees of both franchisors and franchisees, and (2) the underlying franchise agreement contains terms that "have an effect on the organization of work and the conditions of work." If those two requirements are satisfied, upon the request of a company union or trade union, the franchisor must engage in negotiations to establish a social dialogue forum for the franchise system. The forum must be comprised of representatives of employees and franchisees and chaired by the franchisor.

The representatives will need to determine, among other things, the forum's composition, the method of appointment of its members, the duration of the members' terms, the frequency of meetings, and the number of hours dedicated for member participation, and memorialize those terms in a written agreement. The Law provides that the forum must have material and financial resources to perform its tasks and that the agreement establish terms for forum operating expenses and member travel and accommodation costs. At its first meeting the forum must adopt rules regarding its operating procedures. During forum meetings representatives must be informed of decisions likely to affect the labor force such as the number or structure of employees, working hours, labor conditions, and training. Additionally, the forum may make proposals geared towards improving working conditions, training, and benefits.

The Constitutional Court largely upheld Article 64 after considering several constitutional challenges to it. The court found that Article 64 is compliant with the French Constitution and that it did not infringe on the constitutional principles of equality and entrepreneurial freedom, despite the fact that franchisees are required to participate in negotiations to establish and maintain the forum. One reason the court offered for that justification was the notion that franchise systems are distinct from other organized businesses because they have a higher degree of regulation on the organization and activity of franchisees. While the legislation originally granted the government authority to decide the hours delegated for employee participation in the forum, the court noted that such power is reserved to the Parliament. Therefore, France's State Council cannot establish such provisions in its implementation decree. Finally, the court also struck down a provision of the Law requiring the franchisor to bear the costs associated with the forum if the representatives are unable to agree.

It is not yet clear whether the Law applies to foreign franchisors who have a France-based master franchisee. Moreover, while it was enacted to improve labor conditions of employees, the Law raises several legitimate concerns for franchisors, including the independence of the franchisor and franchisee to make decisions vis-à-vis their respective employees, potential joint employer considerations, and ambiguity as to the type of terms that will be deemed to have an effect "on the organization of work and the conditions of work" sufficient to trigger the Law's forum requirement.

The State Council is expected to enact an implementing decree later this year to set forth the supplemental conditions of many of the terms outlined above and, as noted above, Parliament must revise the parts of the Law addressing the hours delegation issue and the allocation of costs. Accordingly, franchisors potentially affected by the Law have some time to begin planning for the Law's implementation.

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