GRAY PLANT MOOTY

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, Assistant Editor

Julia C. Colarusso, Assistant Editor

DATE: November 17, 2016—No. 211

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

FRAUD

FRANCHISEE'S FRAUD AND BREACH OF CONTRACT CLAIMS SURVIVE FRANCHISOR'S MOTION TO DISMISS

A federal court in Florida partially granted, and partially denied, a motion to dismiss filed by franchisor Le Macaron Development LLC regarding claims brought by a franchisee for fraud, misrepresentation, and breach of contract. *Le Macaron, LLC v. Le Macaron Development LLC*, 2016 WL 6211718 (M.D. Fla. Oct. 24, 2016). The franchisee claimed that it based its decision to purchase a Le Macaron pastry franchise on several misrepresentations by Le Macaron, including oral representations regarding, among other things, the franchisee's "huge profit potential," and false statements regarding the background of the franchise system's pastry chef, who allegedly had no prior professional pastry experience. The franchisee also pointed to deficiencies in Le Macaron's Franchise Disclosure Document, such as an alleged significant understatement of the franchisee's estimated initial expenses and the absence of required disclosures regarding Le Macaron's owner's involvement in a number of bankrupted businesses. Moreover, the franchisee alleged that Le Macaron referred it to a specific franchisee for business insights without disclosing that Le Macaron had paid the franchisee $5,000 to exaggerate its earnings, and that Le Macaron approved a lease that would have made it "impossible" for the franchisee to turn a profit. The franchisee further claimed that, after the parties entered into the franchise agreement, Le Macaron failed to provide required training and assistance, and failed to include the franchisee's stores on the company's website. Finally, the franchisee alleged that Le Macaron's affiliate supplied the franchisee with more than 51,000 defective macarons that it could not sell.

Based on these facts, the franchisee lodged claims against Le Macaron for fraudulent inducement, a violation of Florida's Deceptive and Unfair Trade Practices Act ("FDUTPA") based on a violation of the FTC's franchise rule, and breach of contract. Regarding the fraud claim, Le Macaron argued that the nonreliance and merger clauses in the franchise agreement (which provided that the franchisee could not rely upon prior statements or representations) negated the franchisee's claims. The court noted, however, that the nonreliance provision expressly excluded statements in the FDD. Further, the court observed that the nonreliance clause stated that the franchisee had not relied on any claims relating to "Gross Sales, expenses, or profit," and therefore did not reach, for instance, the franchisor's exaggerations regarding the pastry chef's level of experience. Turning to the FDUTPA violation, Le Macaron argued that the franchisee could not have relied on the allegedly defective FDD because the franchisee purchased an additional franchised business after receiving a corrected FDD. Rejecting this claim, the court held that such a conclusion required inferences that were inappropriate at the motion to dismiss stage. The court further held that Le Macaron's failure to provide grand opening assistance and to include the store on its website appeared to be breaches of the franchise agreement, and declined to dismiss that claim. Due to the franchisee's imprecise pleadings concerning several of its other allegations, the court partially granted Le Macaron's motion, but invited the franchisee to amend its complaint and resubmit the remaining claims.

FEDERAL COURT DENIES FRANCHISOR'S MOTION TO DISMISS FRAUDULENT INDUCEMENT CLAIM DESPITE FRANCHISEE'S RELEASE

The United States District Court for the District of Arizona rejected an argument that a general release clause barred a franchisee's counterclaims for fraudulent inducement. *Zounds Hearing Franchising LLC v. Moser*, 2016 WL 6476291 (D. Ariz. Nov. 2, 2016). Moser, a franchisee of Zounds, had purchased an existing franchise through an assignment agreement. The agreement contained broad release language in which the parties waived "known and unknown" claims. The relationship between Moser and Zounds eventually soured, and Zounds sued Moser, who in turn, brought counterclaims based on fraudulent inducement and statutory theories. Zounds moved to dismiss the counterclaims, arguing that a fraudulent inducement claim was barred by the release.

The court granted in part the franchisor's motion as to one of the franchisee's statutory claims, but allowed the fraudulent inducement claims to survive. The court found that the broad language of the release did demonstrate the parties' intent to release unknown claims. However, because Moser alleged that she was fraudulently induced to enter into the agreement that contained the release, the court had to consider whether the release was valid. The court determined that, to find that the release applied to the fraudulent misrepresentation claims, the language of the release would have to demonstrate the express intent to cover such claims. In this case, the court did not find the release broad enough to cover the fraudulent inducement counterclaims, and declined to dismiss them. The court also rejected Zounds' contention that the fraudulent inducement claims were barred by the contract's integration clause, since at least two of the alleged misrepresentations were contained in Zounds' FDDs.

DATA SECURITY

CALIFORNIA FEDERAL COURT DENIES FRANCHISOR'S MOTION TO DISMISS CLAIMS UNDER CALIFORNIA CUSTOMER RECORDS ACT

A California federal district court recently denied a hotel's motion to dismiss a claim that it violated the California Customer Records Act ("CRA"), which requires businesses to "implement and maintain reasonable security measures." *Dugas v. Starwood Hotels & Resorts Worldwide, Inc.*, 2016 WL 6523428 (S.D. Cal. Nov. 3, 2016). Following a breach of Starwood's computer system, Paul Dugas, a customer of Starwood's Sheraton San Diego Hotel, claimed that the hotel and its franchisor violated the CRA by failing to follow industry-standard encryption procedures to safeguard its customers' data, and failing to notify the affected customers for seven months following the data breach.

The court ruled that while the complaint was "short on specifics," because Dugas alleged that he provided his personally identifiable information to Starwood as part of a commercial transaction, and that Starwood failed to employ reasonable security measures to protect his information (such as the use of industry-standard encryption), Dugas had sufficiently alleged a cause of action under the CRA. The court did, however, dismiss Dugas' claim that Starwood violated the breach notification provision of the CRA by waiting seven months after the discovery of the breach to notify customers.

NONCOMPETES

FLORIDA FEDERAL COURT ENJOINS FORMER FRANCHISEE'S USE OF CONFIDENTIAL INFORMATION AND OPERATION OF A COMPETING BUSINESS

In *Pirtek USA, LLC v. Twillman*, 2016 WL 5846978 (M.D. Fla. Oct. 6, 2016), a federal court granted, in part, Pirtek's motion for a preliminary injunction seeking to enjoin the use of confidential information and the operation of a competing business by former franchisees, Michael Twillman, Dolores Twillman, and Donald Twillman, in Missouri. In

February 2016, Michael Twillman executed a franchise agreement for the operation of a Pirtek franchise in Missouri. Each of the Twillmans also executed a personal guaranty. Both the franchise agreement and the personal guaranty prohibited the Twillmans' unauthorized use of Pirtek's confidential information or operation of a competing business. Approximately three weeks after they signed the franchise agreement and personal guaranty, the Twillmans requested cancellation of the franchise agreement and Pirtek refunded the partial franchise fee paid. Shortly thereafter, the Twillmans began operating a competing business under the name American Hydraulics.

Pirtek filed a motion to enjoin the Twillmans' operation of the business and use of Pirtek's confidential information. In response, the Twillmans explained they intended to open a Pirtek franchise, but were stymied by the activities and influence of a local union in Missouri, and they argued they properly canceled or "rescinded" the franchise agreement in accordance with the controlling FDD such that the noncompete provision did not apply. The court disagreed, finding that the FDD plainly explained the circumstances under which a franchise *applicant* would be entitled to a refund of franchise fees, but that there was no evidence that the FDD was integrated into the franchise agreement. Further, the court pointed out that cancellation of the franchise agreement is not equivalent to rescission, noting the franchise agreement expressly prohibited rescission unless both parties so agreed in writing, which never occurred. The court also noted the Twillmans did not allege any fraud, duress, or mistake that would support post-formation rescission. Finding that Pirtek had established the elements in support of its claim for injunctive relief, the court granted Pirtek's motion but narrowed the scope of the remedy proposed by Pirtek to prevent only conduct constituting a clear violation of the franchise agreement's restrictive covenants.

FLORIDA COURT ENFORCES FRANCHISOR'S NONCOMPETE AGREEMENT

The United States District Court for the Middle District of Florida granted U.S. Lawns, Inc.'s request to enjoin its former franchisee, Landscape Concepts of CT, LLC, from competing after termination. U.S. Lawns sought the preliminary injunction enforcing the covenant not to compete pending arbitration of other claims. *U.S. Lawns, Inc. v. Landscape Concepts of CT, LLC*, No. 6:16-cv-929-Orl-41DAB (M.D. Fla. Oct. 31, 2016). In granting the motion the court found U.S. Lawns had established legitimate business interests in protecting its goodwill, franchise system, relationship with other franchisees, and ability to refranchise the territory. Further, the court found U.S. Lawns showed its noncompetition clause to be reasonable in scope and duration—for two years from the date of termination, Landscape Concepts was enjoined from contacting or servicing any customers that it had serviced within the preceding twenty-four months.

The injunction also required that Landscape Concepts not "communicate, divulge or use for the benefit of any other person or persons, [or] Business Entity any confidential information, knowledge or know-how concerning the systems of operation, services, products, customers, or prospective customers of . . . U.S. Lawns." Further, Landscape Concepts was barred from "divert[ing] any business to competitors of U.S. Lawns" and from having "any and all contacts with customers, for any purposes whatsoever." The court also found that the former franchisee's new corporate entity, which was not a signatory on the franchise agreement, could be bound by the preliminary injunction based on Federal Rule of Civil Procedure 65 as a person "in active concert or participation with" the former franchisee, Landscape Concepts. Finally, the court set the injunction bond at $500,000 based on Landscape Concepts' estimated lost profits for the two-year period of the injunction.

EMPLOYMENT

NEW YORK APPELLATE COURT AFFIRMS ADMINISTRATIVE RULING THAT FRANCHISEE IS AN EMPLOYEE OF FRANCHISOR

The Appellate Division of the New York Supreme Court recently affirmed rulings by New York's Unemployment Appeal Board that the Jan-Pro Cleaning Systems franchisor was the employer of some of its franchisees for unemployment tax purposes. The case, *In re Baez*, 2016 WL 6270685 (N.Y. App. Div. Oct. 27, 2016), is an important reminder of the continued need for franchisors to carefully structure their relationships with franchisees to minimize employee misclassification risks.

Following an unemployment insurance tax audit of Jan-Pro, the New York Department of Labor determined that Jan-Pro was the employer of its franchisee, Bertrand Baez, and similarly situated franchisees who operated Jan-Pro janitorial cleaning franchises. After the Unemployment Insurance Appeal Board affirmed this finding, Jan-Pro appealed to the Appellate Division of the New York Supreme Court. In determining whether an employer-employee relationship existed between Jan-Pro and its franchisees, the Appellate Division considered whether Jan-Pro exercised control over its franchisees' results or the means used to achieve those results—with the latter being given greater weight. Finding an employment relationship, the court pointed to the following substantial evidence of control by Jan-Pro: (i) it assigned franchisees a specific geographic territory; (ii) it mandated initial training paid for by Jan-Pro; (iii) it required franchisees to operate in accordance with Jan-Pro standards and procedures, including the use of Jan-Pro equipment, supplies, products, and business forms; (iv) it helped resolve conflicts between franchisees and their customers; (v) it retained the sole right to invoice and collect from franchisee customers and to discontinue franchisee services to customers; (vi) it provided franchisees with business cards that contained the Jan-Pro name, logo, and address and retained the right to approve alternative business cards; (vii) it imposed a post-termination non-compete; and (vii) it retained control over concepts and techniques developed by franchisees.

ARBITRATION

COURT FINDS THAT WAIVER BY LITIGATION CONDUCT PRECLUDES ARBITRATION

The District of Columbia Court of Appeals recently affirmed a lower court's denial of a franchisee's late attempt to compel arbitration. In *Hossain v. JMU Properties, LLC*, 2016 WL 6134871 (D.C. Oct. 20, 2016), Hossain, a franchisee, sued its landlord and the landlord's owner for wrongful eviction. The landlord's owner, who also owned the tax-preparation franchisor that had contracted with Hossain, responded by suing Hossain for breach of the franchise agreement. Early in the case, JMU brought a motion to stay the proceedings and compel arbitration pursuant to an arbitration provision in the franchise agreement. Hossain opposed the motion arguing that the claims were made under the lease, which did not contain an arbitration clause. The trial court ruled in favor of Hossain and denied the motion to compel arbitration, and the parties continued with the litigation.

Nearly a year later and after a bench trial had begun, Hossain changed course and asked the court to stay the proceedings and compel arbitration in accordance with the franchise agreement. The trial court denied the request holding that Hossain had waived its right to arbitration by virtue of its litigation conduct – namely, its previous opposition to arbitration and its active participation in the litigation. The court then found Hossain liable for breaching the franchise agreement. Hossain appealed and argued that the trial court should have stayed the matter and compelled arbitration. The court of appeals disagreed, holding that the trial court's findings of waiver by litigation conduct were well supported by the evidence.

ANTITRUST

COURT DISMISSES ANTITRUST CLAIM BECAUSE REQUIREMENT TO PURCHASE PRODUCTS FROM EXCLUSIVE SUPPLIER DID NOT ESTABLISH RELEVANT MARKET

A North Carolina trial court dismissed a state-law antitrust claim that Window World franchisees brought against their franchisor in *Window World of Baton Rouge, LLC v. Window World, Inc.*, 2016 WL 6242945 (N.C. Super. Ct. Oct. 25, 2016). The franchisees claimed that Window World conspired with a supplier of vinyl replacement windows by requiring franchisees to purchase products at inflated prices, rather than allowing them to pay the lowest price available among suppliers of their own choosing. Although federal Sherman Act precedent was instructive to the court's analysis, Window World's motion to dismiss was reviewed under a more lenient North Carolina pleading standard. Nevertheless, even under that standard, the court concluded that the relevant market identified by the franchisees could not, as a matter of law, constitute a valid market for antitrust liability in light of the circumstances pleaded in the complaint.

Instead of alleging that Window World had exercised dominant market power in the broad market for windows and related accessories, the franchisees alleged a "lock-in" theory of antitrust liability. In other words, the franchisees alleged that Window World exercised market power over its franchisees by locking them into franchise agreements and then imposing burdensome and excessive prices. The court concluded that franchisees could only be locked in to such a narrow "market" when there was a "change of policy" that could not have been foreseen at the time that a franchisee entered into its franchise agreement. In this case, however, the agreement unambiguously provided that Window World may require franchisees to purchase products from an exclusive supplier, putting franchisees on notice of possible exclusive arrangements before they entered into the franchise relationship. Therefore, to the extent that franchisees were "locked in" to purchasing from a sole supplier, the court concluded that it was the result of franchisees' voluntary contractual agreements, not because of Window World's market power.

FRANCHISING COULD BE AFFECTED BY ANNOUNCED FEDERAL FOCUS ON WAGE COLLUSION, NONCOMPETES, AND "OTHER ANTICOMPETITIVE PRACTICES"

The White House last month announced a broad series of new administrative steps "calling for actions that enhance competition" in employment practices. One aspect of the new antitrust focus on employment matters may intentionally or unintentionally also affect franchise agreements. That possibility involves terms in many franchise agreements that prohibit franchisees from soliciting employees away from other franchisees or from the franchisor itself. Under the new emphasis, such "anti-poaching" agreements could be deemed illegal—or at least subject to investigations or litigation. The new "Antitrust Guidance for HR Professionals" jointly issued by the FTC and the United States Department of Justice, instructs human resources professionals how to spot and report collusion among employers that may violate antitrust law, such as wage collusion or no-poaching agreements. The indication is that going forward, the DOJ will criminally investigate allegations that employers have agreed amongst themselves on employee compensation or not to solicit or hire one another's employees. Whether this same theory will be applied to franchise agreement anti-poaching provisions remains to be seen. Although leadership of the DOJ will change under the Trump administration, no immediate changes are expected in the direction of the FTC.

Although these announcements do not include specific new prohibitions and generally do not require immediate action, they do raise the possibility of near-term actions for which employers and franchisors should be watchful. For example, in formulating new versions of franchise agreements for 2017 and beyond, franchisors should consider whether to remove anti-poaching language that may exist.

GRAY PLANT MOOTY

Minneapolis, MN Office

John W. Fitzgerald, co-chair (612.632.3064)
* Megan L. Anderson (612.632.3004)
Sandy Y. Bodeau (612.632.3211)
Phillip W. Bohl (612.632.3019)
Jennifer C. Debrow (612.632.3357)
Danell Olson Caron (612.632.3383)
Elizabeth S. Dillon (612.632.3284)
Lavon Emerson-Henry (612.632.3022)
Ashley Bennett Ewald (612.632.3449)
* Michael R. Gray (612.632.3078)
* Kathryn E. Hauff (612.632.3261)
* Karli B. Hussey (612.632.3278)
Franklin C. Jesse, Jr. (612.632.3205)
Gaylen L. Knack (612.632.3217)

Kirk W. Reilly, co-chair (612.632.3305)
* Raymond J. Konz (612.632.3018)
* Richard C. Landon (612.632.3429)
* Craig P. Miller (612.632.3258)
Bruce W. Mooty (612.632.3333)
Kevin J. Moran (612.632.3269)
* Kate G. Nilan (612.632.3419)
* Ryan R. Palmer (612.632.3013)
Daniel J. Ringquist (612.632.3299)
Max J. Schott II (612.632.3327)
Michael P. Sullivan, Jr. (612.632.3350)
Lori L. Wiese-Parks (612.632.3375)
* Quentin R. Wittrock (612.632.3382)

Washington, DC Office

Robert L. Zisk, co-chair (202.295.2202)
* Julia C. Colarusso (202.295.2217)
* Whitney A. Fore (202.295.2238)
* Maisa Jean Frank (202.295.2209)
Jan S. Gilbert (202.295.2230)
Virginia D. Horton (202.295.2237)
Mark A. Kirsch (202.295.2229)
Peter J. Klarfeld (202.295.2226)
Sheldon H. Klein (202.295.2215)

John J. McNutt (202.205.2227)
* Iris F. Rosario (202.295.2204)
* Justin L. Sallis (202.295.2223)
* Frank J. Sciremammano (202.295.2232)
* Erica L. Tokar (202.295.2239)
Stephen J. Vaughan (202.295.2208)
Diana V. Vilmenay (202.295.2203)
* Eric L. Yaffe (202.295.2222)
* 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, DC 20037-1905
Phone: 202.295.2200

franchise@gpmlaw.com