GRAY PLANT MOOTY

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.

VICARIOUS LIABILITY

FOURTH CIRCUIT FINDS FRANCHISOR NOT LIABLE FOR GUEST'S DEATH IN TERRORIST ATTACK

Last month, the United States Court of Appeals for the Fourth Circuit affirmed the District of Maryland's holding that a hotel franchisor was not responsible for a guest's death at one of its franchised hotels. *DiFederico v. Marriott Int'l, Inc.*, 2017 WL 444690 (4th Cir. Feb. 2, 2017). The guest was killed in the September 20, 2008 terrorist attack on the Marriott Islamabad, a hotel owned and operated by one of Marriott International's franchisees. The guest's family brought a wrongful death suit against Marriott but did not name the franchisee as a defendant. The Fourth Circuit affirmed the district court's grant of summary judgment for Marriott, finding that it did not exercise sufficient control over the franchisee's security procedures to be held liable for the guest's death. The plaintiffs had earlier survived Marriott's motion to dismiss.

The court first determined that since Pakistan law (essentially identical to Maryland law on this point) applied, the standard for franchisor liability would be whether Marriott had sufficient control over the instrumentality leading to the guest's death. The court then conducted a detailed factual inquiry to determine what control Marriott exerted over the hotel's security protocols. The court found that all of Marriott's franchised hotels were required to meet its crisis management standards, which delineate the minimum security standards a franchised hotel must meet based on its level of threat risk, but were not required to use either the Crisis Plan or International Plan used by franchisor-managed units. Those plans were distributed by Marriott to franchised hotels as guidance. Notably, the plaintiffs did not allege that either adherence to or failure to meet any of the franchisor's crisis management standards led to the guest's death.

Finally, the court noted that Marriott franchisees were responsible for hiring, training, and managing their own security staff and that Marriott never trained the franchisee's employees on how to respond to such a situation, never established a plan for such a situation, and never even reviewed the plan that the franchisee had developed. Based on this evidence, the court found that as a matter of law, the franchisee, not Marriott, had control over how hotel employees would respond to the attack that killed the guest.

ARBITRATION

MARYLAND DISTRICT COURT EQUITABLY TOLLS NONCOMPETITION PERIOD FOR FRANCHISOR

In *Frye v. Wild Bird Centers of America, Inc.*, 2017 WL 605285 (D. Md. Feb. 14, 2017), the district court upheld an arbitration award that equitably tolled the start of a post-termination noncompetition period until the date of actual compliance. Gray Plant Mooty represented the franchisor in the case. The franchisees, Frye, had allowed their franchise agreement to expire, but they nevertheless continued to use the Wild Bird Centers of America's ("WBCA's") marks and to operate a WBCA store at their Colorado location without paying any fees to WBCA, without WBCA's permission, and in disregard of the terms of the franchise agreement. As a result, WBCA commenced arbitration. The arbitrator held in favor of WBCA and ordered the franchisees to comply with their noncompetition obligations for two years beginning on the date on which they first complied.

Frye filed a petition in the federal court in Maryland to vacate the award, arguing that the arbitrator displayed a manifest disregard of the law and that the award failed to draw its essence from the parties' franchise agreement. The crux of the franchisees' argument was that the arbitrator extended the noncompetition period for two years from the date of first compliance, rather than from the date on which the franchise agreement expired. WBCA successfully argued that the parties' bargained-for expectation was that the covenant would be in effect for two full years and that Maryland law recognizes equitable tolling of noncompetition periods. The district court affirmed the award and held that the noncompetition period would begin to run on the date of Frye's first compliance with their post-termination obligations.

COURT AFFIRMS ARBITRATION AWARD UNDER MANIFEST DISREGARD STANDARD

The United States District Court for the Northern District of California denied a former franchisee's motion for vacatur of an arbitration award and affirmed the arbitration award in favor of franchisor Jiffy Lube International, Inc. on the grounds that the franchisee failed to show the arbitrator's manifest disregard for the law. *Stevens v. Jiffy Lube Int'l, Inc.*, 2017 WL 512888 (N.D. Cal. Feb. 8, 2017). After Randy and Elissa Stevens failed to successfully negotiate a new lease with their existing landlord, Jiffy Lube terminated their franchise agreement for loss of right to possession of the franchised business premises. Stevens claimed in arbitration that Jiffy Lube violated a provision of the California Business & Professions Code for terminating the franchise without giving Stevens an opportunity to cure. The arbitrator determined that Stevens' claim was time-barred by the franchise agreement's two-year limitation period.

Stevens argued in a motion to the court that the arbitrator manifestly disregarded the law because the legal doctrines of equitable tolling and relation back salvaged their claim. Citing existing precedent that the manifest disregard standard may only be met where the arbitrator ignores a governing legal principle after it has been brought to the arbitrator's attention, the court rejected Stevens' argument. The court noted that Stevens failed to show any evidence that the arbitrator knew or was aware of the law on equitable tolling and relation back and that Stevens did not appear to have raised those issues for the arbitrator's consideration.

AGREEMENT TO ARBITRATE DID NOT DELEGATE QUESTION OF ARBITRABILITY TO ARBITRATOR

Meanwhile, the same court held that a franchise agreement delegated to the court the power to determine arbitrability. *Han v. Synergy Homecare Franchising, LLC*, 2017 WL 446881 (N.D. Cal. Feb. 2, 2017). The issue arose when Synergy moved to dismiss the complaint of its franchisee, Han, and to compel arbitration pursuant to an arbitration clause in the franchise agreement. In furtherance of its motion, Synergy argued that an arbitrator must decide the threshold question of whether the claims asserted by Han were subject to arbitration. Han argued that the question of arbitrability was one for the court. Following a detailed analysis of the grammatical structure and punctuation of the arbitration clause, the court agreed with Han.

Generally, the arbitrability of a claim is a question for the court, unless the parties' arbitration clause clearly and unmistakably provides otherwise. The incorporation of specified arbitration rules, such as the AAA's rules, into an arbitration clause through a delegation provision generally constitutes clear and unmistakable evidence of intent to submit the question of arbitrability to arbitration. However, the United States Court of Appeals for the Ninth Circuit recently distinguished between arbitration clauses in which the delegation provision is subject to a carve out of claims from an agreement to arbitrate, and those in which the delegation provision is independent from such a carve out. The latter demonstrates a clear and unmistakable intent to submit the question of arbitrability to arbitration, while the former does not.

The district court held that the arbitration clause contained in Synergy's franchise agreement was more akin to the former; thus, the court had to determine whether the claims asserted by Han fell within the carve-out provision before compelling arbitration. Specifically, the agreement to arbitrate, carve out of claims, and delegation of arbitration to the AAA were contained in a single sentence, separated by commas (e.g., except for claims relating to x, y, or z, any dispute arising out of this agreement shall be settled by arbitration, in accordance with the AAA's rules), such that both the agreement to arbitrate *and* the delegation to the AAA appeared to be subject to the carve-out provision. The court noted that had the clause separated the agreement to arbitrate and the carve out from the delegation provision with a period or a semicolon, the delegation to the AAA would not have been subject to the carve out and the clause would have demonstrated a clear and unmistakable intent to submit the question of arbitrability of all claims to arbitration. Applying the provision to the claims at issue, the court held that the carve out was broad in its wording and excluded several of Han's claims from arbitration. Pursuant to the Federal Arbitration Act, the court stayed the court action pending arbitration of the arbitrable claims.

STATE FRANCHISE LAWS

EIGHTH CIRCUIT AFFIRMS DISTRICT COURT'S DISMISSAL OF NORTH DAKOTA FRANCHISE INVESTMENT LAW CLAIM

The Eighth Circuit Court of Appeals recently affirmed a district court's dismissal of a contractor's claims against FedEx Corporation. *Neubauer v. FedEx Corp.*, 2017 WL 655434 (8th Cir. Feb. 17, 2017). From 2004 to 2011, Neubauer and his corporate entity were parties to a series of Standard Operating Agreements with FedEx under which Neubauer would pick up and deliver FedEx packages within specific geographic areas in return for weekly payments based on stops made. Neubauer was described as an independent contractor of FedEx. In early 2011, FedEx transitioned to a new business model and, upon renewal, Neubauer entered into an Independent Service Provider Agreement with FedEx. In 2014, FedEx terminated Neubauer's contract for purported breaches and, in response, Neubauer brought suit claiming, among other things, that FedEx had sold him an unregistered franchise in violation of North Dakota's Franchise Investment Law.

The district court dismissed Neubauer's complaint for failure to state a claim upon which relief could be granted, and the appellate court affirmed. The appellate court explained that in order for Neubauer's claim to succeed, he had to plead sufficient facts to plausibly allege that he was a franchisee, meaning (1) he was granted the right to offer, sell, or distribute services under a marketing plan prescribed by FedEx, (2) the operation of his business was substantially associated with FedEx's trademarks, and (3) he was required to pay a franchise fee. The appellate court held that Neubauer failed to plead sufficient facts to satisfy the marketing plan element because he merely delivered FedEx packages, and did not have the right to offer, sell, or distribute services to individual customers. The court also found persuasive the fact that the agreements explicitly stated that Neubauer was an independent contractor, and that he received payments not through customers, but from FedEx through weekly settlement checks.

POST-TERMINATION OBLIGATIONS

COURT DENIES ENFORCEMENT OF POST-TERMINATION OBLIGATIONS AND AWARDS FRANCHISEE DAMAGES ON COUNTERCLAIMS

A federal court in Virginia recently denied a franchisor's claim that a franchisee of its tax preparation system breached its post-termination obligations and awarded the franchisee $2,736,896.17 on its counterclaims. *JTH Tax, Inc. v. Aime*, 2017 WL 640092 (E.D. Va. Feb. 15, 2017). The matter arose out of the IRS's revocation of Aime's Electronic Filing Identification Number ("EFIN"), which the franchise agreements required Aime to maintain. Rather than simply terminate the franchise agreements for Aime's nine offices, JTH entered into a purchase and sale agreement that terminated the franchise agreements (except for the post-termination obligations) but gave Aime an opportunity to obtain a valid EFIN and buy back the franchises. Ultimately, JTH neither paid the purchase price for the offices nor accepted a buy back offer from Aime. Aime then changed the locks and continued operation. JTH sued for fees owed and enforcement of Aime's post-termination obligations.

Following a bench trial, the court concluded that Aime had not breached its covenants because JTH had instructed Aime to keep its signs up and operate the offices as company-owned locations. The court also concluded that JTH breached the purchase and sale agreement before Aime changed the locks by, among other things, failing to pay utility expenses, failing to pay the purchase price for the offices, and interviewing Aime's CFO to become the new franchisee despite the purchase and sale agreement. In assessing damages, the court awarded to Aime the offices' profits for 2016 and lost future profits, which the court refused to discount considering Aime's "conservative" estimates. The court refused, however, to award punitive damages or attorneys' fees.

SYSTEM STANDARDS

FEDERAL COURT HOLDS THAT FRANCHISOR UNREASONABLY DELAYED LAWSUIT FOR UNAPPROVED PRODUCTS

A federal court in Indiana has dismissed a franchisor's Lanham Act claim on the grounds that the franchisor unreasonably delayed bringing the claim. *Noble Roman's, Inc. v. Hattenhauer Distrib. Co.*, 2017 WL 640092 (S.D. Ind. Feb. 27, 2017). Under the parties' franchise agreements, Hattenhauer was required to use only Noble Roman's approved ingredients at its pizza franchises. However, after Noble Roman's changed its approved distributor in 2010, Hattenhauer began purchasing and using unapproved cheese at one of its franchised locations. In 2014, Noble Roman's sued Hattenhauer for using unapproved cheese and asserted a claim for violation of the federal Lanham Act in addition to state law claims. Hattenhauer moved for summary judgment, arguing that Noble Roman's Lanham Act claim was barred by the doctrine of laches (i.e., that there was an unreasonable delay in asserting a right).

The court agreed with Hattenhauer and dismissed the Lanham Act claim. First, the court found that Noble Roman's had knowledge that Hattenhauer was using unapproved cheese as early as August 2010, when Noble Roman's began receiving monthly reports from its distributor showing the unapproved purchases. Second, the court held that Noble Roman's four-year delay in taking action with regard to Hattenhauer's use of unapproved cheese was unreasonable and constituted inexcusable delay. Third, the court found that Hattenhauer would be prejudiced by having to disgorge its profits for years of infringing sales that would not have been made had Noble Roman's acted promptly on the information that was readily available to it. Accordingly, the court dismissed the Lanham Act claim. The court further declined to exercise supplemental jurisdiction over the remaining state law claims and dismissed the case. This case serves as an important reminder that franchisors should not delay in enforcing brand standards.

PRACTICE OF FRANCHISE LAW

FLORIDA APPELLATE COURT REINSTATES DEFAMATION CASE

A trial court's dismissal of defamation claims against a franchisor and related parties, including the franchisor's legal counsel, was reversed last week by a court of appeals in Florida. *Rolle v. Cold Stone Creamery, Inc., et al.*, 2017 WL 815365 (Fla. App. March 1, 2017). This case arose when Rolle, a former franchisee, participated in a 2010 CNBC documentary regarding franchising. In response to the documentary, the franchisor retained attorney Robert Zarco, who wrote a letter to CNBC (with a copy to Janet Sparks, a freelance writer for the Blue Mau Mau website), asking that CNBC discontinue airing the program. The letter contained a number of statements critical of the franchisee, and the franchisee responded by suing the franchisor and its counsel for defamation. The defendants moved to dismiss the case on the grounds that the letter could not be actionable in defamation due to the "litigation privilege" doctrine.

In reversing the trial court's dismissal order, the Florida appellate court held that the attorney's letter was not absolutely privileged, at least under the facts as pleaded in the franchisee's complaint. There was no litigation on file at the time the letter was sent, and the letter did not "explicitly threaten litigation," according to the appellate court. In addition, the court ruled that the letter was not framed as a "pre-suit notice" under Florida law. While the court noted that the defendants ultimately might prevail on litigation privilege grounds or another defense, the franchisee's defamation case will be allowed to proceed for the time being.

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