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.

CLASS ACTIONS

SECOND CIRCUIT AFFIRMS DISMISSAL OF PUTATIVE CLASS ACTION AGAINST FRANCHISOR AND FRANCHISEES REGARDING SALES TAX CHARGES

The United States Court of Appeals for the Second Circuit affirmed the Southern District of New York's dismissal of a putative class action against Dunkin' Donuts and several of its New York franchisees for allegedly improperly charging sales tax on pre-packaged coffee. *Estler v. Dunkin' Brands, Inc.*, 2017 WL 2258614 (2d Cir. May 23, 2017). In New York, as in many other states, pre-packaged coffee is considered a grocery item and is not subject to the sales tax charged on ready-to-eat restaurant items.

Dunkin' contended that its franchisees determined and charged sales tax without its involvement, however the matter was resolved not on that ground but on other grounds advanced by Dunkin'. Specifically, the Second Circuit affirmed the trial court's determination that it did not have jurisdiction to hear the case because the putative class failed to exhaust the exclusive administrative remedy provided by New York Tax Law §§ 1139-40. This remedy provides an administrative procedure through which customers who believe they have been improperly charged sales tax can obtain a

refund from the state tax commission. The Second Circuit rejected the plaintiffs' argument that this administrative procedure should not apply to exempted grocery items such as pre-packaged coffee. The court also found that it could not offer relief under the plaintiffs' constitutional claims because the plaintiffs had an adequate remedy available under state law. Finally, the court found that the exclusive administrative remedy applied to allegations of a violation of New York's deceptive business practices statute, despite a provision of that law stating that the statute applies to any conduct "whether or not subject to any other law of this state." The court found that this provision merely stands for the principle that the availability of other causes of action would not bar an additional claim under the statute and that this provision did not relate to the exclusivity of administrative remedies.

Putative plaintiff classes had filed four similar suits against Dunkin' in New Jersey, Florida, and Illinois. Over the past year, Gray Plant Mooty has successfully defended each of these cases on behalf of Dunkin'.

TRADEMARKS

EIGHTH CIRCUIT OVERTURNS DAMAGES AWARD FOR TRADEMARK INFRINGEMENT

The Eighth Circuit Court of Appeals recently overturned an award of monetary damages for trademark infringement under the Lanham Act and violations of the Minnesota Deceptive Trade Practices Act. *Martinizing Int'l, LLC v. BC Cleaners LLC*, 855 F.3d 847 (8th Cir. Apr. 28, 2017). Martinizing International entered into two franchise agreements with KM Cleaners authorizing the use of Martinizing's trademarks and system in KM Cleaners' two dry cleaning stores. The agreements prohibited KM Cleaners from selling the franchise locations or assigning the franchise agreements without Martinizing's prior written consent. KM Cleaners subsequently entered into an asset purchase agreement with BC Cleaners, and thereafter BC Cleaners continued to display the Martinizing trademark without Martinizing's consent.

Martinizing filed suit against BC Cleaners and two of its member managers. The defendants failed to appear and the lower court granted default judgment against BC Cleaners on all claims and imposed a permanent injunction and monetary damages. Despite the favorable ruling, Martinizing appealed the trial court's denial of default judgment against the member-managers, and its 20% reduction of Martinizing's attorneys' fees.

On appeal, the Eighth Circuit affirmed the injunction but reversed the award of monetary damages. It held that because BC Cleaners used the Martinizing trademark without permission (but agreed to stop when Martinizing issued a cease and desist

letter), a permanent injunction enjoining BC Cleaners from further use of the trademark was appropriate. However, the court reasoned that the record established only that BC Cleaners (i) entered into an agreement to acquire the store assets and obtain a valid assignment of the franchise agreements, (ii) operated the stores during the period when KM Cleaners had promised to obtain Martinizing's consent to the assignments, and then (iii) vacated the stores when the uncompleted deal fell through. Accordingly, the Eight Circuit held that Martinizing failed to prove that BC Cleaners' conduct was of the exceptional kind that would entitle Martinizing to monetary damages in addition to injunctive relief.

EMPLOYMENT

COURT DISMISSES FLSA CLAIMS FOR LACK OF EMPLOYER RELATIONSHIP BUT LEAVES DOOR OPEN FOR JOINT-EMPLOYER BASIS

A federal district court in Alabama has granted a franchisor's motion to dismiss for failure to state a claim, holding that the plaintiff failed to show that the franchisor was the plaintiff's employer under the Fair Labor Standards Act ("FLSA"). *Rodriguez v. America's Favorite Chicken Co.*, 2017 WL 1684543 (N.D. Ala. May 3, 2017). Rodriguez was employed as a counter customer service employee at a Church's Chicken franchise location in Alabama. She alleged three claims against the franchisor and the franchisee: (1) failure to pay overtime pay under the FLSA; (2) failure to pay minimum wage under the FLSA; and (3) negligent supervision under state law. The franchisor moved to dismiss the complaint in full, and the franchisee defendant moved to dismiss the negligent supervision claim.

The Alabama court held that a franchisor's "[m]anagement and oversight of a franchisee" does not necessarily mean that an employment relationship exists between the franchisor and a person who works at a franchise. The court did not find persuasive Rodriguez's general assertions that the franchisor held a management role in the franchisee's business, or that the franchisor had the ability to remove the franchisee's management-level employees from its training program. The court left the door open, however, for Rodriguez to amend her complaint, alluding to the test for joint-employment as a possible basis for her claims. In addition, the court dismissed the state law claim as it could find no common nucleus of operative fact between the FLSA and negligent supervision claims.

CALIFORNIA FEDERAL COURT REJECTS JOINT EMPLOYER CLAIM BY UNIT FRANCHISEES OF MASTER FRANCHISEES

A federal court in California recently granted the franchisor of the Jan-Pro franchise system summary judgment on wage-and-hour claims asserted by unit franchisees of its

regional master franchisees, concluding that Jan-Pro did not employ the unit franchisees. *Roman v. Jan-Pro Franchising Int'l, Inc.*, 2017 WL 2265447 (N.D. Cal. May 24, 2017). In assessing the unit franchisees' joint employer claims, the court applied the test articulated by the Supreme Court of California in *Martinez v. Combs*, 231 P.3d 259 (Cal. 2010), which consists of three alternative bases to find an employer-employee relationship: (i) the exercise of control over wages, hours, or working conditions; (ii) the power to "suffer or permit to work" (*i.e.*, possessing the knowledge of and power to prevent the work from occurring); or (iii) the existence of facts supporting a common-law employment relationship. A common-law employment relationship required evidence of control over day-to-day operations. The court found that the unit franchisees failed to raise a genuine dispute of material fact to prevent the court from ruling in Jan-Pro's favor on all three potential bases.

The court considered the first and third bases together and found that the unit franchisees' franchise agreements with their respective master franchisees did not create any rights for Jan-Pro vis-à-vis the unit franchisees. The court observed that the elements of control that the unit franchisees relied on concerned Jan-Pro's right to set the policies of its master franchisees and were found in Jan-Pro's contracts with its master franchisees. Next, the court found that Jan-Pro did not have the authority to stop the unit franchisees from working. Finally, the court also rejected an ostensible agency theory raised by the unit franchisees because they failed to proffer evidence that they believed that the master franchisees were agents of Jan-Pro. The only evidence in the record suggested that the unit franchisees were unaware of the franchisor's existence.

VICARIOUS LIABILITY

WASHINGTON FEDERAL DISTRICT COURT DENIES MOTION TO DISMISS VICARIOUS LIABILITY LAWSUIT, GRANTS LEAVE TO AMEND

A federal court in the Western District of Washington granted a personal injury plaintiff's motion to amend, filed in response to the franchisor's motion to dismiss. *Johnson v. Marriott Int'l Inc.*, 2017 WL 1957071 (W.D. Wash. May 11, 2017). After sustaining an injury in a trip-and-fall incident at a franchised Marriott hotel in Bangkok, Thailand, the plaintiff, Johnson, sued Marriott. Johnson did not sue the Thai franchisee. Marriott moved to dismiss, arguing that it did not own the Thai hotel or have responsibility for the hotel's operation or management. In response, Johnson moved to amend the complaint, seeking to add the Thai franchisee, and assert apparent agency and alter ego theories of liability against Marriott. Marriott argued that Johnson's proposed amendments would be futile.

The district court disagreed with Marriott. Noting that leave to amend should be "freely given when justice so requires," the court allowed Johnson to amend her complaint. Marriott argued that the franchisee should not be added because the court lacked jurisdiction over the franchisee. However, the court refused "at this early stage of litigation" to reject Johnson's theory that Marriott and its franchisee were alter egos of each other (considering the franchisee's use of Marriott's name, reputation, and reservation system), which would allow facts establishing jurisdiction over Marriott to be imputed to the franchisee. Regarding Johnson's apparent agency theory, the court found that Marriott's mere denial of an agency relationship alone was insufficient to fulfill Marriott's burden to show that Johnson's proposed amendment was futile. Since it granted Johnson's motion for leave to amend, the court denied Marriott's motion to dismiss as moot.

FIDUCIARY DUTY

KANSAS FEDERAL COURT DENIES FRANCHISOR'S MOTION TO DISMISS FRANCHISEE'S BREACH OF FIDUCIARY DUTY CLAIM

A Kansas district court, applying Georgia law, recently denied a franchisor's motion to dismiss a franchisee's claim for breach of fiduciary duty. *Lenexa Hotel, LP v. Holiday Hosp. Franchising, Inc.*, 2017 WL 2264358 (D. Kan. May 24, 2017). The franchisee, Lenexa, previously entered into a franchise licensing agreement with the franchisor, Holiday, to build and operate a Crowne Plaza hotel. In the agreement, Holiday represented that it would drive demand for the new hotel through its central reservation system and marketing resources. In its complaint, Lenexa alleged that Holiday failed to market and promote the hotel as promised, denying Lenexa the "fruits of its License Agreement." Lenexa argued that these failures constituted a breach of Holiday's fiduciary duty to Lenexa. Holiday countered that under Georgia law, a franchisor does not owe a fiduciary duty to a franchisee. Further, Holiday argued that the parties' licensing agreement specifically disclaimed a fiduciary relationship.

The district court acknowledged authority finding that a franchisor-franchisee relationship does not in itself create a fiduciary duty. However, the court found that Lenexa had alleged more than a mere franchisor-franchisee relationship. Lenexa alleged that Holiday exercised a controlling influence over Lenexa's business because: (1) Holiday required Lenexa to use a reservation system over which Holiday had complete control; (2) Lenexa's business was entirely dependent on that system; and (3) the parties sought a common business interest—to drive business to the hotel. The court further found that language in the parties' licensing agreement disavowing a fiduciary relationship was also not dispositive as to the existence of such a relationship because of the parties' common business objective. Finally, the district court declined to

dismiss Lenexa's claims for breach of contract and breach of the implied duty of good faith and fair dealing and its request for a declaratory judgment.

ARBITRATION

TEXAS COURT DENIES MOTION TO COMPEL ARBITRATION

A district court in Texas denied a franchisee's motion to compel arbitration in *Stockade Companies, LLC v. Kelly Restaurant Group, LLC*, 2017 WL 1968328 (W.D. Tex. May 11, 2017). Although the parties' franchise agreements contained an arbitration clause, the court held that the substance of the claims at issue had been expressly excluded from the arbitration clause. In part because the substance of the claims were excluded from arbitration, the court also held that the franchise agreements did not contain sufficient evidence that the parties had agreed to arbitrate the issue of arbitrability.

The franchisor, Stockade Companies, brought an action against the franchisee for continuing to use Stockade's trademarks after the parties' franchise agreements had terminated, and for violating the covenant against competition. The franchisee argued that the franchise agreements required that the parties arbitrate the dispute. The franchise agreements contained two clauses regarding arbitration. First, the franchise agreements stated that "any and all controversies, claims and disputes . . . arising out of or related to" the agreements would be resolved through arbitration under American Arbitration Association (AAA) rules. Next, the franchise agreements carved out Stockade's right to seek "temporary or permanent equitable relief . . . that may be necessary to protect its Proprietary Marks or other rights or property" in court.

The court observed that while adopting the AAA rules is usually viewed as clear evidence that the parties agreed to arbitrate the arbitrability of claims, the presence of a clause excluding claims from arbitration negates that evidence. It concluded that the franchise agreements did not contain sufficient evidence that the parties intended to arbitrate the issue of arbitrability. The court further held that the claims and type of relief Stockade was seeking fit the explicit exception from arbitration in the franchise agreements because Stockade was suing to enjoin the franchisee from infringing on its trademark and from violating the covenant not to compete. Accordingly, the court denied the franchisee's motion to compel arbitration.

Along with the attorneys indicated on the next page, summer associates Maria de Sam Lazaro, Chelsey Enderle, Amy Fiecke, Hannah Holloran, Hannah Shirey, and Abby Swanson Garney contributed to this issue.

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