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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.

POST-TERMINATION INJUNCTIONS

ELEVENTH CIRCUIT AFFIRMS DENIAL OF FRANCHISOR'S MOTION FOR PRELIMINARY INJUNCTION DUE TO FAILURE TO MEDIATE

Franchisor World of Beer Franchising, Inc. ("WOB") recently lost an appeal of the district court's denial of its motion for a preliminary injunction. *World of Beer Franchising, Inc. v. MWB Development I, LLC*, 2017 WL 4618565 (11th Cir. Oct. 16, 2017). WOB and three franchisee entities owned and operated by Evan Matz were parties to three franchise agreements to operate World of Beer restaurants. After mutual termination of the agreements, Matz began operating competing businesses. WOB sought to enjoin Matz from using its marks, confidential information, and trade dress and from violating the post-termination noncompete covenant. The district court denied WOB's motion on the basis that the franchise agreements required the parties to first mediate their dispute. WOB appealed, arguing that the district court misinterpreted the dispute resolution provisions of the franchise agreements.

The franchise agreements included a general requirement that all disputes, except those relating to the marks, be submitted to arbitration. The agreements also required that, before commencing arbitration, the parties submit disputes to nonbinding mediation. The same section required

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submission of any dispute to mediation contemporaneously with any request for injunctive relief. Further, the agreements stated that in connection with any request for injunctive relief, the parties must submit the dispute to arbitration. Determining that each of those provisions could be interpreted together, the court held that WOB was required to submit the dispute to mediation and arbitration contemporaneously with its motion for a preliminary injunction. WOB argued that because its claim related to the marks, the dispute was not subject to arbitration, and therefore also exempt from mediation. The court disagreed, finding that the scope of WOB's claims extended beyond the marks. In addition, the court noted that the agreements required the parties to submit the dispute to mediation regardless of whether the dispute was arbitrable. WOB alternatively argued that even if mediation was required, it had sufficiently attempted to comply with that requirement because it had asked Matz whether he preferred mediating through the AAA or a private mediator, and Matz did not respond. The court was unmoved by this argument, noting that the franchise agreements expressly required mediation under the AAA Commercial Mediation Rules, making it possible for WOB to submit the dispute to mediation without any cooperation from Matz. Therefore, because WOB did not submit the dispute to mediation contemporaneously with its motion for injunctive relief, the Eleventh Circuit affirmed the district court's order denying WOB's motion for a preliminary injunction.

TEXAS FEDERAL DISTRICT COURT DENIES POST-TERMINATION MOTION FOR PRELIMINARY INJUNCTION

A federal court in Texas has denied a franchisor's motion to enjoin a former franchisee from using confidential information, misappropriating trade secrets, and infringing on trade dress in the post-termination operation of competing buffet restaurants. *Stockade Cos., LLC, v. Kelly Rest. Grp., LLC*, 2017 WL 4640443 (W.D. Tex. Oct. 16, 2017). Earlier in the case, the court had entered an order requiring the franchisee to de-identify its formerly franchised buffet restaurants. Subsequently, the franchisee rebranded and began operating the restaurants as a competing business. There was no post-termination noncompete provision at issue.

The court denied the motion, finding that Stockade had not demonstrated a likelihood of success on its claims. Regarding the breach of confidentiality claim, the court found that the "specialty nights" promotions used by both Stockade and the former franchisee's competing restaurants were ubiquitous in the restaurant industry. The court further found that most of the recipes used by the franchisee's competing restaurants were distinguishable from Stockade's recipes, and the few identical recipes were too simple to qualify as confidential. Regarding the trade secrets claim, the court held there was no showing that any trade secret was acquired by the franchisee through improper means since its access to Stockade's proprietary information ended upon termination, and Stockade admitted that the franchisee was not using Stockade's buffet system in its

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entirety. The court further criticized Stockade for failing to enforce the franchisee's contractual requirement to obtain confidentiality and noncompete agreements from the franchisee's employees, and for disposing of allegedly confidential documents in a public, unlocked dumpster. Finally, regarding the trade dress claim, the court found that a lack of uniformity among Stockade's restaurants undermined the distinctiveness element of the claim, and that any customer confusion was likely the result of Stockade's own conduct in sending out marketing emails listing the locations of the competing business as system restaurants despite the termination and in failing to close the former franchisee's social media accounts.

POST-TERMINATION COVENANT AGAINST COMPETITION

COURT ENFORCES NONCOMPETE AGREEMENT USING RULE OF REASON

A federal court in Michigan recently applied the "rule of reason" doctrine in enforcing a covenant not to compete contained in a Little Caesar franchise agreement. *Little Caesar Enters., Inc. v. Creative Rests., Inc.*, 2017 WL 4778721 (E.D. Mich. Oct. 23, 2017). The noncompete provision restricted the former franchisee from engaging in certain competitive conduct for a one-year period within any "Designated Market Area" and for a two-year period within the Designated Market Area where the franchise at issue was located. The former franchisee moved for partial summary judgment arguing that the noncompete provision was governed by the Michigan Antitrust Reform Act's reasonableness standard, and that under that standard it was unreasonable and unenforceable. However, the court held that under a recent ruling from the Supreme Court of Michigan, commercial noncompete provisions must be evaluated under the "rule of reason" doctrine, and not under the Michigan Antitrust Reform Act.

The court then held that the noncompete provision did not violate the "rule of reason." Generally, a noncompete provision violates the "rule of reason" if it may suppress or destroy, rather than promote, competition. The court held that rather than showing that the noncompete agreement had anticompetitive effects in the overall pizza or quick-service restaurant market, the evidence tended to show healthy competition between pizza restaurants in the relevant geographic location. Moreover, although the defendants argued that they had suffered individual injury as a result of the noncompete, the court held that the "rule of reason" protects competition, not individual competitors. Accordingly, the court denied the former franchisee's motion for partial summary judgment.

JURISDICTION

DE FACTO FRANCHISEE'S CONTACTS WITH FRANCHISOR NOT SUFFICIENT TO CONFER PERSONAL JURISDICTION

The United States District Court for the District of Colorado dismissed a trademark infringement action for lack of personal jurisdiction, finding that discussions between a franchisor and an out-of-state potential franchisee were not sufficient to confer personal jurisdiction over the potential franchisee. *Rocky Mountain Chocolate Factory v. Arellano*, 2017 WL 4697503 (D. Colo. Oct. 19, 2017). The dispute began when the Colorado-based franchisor, Rocky Mountain Chocolate Factory ("RMCF"), and Timothy Arellano pursued negotiations to transfer an existing RMCF franchise in Nevada to Arellano. Negotiations eventually failed before the parties entered into an agreement, but Arellano continued operational control of the store, acting as a de facto franchisee. RMCF brought suit in Colorado for trademark infringement, alleging that although the infringement occurred exclusively in Nevada, it harmed RMCF in Colorado, where it is entitled to receive royalty and other payments from Arellano.

The court declined to exercise jurisdiction, holding that Arellano's contacts with Colorado were so weak that subjecting him to jurisdiction in Colorado would be unreasonable and against due process. The court underwent a three-step analysis, first finding that RMCF "just barely" satisfied the minimum contacts standard needed to confer jurisdiction. Calling it a very close call, the court concluded that Arellano's application to be a franchisee, his purposeful acts in negotiating to take over the existing franchise, and his operations as a de facto franchisee provided a sufficient showing of minimum contacts with Colorado. However, those contacts were outweighed by a majority of reasonableness factors, notably that it was not reasonably foreseeable that Arellano might have to defend claims in Colorado. The court found it "highly significant" that RMCF decided to initiate a business relationship with Arellano without a signed franchise agreement. In the court's view, RMCF and its lawyers should have foreseen the possibility that without the executed franchise agreement, and the choice of law and venue protections it would have provided, a court might determine that Nevada would be a more appropriate venue. Furthermore, Nevada would be more convenient because its substantive law likely governed the tort claims, and RMCF sought an injunction that would only have effects in Nevada. In light of these factors, combined with Arellano's weak contacts with Colorado, the court refused to exercise personal jurisdiction over him.

TERMINATIONS

TERMINATION UPHELD DESPITE FRANCHISEE'S EXPRESSED WILLINGNESS TO PAY

A franchisee's failure to pay royalties and other fees constitutes a material breach of contract justifying termination—even if the franchisee had expressed a willingness to pay—according to a Florida federal district court. *Tim Hortons USA, Inc. v. Singh*, 2017 WL 4837552 (S.D. Fla. Oct. 25, 2017). Following a bench trial, the court upheld Tim Hortons' decision to terminate Singh for failure to pay monies owed and ordered Singh to pay all past-due amounts. The court did deny Tim Hortons its lost future royalties because the testimony of its senior finance manager regarding how much revenue Singh would have received (and paid fees on) was inadmissible.

Singh, through counsel, responded to a default notice with an "aggressive" letter in which the attorney claimed, among other things, that the parties had previously agreed to a payment plan, which turned out not to be true. Singh then later said it was willing to pay and asked for wiring instructions, but the court found that to be an "offer to pay," which was not the same as actual payment (and it came after the cure deadline anyway). Under Florida law, payment has not occurred until there is an actual "tender" of funds, and a suggested willingness to send funds and a request for information on where to send them do not a tender make, according to the court. That simply was not "substantial compliance" with the franchise agreement; thus, the franchisor had the right to terminate. The court also recognized that "contracts do not become unenforceable merely because their agreed-upon remedies create an unpleasant result for the breaching party." Course of conduct and detrimental reliance arguments also failed to help Singh.

PERSONAL LIABILITY

COURT ENFORCES PERSONAL GUARANTY

The United States District Court for the Northern District of Texas granted summary judgment to franchisor Jani-King Franchising, Inc. in a contract dispute it had with its regional franchisee in Great Britain, Jani-King GB Ltd. ("JKGB"), and JKGB's majority shareholder and director, Ian Thomas ("Thomas"). *Jani-King Franchising, Inc. v. Jani-King (GB) Ltd.*, 2017 WL 4758673 (N.D. Tex. Oct. 20, 2017). When the parties executed a franchise agreement to extend their existing relationship, Thomas signed a personal guaranty (governed by English law) promising to pay Jani-King all monies due under the franchise agreement if JKGB failed to do so. When JKGB stopped paying fees to Jani-King and terminated the franchise agreement, Thomas refused to pay any fees that had accrued prior to the termination date. Jani-King sued JKGB and Thomas for breach of contract, and the court granted Jani-King summary judgment. The district court subsequently reopened the matter to determine whether Thomas was liable under the personal guaranty to Jani-King for fees that had accrued prior to the termination date. Noting that the parties had agreed that Texas law and English law did not materially differ regarding personal guaranties, the court considered the parties' motions for summary judgment.

The court enforced the guaranty, rejecting Thomas's argument that Jani-King could not enforce the personal guaranty because Jani-King had not satisfied a condition precedent to enforcement, the mitigation of Jani-King's termination-related damages. The court observed that the mitigation condition only applied to damages arising from termination, but Jani-King only sought fees owed by JKGB prior to the termination date. The court also rejected Thomas's claim that due to Jani-King's alleged fraudulent business practices, subsequent negative online reviews posted about JKGB by its unit franchisees, and a steep decline in JKGB's revenue, Thomas was not obligated to pay Jani-King under a carve-out in the guaranty for any losses, damages, or claims that were caused directly or indirectly by an act outside of JKGB's control. The court noted that the fees were simply what JKGB had promised to pay Jani-King in exchange for JKGB's rights under the franchise agreement and did not constitute losses, damages, or claims. Therefore, the court granted Jani-King's motion.

VICARIOUS LIABILITY

CALIFORNIA DISTRICT COURT DISMISSES FRAUD COMPLAINT AGAINST FRANCHISOR FOR FAILURE TO MEET HEIGHTENED PLEADING STANDARDS

The United States District Court for the Central District of California dismissed a putative class action complaint against franchisor Jackson Hewitt Tax Service on the grounds that the plaintiff had not sufficiently pled claims for fraud and vicarious liability against Jackson Hewitt for fraudulent conduct that was done by a rogue employee of the franchisee. *Lomeli vs. Jackson Hewitt, Inc.,* 2017 WL 4773099 (C.D. Cal. Oct. 19, 2017). The aggrieved customer of the franchisee alleged, in part, that the franchisee submitted returns to the IRS without the customer's permission that were manipulated to cause him to receive a refund that was deposited in an account he was unaware of, and that the franchisee used the refund money without the customer's knowledge.

In granting Jackson Hewitt's motion to dismiss, the court acknowledged that Jackson Hewitt exerted controls that are typical of a franchisee–franchisor relationship, including controls over the operational standards of the business, the products offered for sale, and the training of personnel. The court found, however, that control over certain aspects of a franchisee's operations is insufficient to create vicarious liability unless the control relates to the instrumentality of harm. In this case, the harm was caused by a rogue employee of the franchisee who prepared false tax returns without the consent of the customer. The court found that Jackson Hewitt's control over the franchisee did not include any control over the "hiring, direction, supervision, discipline, or discharge of franchise employees." Hence, Jackson Hewitt could not be responsible for the fraudulent activities of an employee it did not supervise.

As to the direct fraud claim, the court dismissed that claim under the heightened pleading standard for fraud claims, holding that the plaintiff's decision to "lump" multiple named defendants together for purposes of the fraud claim was improper. The court found that the plaintiff must provide additional details in the complaint regarding the *specific* fraudulent acts allegedly committed by Jackson Hewitt. The court did grant the plaintiff leave to amend to try and correct the deficiencies in the complaint.

EMPLOYMENT

OREGON COURT AFFIRMS RULING THAT FRANCHISEES ARE EMPLOYEES OF FRANCHISOR FOR PURPOSES OF UNEMPLOYMENT INSURANCE TAX

The Oregon Court of Appeals recently affirmed rulings by the Oregon Employment Department and an administrative law judge that National Maintenance Contractors ("NMC"), a maintenance services franchisor, owed $138,029.69 in unemployment insurance taxes because its franchisees were not independent contractors but its employees. *Nat'l Maintenance Contractors, LLC v. Employment Dep't*, 2017 WL 4675106 (Or. Ct. App. Oct. 18, 2017). NMC had argued that it was exempt from unemployment insurance taxes because, as its franchise agreements stated, its franchisees were independent contractors. Applicable Oregon law defined independent contractors as persons "free from direction and control over the means and manner of providing . . . services." In agreeing that NMC controlled the means and manner by which its franchisees provided maintenance services, the court relied on several rights retained and requirements imposed by NMC in its franchise agreements. Those rights and requirements included the right to choose the equipment that its franchisees used, down to the brand; the right to dictate who performed the maintenance services by requiring that franchisees personally perform or supervise the work; and the requirement that franchisees complete training and pass testing on the training regardless of their level of experience. Therefore, the court of appeals affirmed the determination that the franchisees fell within the statutory definition of employee for unemployment insurance purposes.

STATE FRANCHISE LAWS

STATE OF VIRGINIA PROPOSES SUBSTANTIAL INVESTMENT EXEMPTION TO FRANCHISE REGISTRATION LAW

The Virginia State Corporation Commission issued an Order to Take Notice on October 11, 2017, stating that the Virginia Division of Securities and Retail Franchising has recommended certain revisions to Chapter 110 of Title 21 of the Virginia Administrative Code entitled "Retail Franchising Act Rules." The proposed amendment provides an exemption from Virginia's franchise registration law for franchisors that offer or sell a single unit franchise in which the actual minimum initial investment exceeds $5 million. The proposed exemption does not exempt franchisors from Virginia's disclosure requirements, but allows franchisors to avoid the registration process when a franchisee's initial investment exceeds the $5 million threshold. To qualify for the exemption, the prospective franchisee must be represented by counsel, and the franchisor must reasonably believe that the prospective franchisee has sufficient knowledge and experience to capably evaluate the merits and risks of the investment.

If adopted, franchisors seeking to take advantage of the proposed exemption must file, no later than ten business days before the offer or sale of a qualifying franchise, a Form H Notice of Claim of Exemption, a uniform consent to service of process, an entity resolution, a copy of the franchisor's FDD in an approved electronic form, and a $500 filing fee ($250 to renew annually; $100 to amend). Franchisors must also obtain from the prospective franchisee a signed certification verifying the grounds for the exemption. The Order to Take Notice did not include a proposed effective date. A complete copy of the proposed exemption can be found at www.scc.virginia.gov/srf. Comments and requests for hearing on the proposed exemption may be submitted to the Commission through December 1, 2017, and may be sent via mail or electronically following the instructions at www.scc.virginia.gov/case. Although the proposed amendment contains some ambiguities, we anticipate that the comment process will resolve most uncertainties.

PRACTICE OF FRANCHISE LAW

SBA ESTABLISHES FRANCHISE DIRECTORY, ALLOWS NEW NEGOTIATED SBA ADDENDA, AND ELIMINATES LENDER DUTIES TO INDEPENDENTLY DETERMINE WHETHER BUSINESS ELIGIBILITY REQUIREMENTS ARE SATISFIED

On October 13, 2017, the SBA announced a revision to its requirements for franchisors to qualify their franchisees for SBA financing programs. As of January 1, 2018 any franchise listed on the SBA Franchise Directory will be deemed to meet SBA's "affiliation," "business eligibility," and "franchise" definitional requirements. The

Directory may be found at www.sba.gov/for-lenders. SBA does not charge for a Directory listing. The Directory is simple, laid out in seven columns, providing the following information, about which SBA writes either "Yes" or "No."

SBA FRANCHISE IDENTIFIER CODE	BRAND	FTC FRANCHISE	IS AN ADDENDUM NEEDED?	SBA ADDENDUM - Form 2462	SBA NEGOTIATED ADDENDUM	NOTES

In the initial Directory, most Notes describe the process lenders must follow if a management agreement is used with a franchise.

In the wake of the November 30, 2016 Standard Operating Procedure ("SOP"), limiting franchisors seeking SBA financing assistance for their franchisees to the use of a "Standard Addendum" ("SBA form 2462"), many lenders and many franchisors were unhappy. Lenders worried about not understanding whether SBA's business eligibility and franchise definitional standards had been met. Because SBA had previously made those determinations, many low-volume franchise lenders backed away from financing franchisees. This new approach is designed to ameliorate their concerns.

Many franchisors were upset by the one-size-fits-all approach of the Standard Addendum, with some announcing that they would abandon using SBA programs to finance their franchisees. In February 2017, SBA re-evaluated its approach and allowed franchisors to qualify if they used a 2015 or 2016 Addendum that they had negotiated with SBA, and certified that no changes had been made to sections of their franchise agreements that were relevant to the Addenda.

Still, many franchisors were unsatisfied. Franchisors using franchise agreements meeting all of SBA's affiliation standards balked at having to use an Addendum at all. Franchisors that no longer wanted to use a 2015 or 2016 negotiated Addendum or the Standard Addendum, and franchisors that had not previously participated in SBA franchise lending programs, but did not want to use the Standard Addendum, all felt excluded by the 2017 SBA process.

The 2018 approach can resolve these problems, assuming that the franchisor and SBA can successfully negotiate an Addendum. The new approach is intended to simplify the process for everyone involved.

Here are some answers to common questions:

How does a franchise get listed on the Directory?

1. SBA will provide an initial Directory listing all franchisors that have been reviewed by SBA that meet SBA eligibility standards. The initial Directory will contain information about more than 2000 franchisors that either have used the

Standard Addendum or an Addendum negotiated with SBA during 2015 or 2016. The Directory will indicate if the Franchisor has negotiated a 2015 or 2016 SBA Addendum or whether it is using the Standard Addendum.

2. Franchisors whose franchise agreements satisfy SBA's affiliation, business eligibility, and definitional standards without the need for an Addendum also qualify for a Directory listing.

3. Franchisors not initially listed may apply to be listed on the Directory by sending their FDDs, franchise agreements, and any other documents they will require their franchisees to sign to SBA at franchise@SBA.gov.

How does a franchise remain on the Directory?

1. Once on the Directory, franchisors that use the Standard Addendum will not need to do anything else to remain on the Directory.

2. Franchisors with negotiated Addenda (a 2015 or 2016 Addendum negotiated with SBA, or one negotiated with SBA following the announcement of SBA SOP 50 10 5(J) (October 13, 2017)), or those brands that do not need to have an Addendum, are required to file an Annual Franchisor Certification. The first Certification must be received by April 30, 2018. Additional Certifications will be required before April 30 of each year for franchisors that do not use a Standard Addendum. SBA will no longer require a Franchisor Certification on a loan by loan basis. No Certification is required for franchisors using the Standard Addendum.

If a franchisor that has used a negotiated Addendum wants to switch to using the Standard Addendum, what is the process that should be followed?

Directory listings for franchisors that have a negotiated Addendum will indicate that they may use either the negotiated Addendum or the Standard Addendum. If they fail to certify the absence of a change by April 30 of any year, they will be limited to using the Standard Addendum.

How can a franchisor either negotiate an Addendum with SBA, or renegotiate an Addendum?

Franchisors should submit a redlined version of their franchise agreement, related agreements that franchisees will be required to sign, and their FDDs to franchise@SBA.gov. SBA has designated a staff of five to work with franchisors to get their brands listed on the Directory.

Must a franchisor that uses a negotiated Addendum or an SBA-approved franchise agreement not requiring an Addendum submit the agreements to SBA for approval if the language in the franchise agreement or negotiated Addendum changes?

> Yes, if the changes materially affect either the negotiated Addendum or if the franchise agreement changes materially.

A copy of the SBA Information Notice describing the new process may be found at this link.

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