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.

DAMAGES

ELEVENTH CIRCUIT CONFIRMS THAT FRANCHISOR'S BREACH OF FRANCHISE AGREEMENT DOES NOT RELIEVE A FRANCHISEE FROM DEBTS INCURRED IN PURCHASING THE FRANCHISE

The United States Court of Appeals for the Eleventh Circuit has affirmed a judgment, following a bench trial, against a franchisee who alleged that his inability to repay a promissory note was caused by the franchisor's breach of the franchise agreement. *DZ Bank AG Deutche Zentral-Genossenschaftsbank v. McCranie*, 2018 WL 345045 (11th Cir. Jan. 10, 2018). McCranie, the former Brooke insurance agency franchisee, had originally financed the purchase of his franchise with a promissory note from the franchisor's affiliate. The franchise agreement itself made the franchisor the "agent of record," meaning the franchisor collected insurance commissions from McCranie's sales, 85% of which were paid back to McCranie. McCranie had a right to terminate the franchise agreement upon thirty days' notice, at which point the contract required the franchisor to make McCranie the "agent of record." The loan documents included several measures to protect against a default by McCranie, but did not include provisions to protect against the possibility of the franchisor's default.

The franchisor later pledged the note to the plaintiff, DZ Bank, as collateral on a loan. Years later, the franchisor stopped paying McCranie his percentage of insurance commissions, and eventually went into bankruptcy. McCranie terminated the franchise agreement and demanded to be made "agent of record," but the franchisor failed to do so. When DZ Bank sought to collect on the loan, McCranie argued that the circumstances forgave his debt. Both the district court and Eleventh Circuit disagreed. The appellate court observed that nothing in the loan documents suggested they were integrated with the franchise agreement, meaning the franchisor's breach of the franchise agreement had no effect on the promissory note. Next, the court observed that the frustration-of-purpose and impossibility-of-performance defenses were inapplicable, because a breach of the franchise agreement was foreseeable, as demonstrated by the protections the lender had included in case of McCranie's default. Finally, the court noted a lack of authority supporting the argument that the duty of good faith and fair dealing imposed an obligation on a third-party lender to ensure McCranie could continue doing business with insurers and collecting insurance commissions.

SEVENTH CIRCUIT AWARDS FRANCHISOR ATTORNEYS' FEES AS SANCTION AGAINST FRANCHISEE'S VEXATIOUS POST-ARBITRATION LITIGATION

In November 2017, the Seventh Circuit affirmed the confirmation of an approximately $9 million arbitration award for Hyatt against one of its former franchisees. In doing so, the Seventh Circuit instructed the parties to agree to the attorneys' fees and costs owed to Hyatt under the attorneys' fee provision in the parties' franchise agreement. But the court also noted that it had the authority to award Hyatt fees and costs as a sanction for the franchisee's refusal to comply with the arbitrator's decision. After the franchisee did not agree to pay Hyatt's attorneys' fees and costs as instructed, Hyatt applied to the Seventh Circuit for relief. As a sanction for what it deemed "unnecessary and pointless litigation," the Seventh Circuit awarded Hyatt attorneys' fees and costs in the amounts claimed by Hyatt for seeking to confirm and enforce the arbitrator's award and to obtain its attorneys' fees and costs. *Hyatt Franchising, LLC v. Shen Zhen New World I, LLC*, 2018 WL 386194 (7th Cir. Jan. 12, 2018). The Seventh Circuit further ordered the franchisees' counsel to show cause as to why they should not be held jointly and severally responsible for Hyatt's attorneys' fees under 28 U.S.C. § 1927, which empowers courts to find counsel liable for attorneys' fees and costs resulting from the unreasonable and vexatious multiplying of proceedings.

ADVERTISING

COURT UPHOLDS PROHIBITION ON ADVERTISING HALAL CHICKEN, AFFIRMING FRANCHISOR'S BROAD CONTROL OVER ADS

The United States District Court for the Northern District of Illinois granted franchisor KFC Corporation's motion to dismiss, rejecting a franchisee's claim that KFC had breached the parties' franchise agreement by prohibiting him from telling customers that his KFC stores sold Halal chicken. *Lokhandwala v. KFC Corp.*, 2018 WL 509959 (N.D. Ill. Jan. 23, 2018). Lokhandwala alleged that in 2002 KFC expressly permitted him to sell Halal chicken at his KFC stores. Relying on KFC's alleged approval, the franchisee chose the locations for his five franchised businesses in part due to their proximity to predominantly Muslim communities. In 2016 or 2017, KFC required Lokhandwala to stop marketing the businesses' chicken as Halal-compliant, purportedly relying on a 2009 company policy that prohibited franchisees from making religious dietary claims about KFC products. Lokhandwala filed claims for breach of contract and promissory estoppel against franchisor KFC, alleging that the policy was not mentioned in the franchise agreement, claiming KFC's conduct was unreasonable, and asserting that Illinois regulations required him to post signs regarding the origin of the chicken sold at his stores.

The court rejected all of Lokhandwala's claims. It observed that the parties' franchise agreement plainly granted KFC "the absolute right" to approve of all advertising. The court also noted express language in the agreement that required Lokhandwala to "strictly comply" with KFC's requirements and instructions pertaining to the brand, and provisions stating that delay by KFC in enforcing its rights under the agreement would not constitute a waiver of those rights. The court further noted that—while the agreement required KFC to behave reasonably with regard to certain issues—the provision pertaining to advertising did not expressly require reasonableness by KFC, and that no such qualifier should be implied. Lastly, the court held that the Illinois regulations did not require Lokhandwala to engage in the advertising that KFC had prohibited. Hence, the court granted KFC's motion to dismiss.

MISREPRESENTATION

FEDERAL COURT GRANTS SUMMARY JUDGMENT BASED ON FRANCHISEE'S ADMISSIONS THAT THERE WAS NO MISREPRESENTATION

Relying substantially on admissions from the franchisee's deposition, a federal court in Washington granted the defendant franchisor's motion for summary judgment on the franchisee's claims for misrepresentation. *DiNardo v. Wow 1 Day Painting, LLC*, 2018 WL 513584 (W.D. Wash. Jan. 23, 2018). Wow licenses a system for providing single-day interior and exterior painting services. DiNardo entered an agreement with Wow in May 2014 to open a franchise in Connecticut, but stopped operating it in late 2015. In May 2016, he brought suit against Wow in Connecticut state court, alleging that Wow had misrepresented the profitability of its franchises and its plans to market the business in Connecticut. Wow first removed the case to federal court and then transferred it to the Western District of Washington, in accordance with the franchise agreement's forum selection clause.

In granting Wow's summary judgment motion, the court dismissed three claims against Wow, including one for intentional misrepresentation. It first noted that DiNardo had testified in his deposition that the representations of which he complained were made in late 2014 or early 2015. Since this period falls after the date of the franchise agreement, DiNardo could not have relied on those representations to enter the franchise agreement. Undaunted, DiNardo responded to Wow's motion for summary judgment with an affidavit asserting for the first time that Wow had made additional misrepresentations prior to signing the franchise agreement, pointing to the text of the franchise agreement in support. The court rejected these new misrepresentation claims because DiNardo had testified in his deposition that he had not read the franchise agreement; therefore, there could not have been a misrepresentation. The court also rejected these new claims based on the "sham affidavit rule," which provides that a party cannot manufacture an issue of fact to defeat a summary judgment motion by submitting an affidavit that contradicts his prior deposition testimony. As a result, the court dismissed DiNardo's misrepresentation claims, as well as his claims for violations of Connecticut's Unfair Trade Practices Act and Business Opportunities Act. It then ordered Wow to show cause as to whether the court still had jurisdiction over Wow's counterclaims for amounts due under the franchise agreement and an injunction against DiNardo to observe his noncompete obligations.

EMPLOYMENT

FEDERAL COURT FINDS FRANCHISOR NOT TO BE JOINT EMPLOYER OF SUBFRANCHISEE'S EMPLOYEE

A federal court in Georgia recently held that a franchisor and its licensee were not joint employers of a subfranchisee's former employee. In *Boon v. Clark Foods, Inc.*, 2017 WL 6622554 (M.D. Ga. Dec. 28, 2017), a server at an IHOP restaurant operated by Clark Foods sued IHOP (the franchisor), an IHOP master licensee named Sunshine Partners, and Clark Foods (an IHOP subfranchisee), claiming she was discriminated against on the basis of her age in violation of the Age Discrimination in Employment Act. IHOP and Sunshine Partners filed for summary judgment on the basis that they were not the server's employer.

The court agreed, restating the general principle that the franchisor/franchisee relationship does not create an employment relationship between a franchisor and a franchisee's employees, and further ruling that neither IHOP nor Sunshine Partners retained sufficient control over the terms and conditions of employment of the sub-franchisee's employees to be considered a joint employer of the server. The court reasoned that under the relevant agreements, the subfranchisee was responsible for all employment-related matters, and there was no factual evidence that either Sunshine Partners or IHOP exercised any level of control over any employment decisions made by the subfranchisee. Accordingly, the court dismissed IHOP and Sunshine Partners from the case.

STATE FRANCHISE LAWS

RESPONDING TO GRAY PLANT MOOTY'S COMMENTS, VIRGINIA REGULATOR CHANGES SUBSTANTIAL INVESTMENT EXEMPTION PROPOSAL

We reported in *The GPMemorandum*, Issue No. 223, that the Virginia State Corporation Commission had issued an Order to Take Notice regarding the state's franchise law. That Order stated that the Virginia Division of Securities and Retail Franchising had recommended certain revisions to Chapter 110 of Title 21 of the Virginia Administrative Code entitled "Retail Franchising Act Rules." The proposed amendment would have provided 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 would not exempt franchisors from Virginia's disclosure requirements, but would have allowed franchisors to avoid the registration process when a franchisee's initial investment exceeded the threshold.

Gray Plant Mooty submitted comments on the proposed exemption to the Virginia State Corporation Commission, which comments generally sought to relax the stringent standards of the proposed exemption, and also to clarify points of ambiguity. More specifically, our comments requested that Virginia: (1) reduce the $5 million threshold amount, (2) calculate the "actual minimum initial investment" using the FTC Franchise Rule's Item 7 requirements, (3) exempt qualifying transactions from both registration and disclosure, and (4) delete the requirement that a qualifying transaction must be for a "single unit" franchise. On January 16, 2018, the Virginia Division of Securities and Retail Franchising issued a response to our comments which amended the proposed exemption to reduce the $5 million threshold amount to $3 million, and to calculate the "actual minimum initial investment" using the FTC Franchise Rule's Item 7 requirements. The response did not include a proposed effective date, but Gray Plant Mooty will continue to monitor the progress of the proposed exemption.

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