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.

EMPLOYMENT

NLRB VACATES *HY-BRAND*, RETURNS TO *BROWNING-FERRIS* JOINT EMPLOYER STANDARD

On February 26, 2018, the National Labor Relations Board issued an order that vacates its December 14, 2017, joint employer decision in ***Hy-Brand Industrial Contractors, Ltd. and Brandt Construction Co***. As we reported in Issue 225 of ***The GPMemorandum***, ***Hy-Brand*** had expressly overruled the expansive joint-employer standard set forth in the Obama-era ***Browning-Ferris Industries***, 362 N.L.R.B. No. 186 (2015). In its recent order, the NLRB accepted its ethics officials' determination that NLRB Member William Emanuel is, and should have been, disqualified from participating in the decision in ***Hy-Brand*** because of a conflict of interest. Emanuel's former law firm represented one of the companies in the ***Browning-Ferris*** case.

The order at least temporarily returns the NLRB to the controversial standard set forth in ***Browning-Ferris***. ***Browning-Ferris*** substantially broadened the circumstances under which entities might be held responsible for collective bargaining and unfair labor practices, and vulnerable to union organizing, picketing, and work stoppages even when the entity is not directly signing employees' checks, such as in a relationship between a franchisor and franchisee or a site employer and a staffing agency. Under ***Browning-Ferris***, the mere existence of "reserved" control, "indirect" control, or control that is "limited and routine" over terms and conditions of employment can result in a finding that two organizations are joint employers. This analysis to which the NLRB has now returned looks at an entity's ***potential*** to control essential terms and conditions of employment, such as its involvement in hiring, firing, discipline, supervision, and direction, as well as in "dictating the number of workers to be supplied; controlling scheduling, seniority, and overtime; and assigning work and determining the manner and method of work performance." The ***Browning-Ferris*** standard means companies may find themselves liable for labor violations, or responsible for collective bargaining matters, at the workplaces of their franchisees, subcontractors, or vendors. It is unclear when the NLRB might again be in position to relax this standard.

On March 1, 2018, the NLRB took the unusual step of asking the United States Court of Appeals for the D.C. Circuit to revisit the ***Browing-Ferris*** case itself, an appeal that had been mooted in late 2017 by the original decision in ***Hy-Brand***.

FEDERAL COURT IN CALIFORNIA DENIES PLAINTIFFS SUMMARY JUDGMENT ON JOINT EMPLOYER CLAIM

A federal district court in California has denied in part a plaintiff's unusual motion for summary judgment on whether a franchisor and its franchisees were joint employers of the franchisees' delivery drivers. ***Campanelli v. ImageFIRST Healthcare Laundry Specialists, Inc.***, 2018 WL 934545 (N.D. Cal. Feb. 16, 2018). ImageFIRST businesses provide industrial laundry service for companies in the healthcare industry. Campanelli brought a putative class action on behalf of ImageFIRST delivery drivers against the franchisor, 17 ImageFIRST franchisees, and another 10 locations "affiliated" with the franchisor through common ownership. Campanelli moved for summary judgment on the issue of whether the franchisor was a joint employer of all delivery drivers, and therefore liable for FLSA violations. Due to a procedural issue, the court declined to rule on the motion with respect to the franchisees.

With respect to the franchisor's affiliate entities, the court denied the motion. Campanelli argued that the common ownership of the affiliates and the franchisor caused the drivers of each to be joint employees. The court disagreed, noting that no employee of an affiliate made deliveries for the franchisor, nor did any franchisor employee directly supervise any affiliate's driver. Since Campanelli also alleged that the affiliates were economically dependent on the franchisor, the court queried whether the affiliates and franchisor might be vertical joint employers of the drivers. In a typical vertical joint relationship, a company contracts for workers who are directly employed by an intermediary. The court noted that the affiliate stores share owners, directors, and officers with the franchisor, and use common employment and hiring documentation, employment policies and training materials—each pointing towards a joint employment arrangement. However, the court declined to find vertical joint employment because of the affiliates' separate local store management. Each affiliate store's manager controlled that store's business operations, including drivers' routes and work schedules. Even though there was common ownership between the affiliates and the corporate franchisor entity, the separate management and supervisory structures at the affiliate store level precluded a finding of joint employment on summary judgment.

POST-TERMINATION INJUNCTIONS: NONCOMPETES

MISSOURI FEDERAL COURT ENJOINS TERMINATED FRANCHISEES' COMPETING BUSINESSES IN TWO H&R BLOCK CASES

Judges in the United States District Court for the Western District of Missouri recently issued orders in two separate cases enjoining two terminated franchisees from operating competing tax-service businesses within 25 miles of their former franchise territory for a period of two years. ***H&R Block Tax Serv., LLC v. Thomas***, 2018 WL 910170 (W.D. Mo. Feb. 15, 2018); ***H&R Block Tax Serv. v. Frias***, 2018 WL 934901 (W.D. Mo. Feb. 16, 2018). In both cases, the terminated franchisees were operating competing businesses in violation of their franchise agreements' post-termination covenants against competition, and the franchisor brought motions for preliminary injunctions. Applying case law from H&R Block's previous successes in injunction cases, both courts easily found (a) a likelihood of success on the merits of the franchisor's claims, (b) that the temporal and spatial scope of the non-compete provisions were reasonable, (c) a threat of irreparable harm to the franchisor resulting from lost customers and an inability to re-establish a new franchise in the territory, (d) a lack of countervailing harm to the ex-franchisees, who only suffered self-inflicted harm, and (e) a public interest in enforcing the contractual noncompetition provisions.

But the courts diverged on whether the noncompetition provisions applied to certain relatives who had not signed the franchise agreements. In ***Thomas***, the court summarily enjoined the ex-franchisees' family members, who were operating a competing tax-service business out of the same location as the former franchise office. The court in ***Frias***, however, refused to enjoin the ex-franchisee's wife. Although the wife admitted she originally opened her business to send customers to her husband's H&R Block franchise, the court found she had done so before the franchise was terminated, not as a means to circumvent the post-termination covenant against competition. The court also found that evidence gathered by the franchisor's investigator failed to demonstrate that the ex-franchisee was participating in the operation of his wife's competing business. Although the court did not enjoin the ex-franchisee's wife from operating a competing business, it did find that the ex-franchisee's referral of customers to his wife's competing business was a violation of the anti-solicitation provision of his franchise agreement and ordered further briefing on whether the ex-franchisee's social media activities also violated the anti-solicitation provision of his agreement.

POST-TERMINATION INJUNCTIONS: TRADEMARKS

FEDERAL COURT GRANTS FRANCHISOR A PRELIMINARY INJUNCTION PREVENTING TRADEMARK INFRINGEMENT

A federal court in Alabama recently granted a preliminary injunction ordering a former IHOP franchisee to deidentify and debrand its restaurants. ***IHOP Rests LLC v. Moeini***, 2018 WL 762343 (S.D. Ala. Feb. 7, 2018). IHOP had terminated three franchise agreements with the franchisee, who had failed to operate the restaurants in compliance with IHOP's standard procedures, polices, and regulations. Following the termination, Moeini continued operating the restaurants as IHOP franchised businesses, so IHOP sued and moved for a preliminary injunction seeking to enforce Moeini's post-termination obligations and to prevent infringement of IHOP's trademarks.

In granting the preliminary injunction, the court applied the familiar four-part preliminary injunction test and granted IHOP's preliminary injunction. First, the court found that IHOP made a sufficient showing that it was likely to succeed in proving that the franchise agreements were properly terminated, that the continued use of the IHOP marks after the franchise agreements were terminated was unauthorized, and that there was a strong risk of consumer confusion. Moeini argued that the franchise agreements were not properly terminated because IHOP conducted operational evaluations before a 30-day cure period expired, but the court rejected that argument, noting that Moeini presented no evidence of cure during the 30-day period, regardless of when the inspections took place. Second, the court reasoned that, based upon evidence of extensive customer complaints (the highest number of complaints in the IHOP system), IHOP had shown that it would suffer irreparable injury unless the injunction was granted. Third, given the evidence of irreparable injury, the court reasoned that the potential injury to IHOP outweighed the potential damage to Moeini should the injunction issue. Fourth, the court reasoned that IHOP presented convincing evidence that customer safety was at risk at each restaurant, given the health and safety violations that were found, and thus the court reasoned that IHOP established that entering an injunction would not be adverse to the public interests.

DAMAGES

FRANCHISOR ALLOWED TO PROCEED WITH LOST FUTURE ROYALTIES CLAIM IN SOUTHERN DISTRICT OF FLORIDA

A federal court denied a franchisee's motion to dismiss its franchisor's claim for lost future profits in ***Interim Healthcare Inc. v. Health Care@Home, LLC***, 2018 WL 830113 (S.D. Fla. Feb. 12, 2018). The defendant franchisee had operated an Interim Healthcare staffing franchise in Arizona for almost two years before Interim issued a notice of default based on the franchisee's failure to pay weekly service charges under the agreement. After the franchisee failed to cure its default, Interim terminated the agreement and brought suit for almost $400,000 in past due royalties. Interim also sought more than $1,400,000 in lost future royalties, calculated by multiplying the number of weeks remaining on the ten-year franchise agreement by the average weekly fees paid under the agreement.

The franchisee asked the court to dismiss the claim for lost future royalties, arguing that it was Interim's decision to terminate the contract—not the franchisee's own breach of agreement—that caused any future damages, and also that any such future profits were inherently speculative. The court denied the motion, noting that at the pleading stage, Interim had sufficiently pled a claim for lost future royalties. Although Florida courts were described as "hesitant" to award future royalties, the court found that Interim's complaint alleged a breach of the franchise agreement, lost profits as a proximate cause of that breach, that the losses were reasonably contemplated by the parties based on the 10-year term of the agreement, and that the losses were reasonably based on the average weekly fees and the remaining term of the agreement. The court acknowledged that Interim would have to prove those damages to "reasonable certainty by competent proof" at trial, but found enough for its claim to survive dismissal at the pleading stage.

MARYLAND FEDERAL COURT HOLDS ATTORNEYS' FEES PROVISION DID NOT APPLY TO FRANCHISEES' PRECONTRACTUAL TORT CLAIMS

A franchisee filed a complaint alleging that the franchisor had committed several pre-contractual torts, including fraud in the inducement, in ***Sumanth v. Essential Brands, Inc.***, 2018 WL 558612 (D. Md. Jan. 25, 2018). After franchisor Essential Brands moved to dismiss, Sumanth voluntarily dismissed its complaint, and Essential Brands sought its attorneys' fees and costs under an attorneys' fees provision contained in the parties' franchise agreement. The provision entitled Essential Brands to recover the attorneys' fees and costs that it incurred in enforcing the franchise agreement as the result of a franchisee's violation of "a term or condition contained within" the agreement, and in defending any related "defenses, counterclaims and/or crossclaims asserted." Applying Maryland law, the court observed that any ambiguity as to whether the attorneys' fees provision included precontractual torts should be resolved against a finding that such claims were included because other provisions in the franchise agreement demonstrated that the parties knew how to provide for the recovery of fees and costs under a specified circumstance when so desired (***e.g.,*** in an indemnification clause). The court also declined Essential Brands' request to award it attorneys' fees as a sanction for Sumanth's purportedly meritless lawsuit.

DISTRICT COURT GRANTS SUMMARY JUDGMENT FOR FRANCHISOR, DISMISSING ITS FORMER EMPLOYEE'S CLAIM FOR INDEMNIFICATION OF LEGAL FEES IN A CRIMINAL INVESTIGATION

A federal court in Ohio recently held that neither IHOP, nor its parent company, DineEquity, Inc., were obligated to indemnify a former employee of IHOP for the legal fees she had accrued during a criminal investigation. ***Tangas v. Intl House of Pancakes, LLC***, 2018 WL 776857 (N.D. Ohio Feb. 8, 2018). Tangas had been indicted by the FBI due to her alleged involvement with an IHOP franchisee who was charged with an array of criminal conduct, including underreporting sales, money laundering, conspiracy to harbor illegal aliens, and mail fraud. Tangas—who was a Franchise Bureau Consultant employed by IHOP to supervise the franchisee—had not disclosed to IHOP the scope of her relationship with the franchisee, including a payment of $50,000 that she had allegedly made to him, the circumstances of which were disputed. At the recommendation of her counsel, Tangas also refused to participate in an interview with IHOP's corporate counsel, in violation of IHOP's code of conduct, which prompted IHOP to fire her. Although the FBI ultimately dismissed its claims against Tangas, the court held that neither IHOP nor DineEquity was obligated to indemnify Tangas for the $130,000 in legal fees she had accrued before and after her firing.

The court looked to DineEquity's bylaws and IHOP's limited liability company agreement to determine whether either entity was obligated to indemnify Tangas. DineEquity's bylaws required it to indemnify Tangas if it had appointed Tangas, as an employee, to a specific position. The court readily held that Tangas had never been an employee of DineEquity because IHOP paid her salary and issued her W-2 forms. Therefore, DineEquity had no obligation to indemnify Tangas. On the other hand, IHOP's LLC agreement stated that the company was obligated to indemnify "any employee," except "with respect to" claims in which the employee "engaged in fraud, willful misconduct, bad faith or gross negligence." The court first concluded that IHOP's duty to indemnify applied only to current employees, and therefore IHOP had no obligation to indemnify Tangas for legal fees that accrued after IHOP fired her. Second, the court held that, in light of Tangas's conduct, IHOP was justified in electing not to indemnify Tangas based on its conclusion, in its reasonable business judgment, that Tangas's actions constituted willful misconduct and/or fraud. It noted that Tangas's failure to disclose to IHOP the full scope of her relationship with the IHOP franchisee would support a finding of fraud, particularly considering the evidence of Tangas's wrongdoing contained in the FBI reports. It further held that Tangas's refusal to participate in the internal IHOP interview could reasonably be considered willful misconduct. Therefore, the court concluded that neither DineEquity nor IHOP had a duty to indemnify Tangas.

ARBITRATION

GEORGIA COURT OF APPEALS UPHOLDS ARBITRATION AGREEMENT

The arbitration clause in a franchise agreement is not superseded by an assignment and assumption agreement when the original franchisee transfers its business, the Georgia Court of Appeals has ruled in affirming a trial court's order compelling arbitration. ***Samaca, LLC v. Cellairis Franchise, Inc.***, 2018 WL 1079806 (Ga. Ct. App. Feb. 28, 2018). Samaca, the successor franchisee, took possession of four existing units in 2014, pursuant to an assignment and assumption agreement to take on the franchise agreements, which contained arbitration requirements. The assignment and assumption agreement itself, however, contained a choice of law provision that talked about a court venue "in the event of litigation" arising out of the assignment and assumption. When a problem later arose, the franchisee did file suit in court, but Cellairis moved for and was granted dismissal based on the mandatory arbitration clause in the underlying franchise agreements.

On appeal, the trial court's ruling compelling arbitration was upheld. Citing the strong federal policy favoring arbitration, the appellate court found that the original franchise agreements and their arbitration clauses were not "subsumed" by the assumption and assignment agreement. To be superseded or discharged, an existing agreement must be replaced by an inconsistent agreement "completely covering the subject-matter embraced by the original contract," the court held. In this case, the assumption and assignment agreement was not inconsistent, as it was viewed as part of a series of documents allowing the transfer. In addition, the appellate court ruled that the entire question of whether the dispute was subject to arbitration was for the arbitrator, not the courts, to decide.

PRACTICE OF FRANCHISE LAW

FTC FRANCHISE RULE SCHEDULED FOR REVIEW IN 2018

In February, the Federal Trade Commission announced its revised regulatory review schedule for 2018. This year, the FTC intends to begin its initial review of, and solicit public comments on, Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. Part 436, which is more commonly known as the FTC Franchise Rule. The current version of the FTC Franchise Rule became effective on July 1, 2007. This scheduled review aligns with the FTC's intention to review its regulations on a ten-year cycle to ensure that they remain up-to-date. Stay tuned for more information as additional details regarding the upcoming review become available.

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