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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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DATE: **May 4, 2018—No. 229**

Below are summaries of recent legal developments of interest to franchisors.

TERMINATIONS

COURT HOLDS THAT TERMINATION OF FRANCHISE AGREEMENTS DID NOT BREACH CONTRACTS OR VIOLATE CALIFORNIA LAW

The United States District Court for the Central District of California recently granted summary judgment in favor of H&R Block Tax Services ("Block") in two consolidated cases in which franchisees had claimed that Block's terminations of their franchises had breached their franchise agreements and violated the California Franchise Relations Act. *Devore v. H&R Block Tax Servs. LLC*, No. 16-cv-946 (C.D. Cal. Mar. 29, 2018). Gray Plant Mooty represents Block in both cases. Block terminated the agreements of the two related franchisees after discovering that they were assisting the operation of a competing business, which for a time operated out of one of their franchised offices. The franchisees sued Block for wrongful termination, arguing that they had received no revenue from the competing business and therefore did not breach their in-term noncompetition covenants. However, the court held that their receipt of management services and favorable financing from the operator of the competing business gave the franchisees a sufficient interest in that business to attribute its competitive activities to them. The court also held that Block's terminations were justified because the franchisees had failed to obtain required employment agreements from their tax preparers and managers that would have prohibited those employees from working for the competitor.

In addition, the court found that the franchisees were not relieved of their obligations to cure all of their defaults because Block had not advised them in response to their inquiries which of their defaults remained uncured. The court also granted summary judgment for Block on numerous derivative claims, finding that those claims failed as the result of the failure of the franchisees' breach of contract claims or were prohibited attempts to restate breach of contract claims as torts. Finally, the court found the franchisees liable on Block's counterclaim for damages resulting from their breach of their in-term covenants and ordered an accounting of the amounts owed to Block.

FEDERAL COURT HOLDS THAT FRANCHISEE'S REFUSAL TO INSTALL A NEW POS SYSTEM IS VALID GROUNDS FOR TERMINATION

A federal district court in Florida recently held that a franchisee's refusal to install a new point-of-sale (POS) system was valid grounds for termination. *Peterbrooke Franchising of Am., LLC v. Miami Chocolates, LLC*, 2018 WL 1083552 (S.D. Fla. Feb. 28, 2018). Peterbrooke Franchising of America (PFA) terminated its agreement with former franchisee Miami Chocolates after it refused to install a new point-of-sale system, as required under the franchise agreement. When Miami Chocolates continued to operate in the same location, PFA sued to enforce the noncompete provision, alleging an additional breach of contract claim for failure to install the new POS system. In response, Miami Chocolates and its owners challenged the validity of the termination, arguing that PFA was not entitled to terminate the agreement on those grounds. Specifically, they argued the termination was invalid because: (1) PFA did not adequately test the new POS system before rolling it out; (2) the quality of the new POS system was inferior; and (3) even if it was a breach, the breach was not material.

The court rejected each of these arguments. The agreement required Miami Chocolate to install the new POS after PFA's "testing and determination that it will prove beneficial to" Miami Chocolates. However, the agreement did not set forth a testing regime, and the court determined that PFA's six-month testing period in corporate-owned stores sufficiently established that PFA tested the POS system in good faith. The franchisee's arguments regarding the quality of the POS system were similarly unavailing, as the agreement granted PFA broad discretion to require a new POS system of its own choosing. Finally, the court rejected the argument that any breach was immaterial because the franchisee already had a working POS system in place. Whether they had a working POS system was irrelevant, as the clear language of the agreement did not impose conditions precedent on PFA's right to require installation of a new POS system.

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EMPLOYMENT

BROWNING-FERRIS APPEAL REINSTATED BECAUSE OF "EXTRAORDINARY CIRCUMSTANCES" SURROUNDING NLRB JOINT-EMPLOYER STANDARD

A series of unusual developments has brought the NLRB's joint-employer standard back in front of the D.C. Circuit, where the federal court will finally weigh in on the 2015 decision in *Browning-Ferris Industries*, 362 NLRB No. 186 (2015). For many years prior to 2015, when determining when two or more entities would be considered a "joint-employer" under the National Labor Relations Act, the NLRB looked at whether an entity possessed and exercised direct control over employees' terms and conditions of employment. In *Browning-Ferris,* however, the board announced that even if an entity had never exercised joint control over the terms and conditions of employment, the Board would also consider whether that entity had either exercised indirect control through an intermediary or had reserved the right to do so. Having been found a joint-employer, Browning-Ferris appealed to the D.C. Circuit for review.

While that appeal was pending, a newly recomposed NLRB overruled *Browning-Ferris* in *Hy-Brand Industrial Contractors, Ltd.*, 365 NLRB No. 156 (2017). As a result, the D.C. Circuit remanded *Browning-Ferris* back to the agency. But on February 26, 2018, the NRLB vacated *Hy-Brand* after a determination by the NLRB Inspector General that one of the NRLB Board Members should have been disqualified from voting in the case because of his former law firm's involvement in *Browning-Ferris*. The vacation of *Hy-Brand* means that *Browning-Ferris* is, for now, the governing joint-employer standard at the NLRB. On April 6, 2018, the D.C. Circuit agreed to reinstate Browning-Ferris' appeal, citing the "extraordinary circumstances" surrounding its procedural history at the NLRB. Meanwhile, Hy-Brand has filed a motion for reconsideration in its case, supported by a brief from the NLRB's General Counsel's office.

BREACH OF CONTRACT

FEDERAL COURT IN INDIANA REJECTS UNDERREPORTING CLAIM BASED ON ESTIMATED GROSS SALES

A federal court in Indiana recently granted a franchisee's motion for summary judgment on the franchisor's underreporting claim. *Noble Roman's, Inc. v. Hattenhauer Distrib. Co.*, 2018 WL 1566812 (S.D. Ind. Mar. 30, 2018). At issue in the case were two gas stations and convenience stores owned by Hattenhauer that contained Noble Roman's pizza franchises. Each location was required to pay a royalty fee on its gross sales. Noble Roman's alleged that Hattenhauer breached its franchise agreement by underreporting those sales by more than 20% and failing to pay the appropriate royalties. In concluding that Hattenhauer underreported its sales, Noble Roman's used an audit of

Hattenhauer's purchases from its distributor and assumptions as to Hattenhauer's rate of waste, product mix, and pricing to estimate Hattenhauer's gross sales. Noble Roman's argued that its method was appropriate because, where food purchases are made at the same register as purchases of convenience-store items, there is significant possibility of error in recording the sale. Further, the franchise agreement required Hattenhauer to keep a variety of records for audit by Noble Roman's, including distributor purchase records, so Noble Roman's reasoned that it could use those records to estimate gross sales. Hattenhauer responded that the audit failed to calculate its actual gross sales, and ignored its actual rate of waste, product mix, and pricing.

The court sided with Hattenhauer, observing that the franchise agreement called for royalty payments based on actual gross sales. It granted Hattenhauer summary judgment on Noble Roman's claim, as well as Hattenhauer's counterclaim that Noble Roman's improper calculation method represented a breach of the franchise agreement. The court additionally granted summary judgment to Hattenhauer on its counterclaim that Noble Roman's breached the franchise agreement by attempting, without authorization, to withdraw from Hattenhauer's bank account the royalty payments Noble Roman's claimed were owed. It further found that Noble Roman's successful unauthorized withdrawal constituted conversion, creating civil liability under the Indiana Crime Victim's Relief Act.

COURT GRANTS IN PART AND DENIES IN PART FRANCHISOR'S SUMMARY JUDGMENT MOTION

The United States District Court for the Southern District of New York recently partially granted and partially denied a franchisor's motion for summary judgment against its former franchisee. *Wyndham Hotel Grp. Int'l, Inc., v. Silver Entm't LLC*, 2018 WL 1585945 (S.D.N.Y. Mar. 28, 2018). Wyndham and its franchisee were parties to a franchise agreement for the operation of a hotel in Panama. After several years of operations, the hotel fell into financial difficulties and the franchisee became delinquent on contractually required fees, installments on a promissory note, and Panamanian gaming taxes. The Panamanian government seized the hotel and Wyndham terminated the franchise agreement and sued the franchisee seeking payment of outstanding fees, liquidated damages, and the outstanding balance due under the promissory note. The franchisee counterclaimed, alleging that Wyndham breached the franchise agreement by failing to provide a variety of support services including: (1) access to Wyndham's reservation and property management systems; (2) a Spanish-language reservation system; (3) training; and (4) marketing, group sales, and transient sales support.

Wyndham moved for summary judgment and the court granted it on the franchisee's claims related to a Spanish-language reservation system, and marketing, group sales, and transient sales support, because Wyndham had no obligation to provide these services under the plain language of the franchise agreement. However, the court held there were genuine disputes of material facts as to whether Wyndham breached an obligation to provide the franchisee with adequate access to its reservation and property management systems, and whether Wyndham owed and provided certain training to the franchisee. Wyndham further argued that the franchisee failed to identify recoverable damages arising from the alleged breaches, but the court held that the franchisee raised a genuine dispute as to the existence of damages, and the amount of damages is a question for the jury. Finally, the court granted Wyndham summary judgment as to liability on its claims, but denied it as to damages, because the amount of fees owed depend on a calculation of gross revenues, which was a jury question.

FRAUD

COURT REJECTS FRANCHISOR'S MOTION TO DISMISS FRAUD CLAIMS UNDER PENNSYLVANIA'S "GIST OF THE ACTION" DOCTRINE

A federal court in Michigan recently determined that Pennsylvania's "gist of the action" doctrine, which is similar to the economic loss rule, did not bar franchisees' fraud claims. *Nutrimost Doctors, LLC v. Sterling*, 2018 WL 1570624 (E.D. Mich. Mar. 30, 2018). Franchisor Nutrimost Doctors sued its three franchisee chiropractors claiming that they had purposely submitted contaminated samples of Nutrimost's supplements to a laboratory in an attempt to void the franchise agreements. Nutrimost had the supplements tested by a different facility that detected no contamination, prompting it to sue the franchisees for fraud and other claims. The franchisees counter-sued alleging breach of contract and tort claims, including fraud. According to the franchisees, Nutrimost had fraudulently represented prior to entering into the franchise agreements that its program was "guaranteed" to result in weight loss of at least "25 pounds in 40 days," that its system was based on "revolutionary breakthrough technology," and presented photos of individuals who had purportedly lost weight. The parties had agreed that Pennsylvania law would govern their dispute.

Nutrimost moved to dismiss the fraud claims, contending that they were precluded by Pennsylvania's "gist of the action" doctrine, a legal theory that precludes a party from recasting a breach of contract claim as a tort claim. The court disagreed with Nutrimost that the doctrine applied, because the fraudulent statements were made <u>before</u> the parties entered into the franchise agreements, and the doctrine is inapplicable where the statements are made to fraudulently induce a party to enter into a contract. The court also rejected Nutrimost's alternative argument that the statements were mere "puffery" that removed them from the realm of fraud. The court found that these representations were "specific and measurable" claims about Nutrimost's system. The court therefore refused to dismiss them.

ARBITRATION

COURT DENIES PETITION TO VACATE ARBITRATION AWARD UNDER ARBITRATOR MISCONDUCT AND "EXCEEDING POWERS" STANDARDS OF REVIEW

The federal court in Connecticut denied a former Subway franchisee's motion to vacate an arbitration award, finding that the franchisee failed to show that the arbitrator was guilty of misconduct in refusing to continue a hearing and reserving judgment on two of the franchisee's motions. The court also declined to find that the arbitrator exceeded his powers by issuing an ex parte award to the franchisor, and confirmed the arbitrator's award. *Vyas v. Doctor's Assocs., Inc.*, 2018 WL 1440179 (D. Conn. Mar. 21, 2018). Doctor's Associates (DAI), the franchisor of Subway, had initiated arbitration proceedings to terminate three franchises operated by Vyas. The arbitration center initially applied its expedited commercial arbitration rules to the dispute, but later moved the matter to its regular commercial arbitration rules after Vyas filed counterclaims alleging up to $500,000 in damages. Vyas did not initially respond to the list of proposed arbitrators, but objected to the appointed arbitrator after receiving his conflicts disclosures. Over Vyas' objection, the selected arbitrator continued to oversee the case. After considering various motions filed by Vyas, the arbitrator declined to continue the date for the evidentiary hearing, compel a witness' attendance, or preclude DAI from calling undisclosed witnesses, but reserved the right to revisit the latter two issues at a later date. Vyas responded with a notice claiming, among things, that (i) the initial application of the expedited rules was improper, and thus the arbitrator selection process was incorrect; and (ii) the arbitrator had repeatedly shown bias by excusing DAI's noncompliance with discovery deadlines, but refusing to extend the same courtesy to Vyas. Vyas withdrew her consent to the arbitrator's jurisdiction and did not participate in the hearing. As a result, the arbitrator issued an ex parte award terminating the three franchise agreements. Vyas appealed to the district court.

The court noted that a party bears a heavy burden to show that an arbitration award falls within the very limited grounds upon which a district court may vacate it. The court rejected Vyas' arguments regarding arbitrator misconduct for failing to extend the hearing date, because she did not show how she was prejudiced. Moreover, the court stated that Vyas failed to explain any prejudice stemming from the arbitrator's reservation of judgment on her two motions, particularly where she declined to participate in the hearing and did not describe how a particular witness' testimony would have been pertinent and material to her case. Finally, observing that the Second Circuit had yet to recognize the methodology of arbitrator appointment as a basis for vacatur of an arbitration award, the court rejected Vyas' argument because she consented to the arbitration procedures in the franchise agreement.

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TENNESSEE FEDERAL DISTRICT COURT REFUSES TO OVERTURN ARBITRATION AWARD IN FAVOR OF FRANCHISEE

A federal court in Tennessee has confirmed an arbitrator's award of damages and rescission against a franchisor, Medex, and in favor of a franchisee. *Altruist, LLC v. Medex Patient Transp., LLC*, 2018 WL 1704111 (M.D. Tenn. Apr. 9, 2018). The franchisee had asserted various claims, including breach of contract, misrepresentation, and breach of the covenant of good faith and fair dealing against Medex, arising out of a failure to disclose a bankruptcy in the FDD and unfulfilled promises of "back door" services including a call center, dispatch, and route management. In seeking to vacate the arbitration award, Medex argued that the arbitrator manifestly disregarded the law.

The court found that, regardless of whether "manifest disregard of law" was an appropriate basis to overturn the award, Medex did "not come close to establishing the arbitrator acted in manifest disregard of the law." Addressing the franchisee's specific arguments, the court first determined that the fact that the arbitrator did not identify the standard of review in the award did not mean that he failed to apply it. Second, prior Tennessee cases demonstrated that an award of both rescission and damages was permissible. Third, the franchise agreement's integration clause did not preclude the claims because the clause specifically permitted reliance on the FDD, where Medex's alleged misrepresentations were contained. Fourth, the Tennessee Consumer Protection Act did apply because Medex made misrepresentations that goods and services were of a particular standard, quality, or grade. And fifth, Tennessee's statutory code explicitly permits directors, owners, officers, and agents to be personally liable for their own acts, so Medex's owners could be held jointly and severally liable. While the court confirmed the award, it went on to deny the franchisee's request for an award of attorney's fees incurred as a result of the confirmation proceedings.

RULEMAKING

NEW FDA MENU LABELING RULES TAKE EFFECT ON MAY 7, 2018

New rules from the Food and Drug Administration take effect on May 7, 2018, requiring certain businesses selling food to disclose calorie counts on their menus. The FDA's menu labeling rules were previously scheduled to take effect in May 2017, but a strong lobbying effort from the restaurant industry led to a delay in implementation. The new rules apply to restaurants and similar businesses with 20 or more locations operating under a common name and offering substantially similar menu items. If enacted, a recent bill, the Common Sense Nutrition Disclosure Act, could loosen some of the requirements of the FDA's new rules. However, that legislation remains pending before the Senate. The FDA's new rules and existing state laws governing menu labeling largely make both franchisors and franchisees responsible for compliance.

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