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.

FRAUD/MISREPRESENTATION

S.D.N.Y. DISMISSES FRANCHISEE'S FRAUD CLAIMS BASED ON ACTS OCCURRING AFTER CONTRACTING

Following a franchisor's motion to dismiss and motion for summary judgment, the United States District Court for the Southern District of New York has dismissed a franchisee's fraud claims based on actions that occurred after it entered the parties' franchise agreement. *Safe Step Walk In Tub Co. v. CKH Indus., Inc.*, 2018 WL 4539656 (S.D.N.Y. Sept. 20, 2018). Under the franchise agreement, Safe Step permitted CKH to use Safe Step's trademarks when marketing, selling, and installing its walk-in bathtubs in the Mid-Atlantic and New England areas. Safe Step brought suit against CKH for nonpayment of fees, and CKH brought counterclaims alleging a variety of contractual, quasi-contractual, and fraud claims.

CKH alleged that Safe Step had failed to provide franchise disclosure documents, intentionally escalated CKH's costs to try to constructively terminate the franchise, expressed a bad-faith intention to renew the franchise, and failed to make buy-out offers for the franchise. The court rejected Safe Step's argument that CKH had failed to plead its fraud claims with sufficient particularity. Instead, the court divided the fraud allegations into those occurring before and those occurring after

the execution of the franchise agreement. The court dismissed the fraud claims based on actions occurring after the execution of the franchise agreement, holding that CKH was limited to its contractual remedies for those claims, but let stand CKH's fraud allegations relating to the parties' pre-agreement negotiations. The court also denied Safe Step's motion for summary judgment on its breach of contract claim because the parties disagreed as to whether there was a meeting of the minds, creating a factual dispute regarding the contract's validity. The court further noted that the motion for summary judgment was premature, since CKH had not yet had the opportunity to conduct discovery.

TRADEMARKS

DEFENDANTS GRANTED SUMMARY JUDGMENT ON TRADEMARK INFRINGEMENT CLAIM

A Massachusetts federal court recently granted summary judgment to the defendants in a trademark dispute that stemmed from their development of restaurants under the plaintiff's trademarks. *Xiao Wei Yang Catering Linkage In Inner Mongolia Co. v. Inner Mongolia Xiao Wei Yang USA, Inc.*, 2018 WL 4516682 (D. Mass. Sept. 20, 2018). Linkage entered into a five-year cooperation agreement with the defendants to support the defendants' promotion and development of a franchise market under trademarks owned by Linkage, including the federally registered trademark LITTLE LAMB. The cooperation agreement also appointed the defendants as Linkage's exclusive agent in the U.S. restaurant franchise market. To maintain such rights, the cooperation agreement required the defendants to meet certain development obligations. The defendants opened LITTLE LAMB restaurants in Boston and Chicago, and Linkage announced the opening of the Boston restaurant in its corporate newsletter, promoted the restaurant on its website, and had representatives visit the restaurant location. The defendants subsequently ceased using the LITTLE LAMB mark before the term of the cooperation agreement expired and changed the name of the Boston restaurant. Linkage then brought a claim for trademark infringement, among other claims.

In opposing the defendants' motion for summary judgment, Linkage argued that the defendants were not authorized to use its trademarks because they did not satisfy the development timelines required under the cooperation agreement. The court disagreed, finding that the defendants' development of locations in Boston and Chicago clearly complied with the required development timeline. Linkage alternatively argued that the cooperation agreement had been rescinded, but the court found no evidence that Linkage properly terminated the agreement. Ultimately, the court concluded that Linkage consented to the defendants' use of its marks based on the express authorization in the cooperation agreement and Linkage's subsequent conduct, including its involvement in the selection of the Boston restaurant location and promotion of the restaurant opening in its newsletter and on its website. Because Linkage could not show that the defendants had used its marks without permission, the court granted the defendants' motion for summary judgment on this claim.

CHOICE OF FORUM/VENUE

COURT TRANSFERS FRANCHISEE'S SECOND-FILED ACTION

A federal district court in Nevada transferred a franchisee's lawsuit against a franchisor to another district court in which the franchisor had filed suit against the franchisee just hours earlier. *Khutob v. L.A. Ins. Agency Franchising, LLC*, 2018 WL 4286171 (D. Nev. Sept. 8, 2018). When a dispute arose between the parties and settlement negotiations broke down, the franchisor, L.A. Insurance Agency (LAIA), filed suit against the franchisee, Khutob, in the U.S. District Court for the Eastern District of Michigan. Later that same day, Khutob filed a parallel lawsuit against LAIA in the District of Nevada.

LAIA moved to dismiss, stay, or transfer the Nevada case based upon the first-to-file rule, pursuant to which the court has the discretion to rule in the interest of efficiency and judicial economy. Khutob argued that the first-to-file rule should not apply because the cases were dissimilar and because LAIA's complaint was an anticipatory suit aimed at forum shopping. The court disagreed, concluding that the lawsuits involved substantially similar issues because the enforceability of the franchise agreements was central to both cases. The court also rejected Khutob's claim that LAIA had engaged in forum shopping, noting that LAIA had signaled its intention to file suit if its settlement offer was not accepted. In exercising its discretion to transfer the case to Michigan, the court declined to consider the parties' arguments about convenience or the enforceability of a forum selection clause that also selected Michigan as the forum for resolution of disputes, holding that those issues were more properly considered by the court in the first-filed action.

STATE FRANCHISE LAWS

FILING AMENDED FDD REGISTRATION APPLICATION IN CALIFORNIA REQUIRES REDISCLOSURE

A federal court in California has denied a franchisor's motion to dismiss a claim that it violated California's disclosure law because it failed to redisclose a prospective franchisee with, among other things, the franchisor's then-effective amended FDD. *Schulenburg v. Handel's Enters., Inc.*, 2018 WL 4282637 (S.D. Cal. Sept. 7, 2018). Handel's provided its FDD to the prospective franchisee, Schulenburg, in October 2015. In December 2015, Schulenburg sent a small deposit of the initial franchise fee to Handel's, without signing the franchise agreement. On January 11, 2016, Handel's submitted an application to the state of California to amend its FDD, which became effective a few days later. Schulenburg paid the remainder of the franchise fee the same day the amended FDD became effective. Handel's then again provided the franchisee with the 2015 FDD, and the parties executed the franchise agreement. Handel's never redisclosed Schulenburg with the amended FDD. Schulenburg subsequently brought several claims against Handel's, including violations of California's disclosure laws.

The court held that, under California law, an offer for a franchise may remain pending while an application for amendment is pending with the state, as long as the franchisor provides certain documents to the franchisee, waits to close the sale until the amended FDD is effective, and then rediscloses the franchisee with the amended FDD and proceeds with the normal sale procedures. Here, even though Schulenburg was properly disclosed with the 2015 FDD in October 2015, and paid a deposit of the initial franchisee fee while the 2015 FDD was effective, the offer was still pending when Handel's filed the application for amendment in 2016. When the parties executed the franchise agreement in January 2016, the 2015 FDD was no longer in effect, and the amended FDD should have been delivered to Schulenburg. Thus, the court held that Schulenburg plausibly stated a claim that Handel's violated California's disclosure laws.

PRELIMINARY INJUNCTIONS

NORTH CAROLINA FEDERAL COURT HOLDS TERMINATED FRANCHISEE IN CONTEMPT FOR VIOLATING PRELIMINARY INJUNCTION ENFORCING NONSOLICITATION COVENANT

After finding a group of terminated franchisees in contempt of court for violating a preliminary injunction enforcing their covenant against solicitation, the U.S. District Court for the Western District of North Carolina awarded a franchisor nearly $100,000 in attorneys' fees and costs and extended the nonsolicitation covenant for an additional year. *Atl. Pinstriping LLC v. Atl. Pinstriping Triad, LLC*, 2018 WL 4265564 (W.D.N.C. Sept. 6, 2018). Atlantic terminated the parties' franchise agreements and then filed a motion for a temporary restraining order seeking to enjoin the former franchisees' patent and trademark infringement and enforce their post-termination covenants against competition and solicitation, both of which had two-year terms. After the motion was granted, the parties engaged in arbitration. The former franchisees initially refused to produce customer invoices, but eventually complied with the arbitrator's order compelling their production.

The invoices, along with third-party discovery, revealed that the former franchisees had solicited at least sixteen former customers to their new business, beginning on the same day the preliminary injunction was entered. The former franchisees asked customers not to contact them by email and to make sure no one saw them perform pin striping work, evidencing the former franchisees' knowledge that their conduct violated the injunction. The court also found the former franchisees had either failed to preserve authentic customer invoices, or altered them in an attempt to cover up their violations. Because the former franchisees' conduct deprived Atlantic of the benefit of the preliminary injunction, the court extended the nonsolicitation covenant for another year. Additionally, in light of the former franchisees' abusive litigation tactics, including repeated last-minute delays and obstruction, the court awarded Atlantic its attorneys' fees and costs.

GRAY PLANT MOOTY

ILLINOIS FEDERAL COURT AWARDS FRANCHISOR PRELIMINARY INJUNCTION AND COMPELS ARBITRATION

An Illinois federal court recently granted a franchisor's motion for a preliminary injunction and two motions to compel arbitration against its former franchisee. *BrightStar Franchising, LLC v. Northern Nevada Care, Inc.*, 2018 WL 4224454 (N.D. Ill. Sept. 4, 2018). BrightStar, a franchisor of home-based health services, entered into a franchise agreement with Northern Nevada Care (NNC) pursuant to which NNC had the right to provide in-home medical care in the Carson City, Nevada area. After BrightStar learned that NNC was providing services to a customer living in another franchisees' territory, it informed NNC that it would have to turn the client over to the other franchisee and pay restitution. In response, NNC informed BrightStar that it was terminating the agreement. NNC then continued operating an in-home medical service company under a different name. BrightStar sued and sought injunctive relief to stop NNC's violation of the noncompete clause. NNC brought a counterclaim against BrightStar for fraud and, at the same time, filed a complaint alleging fraud against BrightStar in Nevada state court. BrightStar subsequently moved to compel arbitration of both claims pursuant to an arbitration provision in the franchise agreement.

The court granted BrightStar's motion for a preliminary injunction after NNC failed to contest the merits of BrightStar's noncompete claim. In addition, the court compelled the parties to arbitrate both the state court fraud claim and the fraud counterclaim. NNC did not contest the validity of the arbitration provision but, instead, contested the court's jurisdiction to compel arbitration because the amount in controversy did not exceed $75,000. The court observed that NNC's alleged damages amounted to $50,000, and that the value of the rescission relief requested in the complaint was greater than $30,000. Therefore, the amount in controversy requirement was satisfied.

DAMAGES

FEDERAL COURT ENFORCES LIQUIDATED DAMAGES PROVISION UNDER WASHINGTON LAW

A federal court in Washington granted a franchisor's motion for summary judgment enforcing the liquidated damages provision in the parties' franchise agreement. *Red Lion Hotels Franchising, Inc. v. First Capital Real Estate Invs., LLC*, 2018 WL 4259241 (E.D. Wash. Sept. 6, 2018). Red Lion brought a breach of contract action against three former franchisees who defaulted under their agreements, seeking liquidated damages and past due fees. The franchisees conceded that the license agreements were enforceable contracts and that Red Lion lawfully terminated the agreements. The only issue in dispute was the enforceability of the liquidated damages clause.

Applying a two-part test under Washington law, the court first analyzed whether the clause was a reasonable forecast of compensation for harm at the time the contract was signed. The franchisees claimed the provision was unreasonable because hotel revenues plummeted immediately after they began operating, and then clientele declined after the shale oil market crashed. The court rejected this argument, noting that these events occurred after execution of the franchise agreements. The court also considered party sophistication in determining the reasonableness of the liquidated damages provision. Here, the franchisees specialized in turning around failing real estate projects, knew of the risks associated with the properties in question, and agreed to the liquidated damages provision. The court further noted that the franchisees demonstrated their expertise when they negotiated other terms in the franchise agreements and received concessions from Red Lion. Finally, the court found the liquidated damages provision satisfied the second factor, as the harm was "incapable or very difficult of assessment" at the time of contracting. The franchise agreements involved inherent risks for both parties, given the failing state of the hotels at the time and their location in difficult markets. Further, Washington courts have recognized that the real estate market is an area in which liquidated damages provisions are reasonable. For these reasons, the court enforced the liquidated damages provision.

Along with the attorneys indicated on the next page, Dean Eyler, a principal in the Intellectual Property, Technology & Privacy practice group, contributed to this issue.

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