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. At the end of this issue, we have included an analysis of new guidance released by the Financial Accounting Standards Board related to the implementation of the revenue recognition accounting rules set to take effect in 2019.

In addition, the Franchise and Distribution Practice Group would like to extend a special thank you to Quentin Wittrock for his 21 years of service as an Editor of *The GPMemorandum*. Quentin has edited over 200 issues of our publication and is now passing the editing baton. Thank you, Quentin!

EMPLOYMENT

TENTH CIRCUIT REVERSES DISMISSAL OF DEPARTMENT OF LABOR'S COMPLAINT AGAINST FRANCHISOR FOR ALLEGED MISCLASSIFICATION OF EMPLOYEES UNDER FLSA

The United States Court of Appeals for the Tenth Circuit recently revived a Department of Labor lawsuit alleging that the franchisor Jani-King failed to maintain proper employee records regarding its franchisees as required under the Fair Labor Standards Act. *Acosta v. Jani-King of Okla., Inc.*, 905 F.3d 1156 (10th Cir. 2018). The DOL alleged that the franchise owners—some of whom were individuals and others of which were corporate entities owned by one or two individuals—were actually employees of the franchisor, misclassified as independent contractors, under the Tenth Circuit's six-factor "economic realities" test. Jani-King filed a motion to dismiss the complaint, which the district court granted, finding the corporate entities that had entered into franchise agreements with the franchisor did not qualify as "individuals" under the FLSA and, because the DOL lumped together individual and corporate entity franchisees, the complaint had not alleged sufficient factual allegations to make plausible FLSA claims as to each actor.

In reversing the district court's decision, the Tenth Circuit found that the franchise owners' corporate structure was not dispositive, since the economic realities test focuses on the parties' working relationship, not "the label or structure overlaying the relationship." Further, even though the complaint did not "specifically name the individuals or entities who allegedly trigger the recordkeeping requirements of the FLSA," the Tenth Circuit concluded that factual allegations in the complaint gave Jani-King sufficient notice as to which franchisees might be implicated and therefore stated a plausible claim.

JURISDICTION AND PROCEDURE

TEXAS FEDERAL COURT GRANTS FRANCHISEE'S MOTION TO REMAND

The U.S. District Court for the Eastern District of Texas has granted a franchisee's motion to remand a case back to state court after finding that its complaint did not raise a substantial issue of federal law. *KMCC Enters., LLC v. Savvy Chic Mgmt. Inc.*, 2018 WL 5295812 (E.D. Tex. Oct. 25, 2018). KMCC Enterprises entered into a franchise agreement with Savvy Chic to operate a nonsurgical weight loss franchise. KMCC later sued Savvy Chic under the Texas Business Opportunities Act (TBOA) alleging that Savvy Chic induced KMCC to enter into the franchise agreement with false representations about the business. The Texas state court granted Savvy Chic's motion to remove the case to federal court on the grounds that the case required interpretation of federal statutes and regulations in order to adjudicate the alleged violation of the TBOA. KMCC then filed a motion to remand the case back to state court.

In granting KMCC's motion, the federal court reasoned that it could not exercise its limited jurisdiction over the case unless KMCC's complaint raised a disputed and substantial federal issue. The TBOA requires interpretation of federal law, such as 16 C.F.R. Part 436 (the FTC Franchise Rule), to adjudicate possible exceptions to the statute, which Savvy Chic raised as an affirmative defense. However, KMCC's complaint, on its face, did not require any reference to or interpretation of federal law. The court concluded that even if it considered the federal law to be tied to the complaint and not the affirmative defense, it still would decline to exercise jurisdiction over the case. According to the court, the case did not present a substantial federal issue given that the FTC Franchise Rule does not create a private cause of action and does not permit preemption of state remedies.

CONTRACTS

FRANCHISEE'S COMPLAINT DISMISSED DUE TO INSUFFICIENT ALLEGATIONS

A federal district court in New Jersey granted a franchisor's motion to dismiss a franchisee's complaint because it failed to sufficiently plead facts in support of each claim it alleged. *Khorchid v. 7-Eleven, Inc.*, 2018 WL 5149643 (D.N.J. Oct. 22, 2018). The parties entered into a franchise agreement in 2009, and then executed a revised franchise agreement in 2016. Khorchid filed a lawsuit against 7-Eleven that included claims for breach of contract, breach of the implied covenant of good faith and fair dealing, and violations of the New Jersey Franchise Practices Act (NJFPA). The complaint alleged, in part, that 7-Eleven initiated policies to diminish Khorchid's profits, failed to properly advertise for Khorchid, targeted Khorchid's store for "take back," and attempted to constructively terminate the franchise agreements.

The court granted 7-Eleven's motion to dismiss all counts of the complaint, holding that Khorchid failed to properly delineate the factual conduct that related to each legal claim, such as which version of franchise agreement was at issue, which provision in the relevant franchise agreement was actually breached, and which underlying facts supported each specific claim. Moreover, under New Jersey law, claims for breach of contract and breach of the implied covenant of good faith and fair dealing must be based upon separate facts. The court found that Khorchid's complaint relied upon the same allegations for both claims and that they therefore were impermissibly duplicative. The court also found that Khorchid failed to identify any specific provisions of the NJFPA that allegedly had been violated and concluded that general references to the statute as a whole did not suffice to state a claim. The court dismissed the case without prejudice, however, because it noted that a potential curative amendment might not be futile.

COLORADO COURT DENIES FRANCHISOR'S MOTION TO DISMISS BREACH OF CONTRACT COUNTERCLAIM THAT WAS BASED ON THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Meanwhile, a federal court in Colorado has denied in part a franchisor's motion to dismiss counterclaims brought by a franchisee, including a claim for breach of contract based on the implied covenant of good faith and fair dealing. *E&I Holdings, Inc. v. Coral Springs Eggs & I, LLC*, 2018 WL 4680339 (D. Colo. Sept. 28, 2018). The dispute arose when E&I Holdings, a franchisor of various restaurants including the Egg & I, terminated two franchise agreements with Coral Springs after it failed to comply with the agreed upon store development schedule. E&I sued for damages and injunctive relief to stop Coral Springs from continuing to operate one of the locations. In response, Coral Springs asserted five counterclaims including breach of contract, fraud in the inducement, and violations of state franchise and unfair and deceptive trade practices statutes. E&I moved to dismiss all of the counterclaims.

The court denied E&I's motion to dismiss the breach of contract counterclaim, finding that the claim was based entirely on the implied covenant of good faith and fair dealing, and that E&I failed to address the implied covenant in its motion. Coral Springs alleged that E&I "was bought by and merged into [a] competing breakfast chain First Watch in 2015," and that the merger of the competing brands created several issues. Specifically, it claimed that E&I refused to approve any new Egg & I locations for at least one year after the merger, that E&I was "strongly opposed" to opening the eleven Egg & I franchises in Coral Springs' development agreement because they would have been in the same area as existing First Watch restaurants, that E&I imposed an undisclosed cap on rent for new restaurants which forced Coral Springs to open in unsuitable locations, and that E&I abandoned and sabotaged the Egg & I brand by removing the most popular menu items to make it less competitive with First Watch stores. These issues, according to Coral Springs, constituted a material breach of the implied covenant of good faith and fair dealing in the development and franchise agreements, which it pled as a breach of contract. Rather than addressing the good faith and fair dealing argument, E&I focused solely on whether the termination was proper under the express terms of the contracts. The court denied E&I's motion to dismiss the breach of contract counterclaim because it "fail[ed] to address the express basis of Defendants' counterclaim." The court granted E&I's motion to dismiss the four other counterclaims.

STATE FRANCHISE LAWS

COURT ALLOWS INSURANCE AGENT TO PURSUE CONNECTICUT FRANCHISE ACT CLAIM AGAINST ALLSTATE

A Connecticut federal court recently allowed a plaintiff to continue with his claim that Allstate violated state franchise laws by terminating him without good cause. In *Kollar v. Allstate Ins. Co.*, 2018 WL 4688301 (D. Conn. Sept. 28, 2018), Kollar alleged a violation of the Connecticut Franchise Act after Allstate terminated his longtime position as an insurance agent without cause in 2014. Allstate disputed that a franchise relationship existed, noting that Connecticut already had extensive legislation governing the relationship between insurance companies and their agents and did not intend for franchise laws to cover insurance agency relationships.

The court disagreed, noting that Connecticut applied a two-step test to establish a franchise relationship: (1) whether the franchisee had the right to offer, sell, or distribute goods or services; and (2) whether the franchisor substantially prescribed a marketing plan associated with a trademark for those sales. Although the Connecticut Supreme Court previously applied this test in an insurance agency case and found that no franchise relationship existed, the federal court concluded it was not bound by that outcome because the inquiry is inherently fact-intensive. Two allegations about Allstate's practices persuaded the court to analyze the relationship at a later stage of the litigation. First, unlike in the prior insurance agency franchise case, Allstate required its agents to sell Allstate's products exclusively. Second, Kollar alleged that Allstate explicitly represented itself as a franchisor in advertising. Those allegations were enough to state a plausible claim satisfying the first step of Connecticut's franchise test. The court noted that the question of control was better addressed after discovery. Allstate alternatively argued that even if the Connecticut Franchise Act applied, it had "good cause" to terminate Kollar, and its 90-day notice of termination complied with the statute. The court noted that it was inappropriate to resolve the issue of "good cause" on a motion to dismiss.

MISREPRESENTATION

ECONOMIC LOSS DOCTRINE DOES NOT BAR CLAIM THAT FRANCHISOR PROMISED TO MEDIATE FRANCHISEE DISPUTE

The U.S. District Court for the District of New Jersey granted in part and denied in part franchisor Meineke Car Care Center's motion to dismiss several counterclaims lodged against it by franchisee JNMVR Enterprises. *Meineke Car Care Ctrs., LLC v. Juliano*, 2018 WL 4629517 (D.N.J. Sept. 26, 2018). The parties' franchise agreement required JNMVR to obtain Meineke's approval before relocating or selling the franchised business. The agreement also contained a territorial protection clause prohibiting Meineke from granting others the right to operate another Meineke franchise within a 3-mile radius of JNMVR's franchised business without first giving JNMVR a right of first refusal. JNMVR sought to relocate after learning that its landlord intended to sell the location of JNMVR's Meineke franchise. After several failed attempts to relocate, JNMVR found a location that was less than a mile away from another franchisee's Meineke franchise. That franchisee had the same territorial protection clause in its franchise agreement with Meineke. The two franchisees attempted unsuccessful negotiations to facilitate JNMVR's transfer to the new location. JNMVR subsequently rescinded its relocation request to Meineke and sold its assets to another car care business. Meineke sued JNMVR for breach of the parties' franchise agreement, and JNMVR counterclaimed for negligent misrepresentation and other claims.

The court dismissed all of JNMVR's counterclaims except its allegation that Meineke promised, but failed, to mediate the territorial protection dispute between the franchisees. The court's decision turned on the economic loss doctrine, which requires a claimant pursuing a tort cause of action to allege a breach of a duty that is separate and distinct from a contractual obligation. Meineke acknowledged, and the court held, that the franchise agreement did not require Meineke to mediate or help settle the franchisees' territorial dispute. Since the negligent misrepresentation claim regarding Meineke's promise to mediate alleged an independent duty outside of the scope of the agreement, the claim was not barred by the economic loss doctrine.

BANKRUPTCY

DELAWARE BANKRUPTCY COURT FINDS THAT FRANCHISE AGREEMENTS WERE NOT TERMINATED PRIOR TO BANKRUPTCY PETITION

Ruling on cross motions for summary judgment, the U.S. Bankruptcy Court for the District of Delaware found that a franchisor had failed to provide clear and unambiguous notice of its intention to terminate in notices it gave to the franchisee, so that no termination occurred prior to the filing of the franchisee's bankruptcy petition. *In re RMH Franchise Holdings, Inc.*, 2018 WL 4637456 (Bankr. D. Del. Sept. 25, 2018). RMH Franchise Holdings and its affiliates are the second-largest franchisee of Applebee's Neighborhood Bar & Grill restaurants, operating 160 restaurants in fifteen different states (some 10 percent of the Applebee's system). RMH ceased making royalty payments in June 2017. On September 20, 2017, Applebee's notified RMH of the deficiency and provided the franchisee with 90 days to cure, explicitly stating that the franchises would be terminated without further notice if RMH failed to cure during that period. Applebee's then extended the cure period several times, but did not restate its intention to terminate. Applebee's next provided an additional period of forbearance of exercising its termination rights. At the end of the forbearance period on May 8, 2018, RMH filed for bankruptcy, and Applebee's brought an independent suit and purported to terminate RMH's franchises in two states retroactive to the end of the extended cure period, on April 27, 2018. Applebee's then filed an adversary action in the bankruptcy court.

The bankruptcy court held that Applebee's failure to repeat in the cure extension letters the termination notice contained in the September 20 letter deprived RMH of clear and unambiguous notice of intent to terminate. Even if there was notice to terminate, the court held, Applebee's also forbore exercise of its remedies until the petition date, May 8. In its forbearance notice, Applebee's did not distinguish between termination and the exercise of post-termination rights. Finally, the fact that Applebee's sought to terminate certain of RMH's franchises retroactively on May 8 showed that no termination had taken effect by that date, when RMH filed its petition.

VICARIOUS LIABILITY

INVESTORS' VICARIOUS LIABILITY CLAIMS AGAINST RE/MAX ALLOWED TO PROCEED UNDER APPARENT AUTHORITY THEORY

National real estate firm RE/MAX may be held vicariously liable for the fraudulent conduct of its former broker, a Delaware court recently held, finding that the plaintiffs adequately pled that the former broker acted as an apparent agent of RE/MAX. *Patel v. Sunvest Realty Corp.*, 2018 WL 4961392 (Del. Super. Ct. Oct. 15, 2018). The dispute arose when a real estate broker formerly employed by a franchised branch of RE/MAX allegedly embezzled funds from a group of promissory note holders. After the former broker declared bankruptcy, the investors brought claims of vicarious liability, common law negligence, negligent hiring, retention, and supervision, breach of contract, and fraud against RE/MAX and the franchisee. RE/MAX moved to dismiss the claims, arguing that the plaintiffs failed to allege the existence of any legally-cognizable relationship between the former broker and RE/MAX.

The court ultimately found that the plaintiffs failed to allege the broker was RE/MAX's employee or actual agent, but allowed the vicarious liability claims to proceed under a theory of apparent authority. Under Delaware law, apparent agency in a franchise relationship exists where a third party reasonably relies on the franchisor's name and the quality it represents. Here, the plaintiffs sufficiently alleged that RE/MAX had apparent authority over the franchisee because its logo and trademark were featured prominently in the franchisee's office and website. The plaintiffs also alleged that they reached out to RE/MAX franchises because they thought the franchises would be backed by RE/MAX and "its philosophy of caring for customers." Accordingly, the court found it was reasonable to infer that the franchisee was RE/MAX's apparent agent. The plaintiffs were allowed to proceed with their claims that RE/MAX was vicariously liable for the former broker's fraudulent conduct and breach of contract, although the court indicated that these claims were not likely to succeed on the merits.

DISCOVERY

FRANCHISOR ENTITLED TO ONLY PORTION OF ACCOUNTING RECORDS REQUESTED IN DISCOVERY

A North Carolina state court recently denied in part and granted in part a franchisor's motion to compel various categories of information from a group of franchisees. *Window World of Baton Rouge, LLC v. Window World, Inc.*, 2018 WL 4649493 (N.C. Super. Ct. Sept. 26, 2018). A group of Window World franchisees sued the franchisor asserting contract, fraud, and statutory causes of action based on allegations that the franchisor knowingly and intentionally withheld information that they were entitled to receive under federal franchise law, failed to provide them access to the best available wholesale prices, and required them to execute license agreements that conflicted with the manner in which the parties had done business in the past. The franchisees sought three categories of damages: (1) the amounts they allegedly overpaid for windows, products, and services from vendors designated by the franchisor; (2) the amount of outstanding debt owed to the franchisor and assumed by certain franchisees when those franchisees acquired various Window World franchises; and (3) the amount of their advertising expenditures, which they argued built value in the Window World trademarks and brand without benefit to the franchisees.

In discovery, the franchisor sought extensive accounting records, including the franchisees' profit and loss statements, balance sheets, corporate tax returns, and individual tax returns; information related to the franchisees' pricing, individual sales, cost of goods sold, and profitability; certain advertising records and metrics; and the franchisees' transaction-by-transaction customer records. The franchisees resisted the discovery arguing that none of the information sought was relevant to their claims or theories of damages. The franchisees argued that the documents at issue related only to a lost profits theory of damages, which they did not plead and expressly disavowed. The franchisor argued that the records were necessary for its damages expert to analyze causation and damages in connection with the franchisees' claims.

The court sided, for the most part, with the franchisees. It did hold that the franchisees had to produce profit and loss statements (with redactions for a line item reflecting the attorneys' fees paid during the litigation), because those records were relevant to the franchisees' alleged overpayment damages, debt damages, and advertising damages. And, it did require the franchisees to produce a limited number of annual advertising records that related to the effectiveness and value of their advertising expenditures over the course of the franchise relationship. However, the court held that the franchisees did not have to produce the rest of the information sought, basing its decision primarily on the conclusion that such information was not relevant to the franchisees' theories of damages, but also adding that requiring production would be unduly burdensome.

PRACTICE OF FRANCHISE LAW

REVIEW OF FTC FRANCHISE RULE WILL BEGIN BY DECEMBER

In a notice published in the Federal Register on October 29, 2018, the Federal Trade Commission announced that, by December 2018, it will begin its decennial review of Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. Part 436, commonly known as the FTC Franchise Rule. The agency will review the rule and seek public comments. We will await guidance from the FTC as to the extent of the review, and will report as we learn more.

FINANCIAL ACCOUNTING STANDARDS BOARD RELEASES GUIDANCE FOR FRANCHISE INDUSTRY IMPLEMENTATION OF REVENUE RECOGNITION RULES

On November 5, 2018, the Financial Accounting Standards Board (FASB) published a staff memo addressing franchise-specific questions surrounding the implementation of the revenue recognition accounting rules set to be applicable to private companies beginning in 2019. Under the previous accounting rules, franchisors recognized the entire initial fee as income when a franchised business opened. Under the new rules and FASB guidance, initial franchise fees must be amortized over the term of a franchise agreement. However, the FASB memo allows franchisors to accelerate their recognition of income when they demonstrate that the revenue is attributable to certain discrete goods or services provided to franchisees; the distinct goods and services need not be brand specific. The FASB memo provides examples for franchisors to consider when deciding how to implement the rules and guidance.

The process of determining whether pre-opening services are distinct goods or services is highly dependent on the business, and therefore should be carefully considered with your accountants. To learn more about how revenue recognition rules and guidance may impact your business, please contact us.

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