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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DATE: **September 1, 2016—No. 209**

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

ARBITRATION

DISTRICT COURT DENIES FRANCHISOR'S PETITION TO VACATE ARBITRATION AWARD FINDING THAT TERMINATION WAS UNREASONABLE

A federal court in New York denied the petition of franchisor Benihana, Inc. to vacate an arbitration award, finding that the arbitration panel acted within its broad authority in concluding that even though Benihana had the right to terminate its license agreement with franchisee Benihana of Tokyo, LLC ("BOT"), Benihana's decision to terminate was unreasonable. *Benihana, Inc. v. Benihana of Tokyo, LLC*, No. 15-cv-7428 (S.D.N.Y. July 15, 2016). In challenging the arbitration panel's decision, Benihana conceded that the license agreement language required the panel to make two distinct inquiries: (1) whether it had the "right" to terminate the license agreement, and (2) whether its termination decision was "reasonable," which the panel interpreted to mean something akin to "fair." In the award, the arbitration panel concluded that Benihana had the contractual right to terminate the license agreement based on BOT's material breaches of the agreement, but concluded that its decision to do so was unreasonable.

Benihana's most fundamental argument in support of vacating the arbitration award was that the panel exceeded its authority in considering two factors in its reasonableness inquiry: (1) what the panel viewed as the "essential purpose" of the license agreement – keeping the Aoki family, who founded the Benihana system, in charge of BOT's restaurant, and (2) the hardship to BOT if the license agreement were terminated. Benihana argued that considering those factors effectively rewrote the license agreement's termination provisions. While the court noted that the arbitration panel's reasoning was suspect and indicated that if presented as a case of original impression the court would have reached a different result, the court held that vacatur of the arbitration award was not justified as the panel did not exceed its authority or rewrite the agreement in finding that Benihana acted unreasonably in terminating the license agreement. Specifically, the court held that because the license agreement failed to define or limit the contours of an arbitrator's "reasonableness" review, the panel did not exceed its authority in applying a flexible standard of reasonableness and considering what harm would come to BOT if the agreement were terminated.

COURT GRANTS PLAINTIFFS' MOTION FOR VOLUNTARY DISMISSAL

In *PCPA, LLC v. The Flying Butcher, LLC*, 2016 WL 3920170 (D.N.H. July 18, 2016), a federal court granted the plaintiffs' motion to dismiss their complaint without prejudice. The Flying Butcher, former franchisees of Meat House Franchising, executed a franchise agreement with Meat House that included an arbitration clause that covered disputes "arising out of or relating to operation of the Franchised Business or this Agreement." In 2014, Meat House's secured creditors entered into an Asset Purchase Agreement with one of the plaintiffs – PCPA, LLC – pursuant to which PCPA claimed that it acquired the right to enforce Meat House's franchise agreements. Shortly thereafter, PCPA claimed that The Flying Butcher improperly terminated the franchise agreement and failed to comply with their post-termination obligations under that agreement.

In response to the termination, PCPA filed a statement of claim with the American Arbitration Association against The Flying Butcher for breach of contract, trademark infringement, and unfair competition. The Flying Butcher argued that the franchise agreement was not validly transferred to PCPA and that PCPA had no right to enforce the agreement's arbitration clause. The arbitrator agreed. Shortly thereafter, PCPA commenced an action in federal court seeking a declaration that the franchise agreement was validly transferred to it, and contemporaneously submitted a motion to the arbitrator arguing, among other things, that the arbitrability questions should be decided by a court, not the arbitrator. The arbitrator eventually rejected PCPA's arguments and closed the case. Upon receiving the arbitrator's order, PCPA promptly notified The Flying Butcher that PCPA intended to dismiss its complaint without prejudice. The Flying Butcher nonetheless filed its answer later that same day, and submitted a motion for summary judgment two days later. PCPA then filed a motion to voluntarily dismiss its lawsuit without prejudice, pursuant to Federal Rule of Civil Procedure 41(a)(2).

Rule 41(a)(2) provides that "an action may be dismissed at the plaintiff's request only by court order, on terms that the court considers proper." The court observed that PCPA's motion for voluntary dismissal was filed early in the process – the pretrial conference was not yet scheduled, no discovery plan had been submitted, and no meaningful discovery had occurred. Although The Flying Butcher claimed that it had already invested significant time and effort into the matter and had filed a motion for summary judgment, the court found that such efforts were primarily the product of The Flying Butcher's own aggressive litigation strategy. In addition, PCPA argued that it moved to dismiss its claims because the arbitrator's orders had rendered many of them moot, and that a petition to vacate the arbitrator's award would be the most appropriate way to challenge the arbitrator's decision. The court agreed, granting the plaintiffs' motion to dismiss without prejudice.

SYSTEM CHANGE

COURT DENIES MOTION TO DISMISS CLAIMS BASED ON ALLEGED FAILURE TO MAINTAIN BRAND

The United States District Court for the Eastern District of Pennsylvania partially denied a motion to dismiss a complaint alleging that a transmission repair franchisor had failed to maintain its brand. *Jade Grp., Inc. v. Cottman Transmission Ctrs., LLC*, 2016 WL 3763024 (E.D. Pa. July 13, 2016). The plaintiff-franchisees entered into license agreements that allegedly required the franchisor, Cottman Transmission Centers, to "continue to develop, promote and protect the good will and reputation associated with the Cottman names and marks." In 2006, Cottman purchased the brand's most significant competitor, AAMCO, and planned to convert its Cottman franchisees into AAMCO centers. Cottman franchisees objected, leading the franchisor to change its position. By 2014, the number of Cottman franchises had dwindled, and at that time the franchisor announced that it would no longer devote any additional resources to the Cottman brand. The franchisees sued, alleging that Cottman had failed to maintain or increase the number of Cottman stores in breach of the parties' contracts and the implied covenant of good faith and fair dealing, among other claims. Cottman moved to dismiss the complaint, arguing that the claims were barred by the statute of limitations, and that there was no contractual obligation to increase or maintain store counts.

The court largely disagreed. Viewing the facts in the light most favorable to the franchisees, the court found the franchisees' claims were based not on an alleged obligation to increase or maintain store counts, but rather an alleged obligation to develop, grow, and protect the brand's goodwill. Further, because the complaint was unclear as to when the breach allegedly occurred, the court could not dismiss the franchisees' contract claims based on the statute of limitations. However, the court dismissed the good faith and fair dealing claims, since those claims were duplicative of the contract claims.

TERMINATIONS

ILLINOIS COURT DENIES MOTION TO DISMISS, PERMITS FRANCHISOR TO SEEK DECLARATORY JUDGMENT THAT TERMINATION WITHOUT CURE IS LAWFUL

The United States District Court for the Northern District of Illinois denied a motion to dismiss and permitted franchisor Tilted Kilt Franchise Operating, LLC to proceed with its request for a declaratory judgment that it had good cause to terminate its agreement with a franchise developer. *Tilted Kilt Franchise Operating v. 1220*, 2016 WL 4063172 (N.D. Ill. July 29, 2016). Tilted Kilt sought to terminate the agreement after discovering that the developer had made financial performance representations to prospective franchisees that were inconsistent with its Franchise Disclosure Document. Franchisees who did not realize the revenue that the developer had projected sought a refund of their franchise fees from Tilted Kilt, as well as other relief. The developer responded to Tilted Kilt's suit by filing a motion to dismiss, asserting, in part, that Tilted Kilt failed to state a claim under Federal Rule of Civil Procedure 12(b)(6). The court ruled against the developer on all counts.

The developer's motion first asserted that Tilted Kilt had not pleaded an "actual controversy" as required under the Declaratory Judgment Act. The court found, however, that the developer's alleged breach constituted a controversy under the Act. The court further held that a declaratory judgment action—rather than a breach of contract claim—was appropriate because Tilted Kilt's requested remedy was a declaration that termination without an opportunity to cure was proper. In response to the developer's claim that Tilted Kilt could not lawfully terminate the agreement without first providing notice and an opportunity to cure, the court examined both the Illinois Franchise Disclosure Act and the parties' agreement. Although the issue had not yet been addressed in the Seventh Circuit or an Illinois state court, the court acknowledged persuasive authority that an incurable breach obviates the need for an opportunity to cure. It further noted Tilted Kilt's argument that the developer's conduct constituted a crime that was injurious to its goodwill as well as a repeated violation of the franchise agreement, both of which are grounds to terminate a franchise agreement without providing a cure period under Illinois law. Finding that these allegations were sufficient to state a claim, the court denied the developer's motion to dismiss.

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POST-TERMINATION COVENANTS NOT TO COMPETE

FEDERAL COURT IN ARIZONA ENFORCES COVENANT NOT TO COMPETE AGAINST FORMER FRANCHISEE

An Arizona federal court enjoined a former ReBath franchisee from violating a covenant not to compete in *ReBath LLC v. New England Bath Inc.*, Bus. Franchise Guide (CCH) ¶ 15,801 (D. Ariz. July 15, 2016). ReBath, a bathroom remodeling franchisor, discovered that franchisee New England Bath, Inc. ("NEBI") conducted business outside of its exclusive territory in breach of its franchise agreement, and demanded payment of liquidated damages. NEBI refused to pay the damages and, after the agreements expired, also failed to comply with its post-expiration obligations, including a covenant not to compete with ReBath. ReBath filed suit and moved for an injunction to bar NEBI from continuing to operate a competing remodeling business in violation of the noncompete clause. NEBI argued that the noncompete clause was unenforceable for two reasons. First, NEBI argued that the covenant was unreasonable in geographic scope because it prohibited any competing activity within fifty miles of the territory. Second, NEBI argued that the covenant was substantively overbroad because it prohibited competition with ReBath in any capacity.

The court disagreed on both points. First, relying on similar cases in the franchise context, the court held that the covenant's fifty-mile radius was geographically reasonable in scope and necessary to protect ReBath's goodwill and customer bases in the territory and surrounding area. Second, relying on the plain language of the agreement, the court held that the covenant was not substantively overbroad because, despite NEBI's contentions, it only prohibited NEBI from engaging in activities related to bathroom remodeling and did not encompass the other kitchen remodeling or plumbing work that NEBI also performed.

INSURANCE

INDEMNIFICATION PROVISION IN FRANCHISE AGREEMENT NOT UNENFORCEABLE DUE TO LACK OF CONSIDERATION

A federal court in Michigan dismissed all of a franchisee's counterclaims and defenses that were based on the franchisee's claim that the franchise agreements between the parties were unenforceable due to indemnification provisions that lacked mutuality. *L.A. Ins. Agency Franchising, LLC. v. Montes*, 2016 WL 4415238 (E.D. Mich. Aug. 19, 2016). Claudia Montes entered into several franchise agreements with L.A. Insurance Agency Franchising, LLC. LA Insurance subsequently sued Montes for breach of the franchise agreements. In turn, Montes asserted several counterclaims and affirmative defenses including lack of consideration. Montes also argued lack of mutuality due to an indemnification provision in the franchise agreements that required her to indemnify LA Insurance for contractual or tort liabilities arising out of Montes' operation of the franchised businesses.

Montes claimed that she could not sue LA Insurance for breach of the franchise agreements because of the existence of the indemnification provision. The court rejected Montes' argument finding that the indemnity provision was narrow and did not exempt LA Insurance from liability if it breached its own contractual obligations to Montes. In so holding, the court distinguished a case cited by Montes which held that a franchise agreement was unenforceable because it included a provision stating that the franchisor was not liable for damages of any kind on account of any event or cause whatsoever.

VICARIOUS LIABILITY

APPELLATE COURT AFFIRMS THAT FRANCHISOR IS NOT VICARIOUSLY LIABLE FOR FRANCHISEE'S ACTS

The Kentucky Court of Appeals recently affirmed the dismissal of a complaint against six Domino's Pizza entities on a motion for summary judgment. *Johnson v. Seagle Pizza, Inc.*, 2016 WL 4410705 (Ky. Ct. App. Aug. 16, 2016). The case arose from a robbery at a Domino's franchise in Kentucky. At the time of the armed robbery, Crystal Roberts, an employee of the franchise, was on break behind the store, talking on the phone with her boyfriend, who lived a block away. The robber forced Roberts back into the store and demanded money. As the assailant was fleeing, he shot and killed Roberts' boyfriend who had run to the store after becoming aware of the situation. The victim's son, who claimed to have witnessed the shooting, brought suit against the franchisee, the building's lessor, Roberts, and Domino's for wrongful death and negligent infliction of emotional distress. The complaint alleged that Domino's was vicariously liable for the franchisee's negligent actions because it controlled the store's security procedures, procedures relating to the handling of cash, and its choice of very late operating hours. The lower court dismissed the complaint against Domino's on a motion for summary judgment, and the plaintiff appealed.

The appeals court affirmed the lower court's decision holding that Domino's could not be held vicariously liable because it did not control or have the right to control the daily operation of the specific aspects of the franchisee's business that caused the harm. The court held that Domino's did not have control over the third-party's criminal acts, nor did it have control over Roberts' actions in propping the door open, the store being open late, or the store operating primarily in cash. In doing so, the court explained that the primary question was not whether Domino's established ubiquitous franchise standards, but whether it retained control over the implementation of those standards.

The court held that Domino's did not retain control over the implementation of those standards because the Domino's operations manual clearly explains that the procedures contained therein are minimum operating standards which exist to protect the Domino's trademark, and the franchisee alone was responsible for signing its lease, supervising its employees, and maintaining its own security. In making its ruling, the court relied on, and reaffirmed, the seminal franchisor vicarious liability case in Kentucky, *Papa John's International, Inc. v. McCoy*, 244 S.W.3d 44 (Ky. 2008).

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