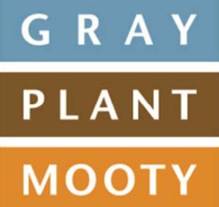

The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

FROM: GRAY PLANT MOOTY'S FRANCHISE AND DISTRIBUTION PRACTICE GROUP

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In this issue of *The GPMemorandum*, we will begin with the next in our yearlong series of retrospective articles in celebration of our 15th year of publication. We will then summarize those decisions of interest to franchisors that have been issued recently.

RETROSPECTIVE

WHAT HAPPENED AFTER THE AMERICANS WITH DISABILITIES ACT CASES OF THE 1990s?

This is the second in our series of articles reviewing the progeny of what we identified in our December 2007 ten-year anniversary edition as the most significant franchise case decisions summarized in Issues 1 through 100 of *The GPMemorandum*, which covered the period from late 1997 through 2007. The second of those ten significant rulings was *United States v. Days Inns of America, Inc.*, which actually represented a series of cases brought around the country against franchisors under the building accessibility requirements of the Americans With Disabilities Act. (Gray Plant Mooty defended many of those cases.) The main *Days Inns* case ended in 1998 and, nine years later, *The GPMemorandum*'s ten-year anniversary issue reported that the ADA cases were an example of "what did *not* become a long-lasting issue."

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Today, after the time period covered by Issues 101-151 of *The GPMemorandum*, it is clear that the volume of ADA litigation has continued to be very small. In fact, the only case we have reported during those four years (and the only one since *Days Inns* in 1998) has been the California federal court case of *Vallabhapurapu v. Burger King Corp.* Unlike *Days Inns* and the other cases from the 1990s, which had been filed by the federal government, *Vallabhapurapu* was a nongovernmental action brought on behalf of a class of private-party customers who alleged that the restaurants in question were inaccessible to customers in wheelchairs, in violation of the federal ADA and California statutes. In one May 2011 ruling in that case, the court denied the franchisor's motion to dismiss—a motion brought based on standing and the failure to join necessary parties. *Vallabhapurapu* is part of a series of attempted class action lawsuits against Burger King as franchisor of 96 restaurants leased to franchisees in California. Another case in the same series, *Castaneda v. Burger King Corp.*, apparently had settled by the time of the May 2011 ruling in *Vallabhapurapu*. In both cases, all that we summarized were initial procedural skirmishes about whether the franchisees were "necessary parties" to the cases. No final, substantive rulings were reported.

The lack of cases involving either private-party or federal challenges under the ADA and similar statutes is itself very significant. If the *Days Inns* cases had gone strongly against the franchisors, and if the government (or private parties) had continued to bring such claims, they could have resulted in substantial exposure and liability.

POST-TERMINATION INJUNCTIONS: NONCOMPETE COVENANTS

COURT ENJOINS FORMER FRANCHISEES FROM COMPETING FOR TWO YEARS WITHIN 100 MILES OF FORMER TERRITORY OR THAT OF ANY OTHER FRANCHISEE

In *Outdoor Lighting Perspective Franchising, Inc. v. Home Amenities, Inc., et al.*, 2012 U.S. Dist. LEXIS 5406 (W.D.N.C. Jan. 18, 2012), the United States District Court for the Western District of North Carolina granted Outdoor Lighting Perspectives Franchising, Inc.'s (OLP's) motion for a preliminary injunction, enjoining a former franchisee from continuing to operate a competing business within its former territory or that of another franchisee for a period of two years. Gray Plant Mooty represented OLP.

The court concluded that a "franchisor's goodwill and reputation would be damaged if a terminated franchisee continued to operate a directly-competitive business in the same location (or market) under a different name." It specifically held that the two-year term of the covenant was reasonable. As for geography, OLP requested that the court blue pencil the covenant so as to delete a 100-mile buffer and enforce the noncompete agreement within the former franchisee's territory or any other franchisee's territory. The court agreed to blue pencil the clause and also ruled that the former franchisees

could not skirt the noncompete by operating their new business under a different corporate name. In so holding, it noted that the former franchisees had agreed to be personally bound by the franchise agreement, and also that Rule 65 of the Federal Rules of Civil Procedure specifies that the scope of every injunction includes the parties, their officers, agents, servants, employees, and attorneys, and other persons who are in active concert or participation with them. The court issued the injunction for two years from the date of the order with no requirement that OLP post a bond.

CLAUSE BARRING FORMER FRANCHISEE FROM EMPLOYMENT IN ANY CAPACITY IN COMPETING BUSINESS VOIDED IN GEORGIA AS "OVERLY BROAD"

In *Fantastic Sams Salons Corp. v. Maxie Enterprises, Inc. and Paul Rubin*, 2012 U.S. Dist. Lexis 8106 (M.D. Ga. Jan. 24, 2012), a former Fantastic Sams franchisee continued to operate a hair salon at its Fantastic Sams location after termination of the franchise agreement. In response to Fantastic Sams' suit to enforce its noncompete agreement, the franchisee argued that the noncompete should be declared invalid under Georgia law. The clause at issue prohibited the former franchisee from "directly or indirectly participating as an owner, partner, member, director, officer, employee . . . or serv[ing] in any other capacity" in any business similar to Fantastic Sams (a) within a five mile radius of the franchised salon for a period of two years and (b) within a two-and-a-half-mile radius of any other Fantastic Sams location for a period of two years or the remaining term of the Franchise Agreement, whichever was greater. The franchise agreement in this case was not set to expire until 2019, nine years after the termination date.

Fantastic Sams conceded that the nine-year term of its clause was unenforceable under Georgia law, but asked that the court sever that provision from the other noncompete clause in the franchise agreement. The court found, however, that the other provision was also invalid, stating that "even though the time (two years) and territory (five mile radius) restrictions are likely reasonable . . . the scope restriction is not." The court held that restricting the former franchisee from serving in "any other capacity" in any business similar to Fantastic Sams was overbroad and noted that Fantastic Sams failed to provide any evidence that the scope was appropriate in this case. Because Georgia's "blue pencil" law was not passed until 2010, the court could not modify the noncompete agreement as written in the 2008 franchise agreement.

COURT DENIES FRANCHISEES' MOTION TO DISMISS CLAIM OF BREACH BASED ON UNDERPAYMENT OF ROYALTIES AND NONCOMPETE VIOLATION

In *Novus Franchising, Inc. v. Livengood*, 2012 U.S. Dist. LEXIS 2610 (D. Minn. Jan. 8, 2012), a Minnesota federal court denied the franchisees' motion to dismiss Novus' claim for breach of contract based on the franchisees' continued operation of their

business during the post-term noncompete period, failure to pay required fees and royalties, underreporting of revenues, and failure to submit accurate financial information. The dispute arose when Novus learned that the franchisees had underpaid their royalties by roughly $10,000 through the end of the franchise term. After the franchise agreement expired, Novus learned that the franchisees continued to operate their business within their designated area. Novus filed suit to collect amounts owed under the franchise agreement and enforce the franchisees' covenant against competition.

The franchisees moved to dismiss the complaint on the grounds that Novus failed to comply with the franchise agreement's alternative dispute resolution clause and failed to state a claim for relief because the noncompete provision was unenforceable under Kansas law. The court denied the motion to dismiss in its entirety. The franchisees argued that the franchise agreement required Novus to engage in good faith negotiations with them before commencing any legal action. The court determined that resolution of this claim was inappropriate on a motion to dismiss because the parties presented conflicting facts about Novus' efforts to contact the franchisees before filing suit. The franchisees also argued that Kansas courts typically void covenants not to compete to the extent that they restrain a person's ability to exercise his trade or calling. The court concluded that it could not determine the enforceability of the covenant not to compete at this stage of the litigation because issues of fact remained concerning its purpose, its effect on the franchisees and the public interest, and the reasonableness of its geographic and temporal restrictions.

ARBITRATION

ARBITRATION VENUE AND CHOICE OF LAW PROVISION IN FRANCHISE AGREEMENT STRUCK DOWN

The Washington Court of Appeals recently upheld a lower court decision affirming an arbitration award against a franchisor after the trial court refused to enforce the venue requirements in the franchise agreement's arbitration clause. In *Saleemi v. Doctor's Associates, Inc.*, 2012 Wash. App. LEXIS 96 (Wash. Ct. App. Jan. 24, 2012), the defendant-appellant (DAI) was the franchisor of Subway restaurants. Saleemi was a franchisee with three restaurants in the state of Washington. DAI alleged that the plaintiff had breached its franchise agreement by violating its noncompetition clause and demanded arbitration in Connecticut, as the contract provided. The plaintiff then filed a lawsuit in Washington state court alleging that it was not given the opportunity to cure the default. DAI moved to compel arbitration in Connecticut pursuant to the franchise agreement. The trial court compelled arbitration, but found the arbitration venue requirement unconscionable and ordered arbitration to be held in Washington under Washington law.

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The franchisee prevailed and was awarded damages in the arbitration proceeding. DAI then moved the trial court to vacate the arbitration award, arguing that its original order to arbitrate in Washington was improper. The trial court refused, relying in part on the franchisor's failure to object to the arbitration order prior to participating in the arbitration. The appellate court affirmed the trial court's decision to confirm the arbitration award, not based on the franchisor's attendance at the arbitration without protest, but because the franchisor was not prejudiced. The appellate court reasoned that the same association conducted the arbitration (AAA), there was no evidence of any advantage DAI would have received by physically arbitrating in Connecticut instead of Washington, and there were no differences between the applicable Connecticut and Washington laws governing the decision.

COURT UPHOLDS ARBITRATION CLAUSE BUT FINDS UNCONSCIONABLE REQUIREMENT THAT PLAINTIFF ADVANCE COSTS

The United States District Court for the Southern District of Ohio recently enforced a franchise agreement's arbitration provision, rejecting a franchisee's claim of unconscionability. In *Rodriguez v. Tropical Smoothie Franchise Development Corp.,* 2012 U.S. Dist. LEXIS 750 (S.D. Ohio, Jan. 4 2012), a franchisee brought suit against the franchisor of the Tropical Smoothie chain alleging that Tropical Smoothie violated state franchise disclosure laws, resulting in failure of the franchisee's business. Tropical Smoothie moved to dismiss or stay the proceedings and compel arbitration, noting that the franchise agreement required all disputes to be submitted to binding arbitration in Atlanta, Georgia. In response, the franchisee asserted that the arbitration clause was "unconscionable."

To be invalidated as unconscionable, an arbitration clause must be found both *procedurally* and *substantively* unconscionable. Substantive unconscionability looks to whether the actual terms of the arbitration clause are "outrageously unfair" so as to "shock the judicial conscience." Here, the plaintiff argued that the arbitration clause was substantively unconscionable because it was mandatory, it required arbitration in Atlanta (he lived in Ohio), it required three arbitrators with experience in franchise law, it excluded class actions and punitive damages, it placed a one-year limit on claims, and it required the party seeking arbitration to initially pay the arbitrator fees and costs. The court found none of these provisions troubling or unusual, save the last one. The court held that, in light of the franchisee's dire financial circumstances and an initial estimate of arbitrator's fees and costs ranging between $20,000 and $40,000, the requirement that the initiating party front all arbitration costs would in effect prevent the plaintiff from asserting any claims. This was true even though the arbitration clause ultimately gave the arbitrator freedom to award costs to the prevailing party.

Procedural unconscionability looks to the manner in which the arbitration agreement was entered. For example, an arbitration provision "hidden in a maze of fine print" has been found procedurally unconscionable. The plaintiff admitted that it had not read the franchise agreement (or the arbitration clause) before signing, which is typically a bar to a claim of procedural unconscionability. The plaintiff argued, however, that because we live in a society in which consumers frequently are required to sign various user and license agreements without reading them, his failure to read the franchise agreement should not be dispositive. The court rejected this reasoning, noting that the franchise agreement was a business contract, not a consumer agreement, and that the plaintiff was a college-educated businessperson. Because both parts of the unconscionability test were not met, the franchisor's motion to dismiss the court action was granted.

FRAUD

CALIFORNIA COURT OF APPEALS REVERSES LOWER COURT'S GRANT OF SUMMARY JUDGMENT IN FAVOR OF FRANCHISOR

The California Court of Appeals, Second Appellate District, has reversed a trial court's grant of summary judgment in favor of a franchisor regarding its former franchisees' claims for negligent misrepresentation and violation of the California Franchise Investment Law and the California Corporations Code. *D.T. Woodard, Inc. v. Mail Boxes Etc., Inc., et al.*, 2012 Cal. App. Unpub. LEXIS 242 (Cal. Jan. 12, 2012). Mail Boxes Etc., Inc. (MBE), a franchisor of packaging and shipping businesses, was acquired by United Parcel Service, which changed the franchise name to "The UPS Store" and altered the franchise system. The plaintiff, an MBE franchisee, converted its existing franchises into The UPS Store franchises. Subsequently, the plaintiff brought suit against MBE, alleging that MBE had misled it into converting its stores, thus committing negligent misrepresentation and breaching the California Franchise Investment Law and the California Corporations Code. The trial court granted MBE's motion for summary judgment, finding that the plaintiff failed to show any false statements of material fact or justifiable reliance and failed to produce evidence of damages cause by the misrepresentation. The plaintiff appealed this decision.

In reversing the summary judgment, the court of appeals found that the plaintiff raised triable issues as to whether MBE made false or misleading representations about the past performance of The UPS Store model in market tests. The court also found that MBE failed to show that the plaintiff did not rely on misrepresentations MBE made in documents presenting market test summaries. Finally, the court found that the disclaimers MBE put in the market test summaries provided to the plaintiff were not effective to preclude plaintiff's reliance on misrepresentations and omissions of fact in the reporting of test results and of the testing procedures that produced those results.

POST-TERMINATION INJUNCTIONS: TRADEMARK/SERVICEMARK VIOLATIONS

CALIFORNIA FEDERAL COURT ENJOINS USE OF CONFUSINGLY SIMILAR NAME

In *Country Inns & Suites By Carlson, Inc. v. Camarillo Hospitality, LLC*, Case No. SACV 11-1802 AG (ANx) (N.D. Cal. Jan. 9, 2012), a case handled by Gray Plant Mooty, the franchisor filed a motion for preliminary injunction seeking to prevent the defendant from using and/or infringing upon its registered trademarks in promoting its new hotel as the "Camarillo Country Inn & Suites." The hotel had been operated as a Country Inn & Suites By Carlson system hotel for over twelve years, but the former franchisee had recently been terminated and the property repossessed by its lender. In granting the franchisor's motion, the court held that the name Camarillo Country Inn & Suites was confusingly similar to the Country Inn & Suites By Carlson trademark. The court noted that the confusion was amplified by the defendant's use of an exterior sign that was nearly indistinguishable from the franchisor's trademarked sign. In addition, the court held that the franchisor had demonstrated irreparable harm and actual confusion by providing evidence from a dissatisfied guest of Camarillo Country Inn & Suites, who had posted a review on Expedia.com revealing that the guest believed the hotel continued to be affiliated with the franchisor's system. The court found that such confusion and harm was precisely the type that federal trademark law seeks to prevent.

FEDERAL COURT DENIES FRANCHISOR'S MOTION FOR A PRELIMINARY INJUNCTION FOLLOWING TERMINATION OF FRANCHISEE

In *KFC Corp. v. JRN, Inc.*, 2012 U.S. Dist. LEXIS 6127 (W.D. Ky. Jan. 19, 2012), a federal district court denied a franchisor's motion for a preliminary injunction seeking to prevent the continued operation of multiple franchises. KFC had terminated ten franchises owned by JRN, Inc., one of its largest franchisees, for not meeting a remodel schedule agreed to after its franchise agreements had gone into effect. KFC sued to enforce the terminations, taking the position that a breach of these ancillary agreements also constituted a breach of the underlying franchise agreements. The franchisor then filed a preliminary injunction motion to prevent the franchisee's continued use of its trademarks, trade secrets, and business system. The court concluded, however, that KFC failed to show a strong likelihood of success because there was a factual dispute over "whether the parties agreed in writing to amend the Remodel Agreement and, if so, upon what new terms they did so." The court also held KFC had not demonstrated it would suffer irreparable harm from the continued operation of the locations with an outdated image because some of the restaurants had been remodeled to some degree, while the others had the same image as some corporate-owned locations. The court also emphasized that KFC continued to receive

royalty payments from the restaurants and that closing the locations "would cause a substantial harm to JRN and its employees, while serving no identifiable public interest."

The court subsequently denied JRN's motion for its attorneys' fees and costs in defending against the preliminary injunction motion. *KFC Corp. v. JRN, Inc.*, 2012 U.S. Dist. LEXIS 6122 (W.D. Ky., Jan. 19, 2012). It noted that while the franchise agreements allowed the franchisee to recover its fees and costs if it "prevail[ed] entirely" in an action brought by KFC, successfully defending against a preliminary injunction motion did not constitute the entire action. The court also declined to find that KFC had engaged in bad faith or abuse of the judicial process by filing its motion.

RENEWALS

CALIFORNIA APPELLATE COURT FINDS NO BREACH IN THE RENEWAL OF FRANCHISE AGREEMENTS

The California Court of Appeals, Second Appellate District, affirmed a trial court's ruling that a franchisor did not breach the franchise agreements with its former franchisees by refusing to renew their franchises on the same terms found in their original franchise agreements. *G.I. McDougal, Inc. v. Mail Boxes Etc., Inc.*, 2012 Cal. App. Unpub. LEXIS 243 (Cal. Jan. 12, 2012). As described earlier in this memorandum, MBE was the franchisor of packaging and shipping businesses that was acquired by United Parcel Service, which changed the franchise name to "The UPS Store." Converting from an MBE to The UPS Store was required upon a franchisee's renewal. This plaintiff refused to convert its MBE franchises to The UPS Store and alleged that UPS breached the MBE franchise agreements by refusing to renew its franchises. The plaintiff filed suit against MBE and UPS, alleging that the franchise agreements gave it the right to renew those agreements and that MBE breached the agreements by refusing to permit renewal on the same material terms and conditions found in its existing agreements. The trial court found in favor of the franchisor, and the plaintiff appealed.

On appeal, in affirming the trial court's judgment, the court of appeals noted that the franchise agreements' renewal provision specifically stated that "[s]uch renewal shall be effected by the execution of an appropriate document extending the term of this Agreement on the same terms and conditions as are contained in the then current Franchise Agreement for the sale of new MBE Centers." Thus, the court found that this language refuted any argument that the franchise agreements required MBE to renew the agreements intact and without change. The court held that the franchise agreements gave MBE the right to change the name and trademarks of the franchises and that by requiring plaintiff to sign franchise agreements for The UPS Store upon renewal, MBE was not in breach of plaintiff's original franchise agreements.

BANKRUPTCY

DISTRICT COURT REVERSES BANKRUPTCY COURT'S RULING ON SEVERABILITY OF WORKOUT AGREEMENTS AND REINSTATES FRANCHISE AGREEMENTS

In *In re Wagstaff Minnesota, Inc.,* 2012 U.S. Dist. LEXIS 372 (D. Minn. Jan. 3, 2012), the United States District Court for the District of Minnesota reversed a United States Bankruptcy Court decision by holding that a comprehensive set of Workout Agreements involving four separate contracts (Reinstatement Agreement, Addendum to Reinstatement Agreement, Letter Agreement, and KFC Franchise Agreement, collectively "Workout Agreements") should be interpreted as forming one executory contract. Under the Bankruptcy Code, all defaults under an executory contract must be cured or assured of being promptly cured before the specific executory contract can be assumed and/or assigned under 11 U.S.C. § 365. The debtor in this case operated 77 separate KFC restaurants as a KFC franchisee. After the debtor defaulted under the KFC franchise agreements, KFC terminated all 77 franchise agreements. Through negotiations, the debtor and KFC entered into a set of Workout Agreements for each of the 77 restaurants designed to replace the terminated KFC franchise agreements with new ones, which would provide the debtor with a short window to sell its KFC restaurants.

At issue in the Bankruptcy Court was whether the debtor could assume the new franchise agreements without also having to assume the obligations under the other Workout Agreements associated with each restaurant. The bankruptcy court held that each set of Workout Agreements did not constitute one indivisible executory contract. The district court disagreed and found that all four Workout Agreements were part of one indivisible executory contract for each restaurant. Accordingly, the debtor was required to comply with the terms of all four agreements before it could assume and assign any of the 77 KFC franchises it currently operated.

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