GRAY PLANT MOOTY

# *The GPMemorandum*

**TO:** **OUR FRANCHISE CLIENTS AND FRIENDS**

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

**Quentin R. Wittrock, Editor of *The GPMemorandum***

**DATE:** **March 26, 2008 – No. 105**

Here are some of the most recent legal developments of interest to franchisors:

## ANTITRUST

### FIFTH CIRCUIT AFFIRMS DISMISSAL OF ANTITRUST COUNTERCLAIM AGAINST FRANCHISOR

The United States Court of Appeals for the Fifth Circuit recently affirmed the dismissal of a distributor's antitrust counterclaim against a franchisor in a lawsuit brought by the franchisor against the distributor. *Schlotzsky's, Ltd. v. Sterling Purchasing & National Distrib. Co.*, 2008 WL 588640 (5th Cir. March 5, 2008). The most important aspect of the case for franchisors is the analysis of relevant market issues in the franchise context.

Plaintiff Schlotzky's is the franchisor for a quick-serve restaurant system and owner of the related trademarks and associated rights. Sterling was a non-exclusive supply chain manager for the Schlotzky's system. After Sterling began to hold itself out to manufacturers and other distributors as the exclusive representative for purchasing and distribution of all goods and services within the Schlotzky's system, Schlotzky's filed suit alleging false designation under the Lanham Act. Sterling counterclaimed that the Schlotzky's mandate to its franchisees to purchase at least 95 percent of their products from two new distributors was an illegal tying arrangement under Section 1 of the Sherman Act, and that it constituted tortious interference with Sterling's relationship with Schlotzky's franchisees. The district court awarded Schlotzky's extensive injunctive relief and attorneys' fees on its Lanham Act claim and dismissed Sterling's antitrust and tortious interference counterclaims.

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On appeal, the Fifth Circuit affirmed the dismissal of Sterling's antitrust counterclaim and drew the distinction between market power, which is required to support a tying claim under the Sherman Act, and contractual power. It noted that each of the Schlotzky's franchise agreements gave Schlotzky's the right to establish system-wide quality standards, specify approved products, and designate manufacturers and distributors for products in which Schlotzky's had a proprietary interest. Citing the Third Circuit's 1997 decision in *Queen City* and the Fifth Circuit's own *United Farmers* decision from 1996, the court held that economic power derived from such contractual agreements "has nothing to do with market power, ultimate consumer welfare, or antitrust," and that Sterling's exclusion from future business with Schlotzky's franchisees was a termination that was consistent with Sterling's status as a non-exclusive supply chain manager. The court held that, even if Schlotzky's required franchisees to turn from Sterling to the other two distributors as part of the franchisees' continuation of doing business under that name, such a requirement was not an antitrust "tying arrangement" because it was not an exercise of market power but of contractual power.

## TERMINATIONS

### COURT DENIES FRANCHISEES' MOTION FOR SUMMARY JUDGMENT, HOLDING FRANCHISOR COMPLIED WITH TERMINATION PROVISIONS

In *Dunkin' Donuts Franchised Restaurants v. Agawam Donuts, Inc.,* 2008 WL 619399 (D. Mass. March 5, 2008), a case being handled by Gray Plant Mooty, Dunkin' Donuts seeks to enforce its termination of 52 franchise agreements entered into with the defendants. As Dunkin' Donuts stated in its notices of termination and complaint, the terminations were based on the defendants' failure to comply with specific provisions of the franchise agreements, including those prohibiting them from: (1) violating federal labor, tax, and immigration laws, (2) engaging in activities injurious to Dunkin' Donuts' goodwill, (3) committing crimes, (4) allowing the franchises to be used for unlawful purposes, and (5) failing to keep accurate books and records. Dunkin' relied upon each basis as independent grounds for terminating the franchise agreements.

Before producing any discovery, the defendants filed a motion for summary judgment. The defendants argued that Dunkin' did not provide "proof" of the violation of the crimes committed provision at the time of the termination and that Dunkin', according to the defendants, failed to provide a cure period for those violations. As the court explained, however, the plain language of the franchise agreements specifically stated that the defendants were not entitled to a cure period for the very conduct alleged. The court further held that the defendants' assertion that Dunkin' had not relied on this provision in terminating the franchise agreements was "patently false" and belied by

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both the complaint and notices of termination. Because Dunkin' identified numerous bases for terminating the franchise agreements and complied with its contractual obligations in doing so, the court denied the defendants' motion.

## SYSTEM CHANGE

### COURT WILL NOT DISMISS TORTIOUS INTERFERENCE WITH CONTRACT CLAIM AGAINST ACQUIRING PARENT OF RE-BRANDING FRANCHISOR

In *Hyatt Corp. v. Epoch-Florida Capital Hotel Partners, Ltd.*, 2008 WL 490121 (M.D. Fla. Feb. 20, 2008), the United States District Court for the Middle District of Florida refused to dismiss a franchisee's breach of contract claims against the franchisor's parent corporation, finding that the parent was a "stranger" to the contract at the time it purchased the subsidiary franchisor such that breach of contract and tortious interference with business relationship actions could proceed against the company.

Hyatt Corporation purchased the AmeriSuites hotel chain and decided that it would cease operating the AmeriSuites brand and instead rebrand qualifying AmeriSuites hotels to the "Hyatt Place" brand. Hyatt stopped advertising and promoting the AmeriSuites brand and diverted support and resources from AmeriSuites to Hyatt Place. The case was originally brought by Hyatt against a holdover AmeriSuites franchisee that it terminated for nonpayment of fees. The franchisee counterclaimed, alleging that Hyatt had tortiously interfered with its franchise agreement with AmeriSuites by refusing to allow the franchisee to rebrand as a Hyatt Place hotel and by ceasing its support of the AmeriSuites brand. Hyatt moved to dismiss, arguing that its status as parent corporation of the AmeriSuites subsidiary made it legally impossible to "interfere" with the contract because Hyatt was in effect a party (not a "stranger") to that contract. Hyatt was invoking the rule that a party cannot be held liable for interfering with its own contract. The court disagreed, finding that Hyatt was a stranger to the contract at the inception of the franchise relationship (i.e., when the franchisee purchased an AmeriSuites franchise), and that there was sufficient evidence that Hyatt had maliciously used its influence as the parent corporation of the new franchisor to breach the franchise agreement.

## PROCEDURE

### FEDERAL COURT DENIES PROTECTIVE ORDER TO STOP DEPOSITION OF COUNSEL, BUT GRANTS FRANCHISOR'S MOTION TO STRIKE JURY DEMAND

In a franchise termination case, the United States District Court for the Eastern District of Pennsylvania recently denied AAMCO's motion for a protective order to stop the deposition of its in-house counsel who signed the termination letter, but granted the franchisor's motion to strike the franchisee's jury demand. *AAMCO Transmissions, Inc. v. Baker,* 2008 WL 509220 (E.D. Pa. Feb. 25, 2008).

AAMCO sought the admission of its vice president and general counsel, James Goniea, to practice before the court for the purpose of the case. The franchisee opposed the admission of Mr. Goniea solely on the grounds that he was or likely would be a trial witness, and sought the deposition of Mr. Goniea. The court granted the pro hac vice motion, but found that while a deposition of opposing counsel can be troublesome, there is nothing in the federal rules that precludes it. Thus, the court denied AAMCO's motion for a protective order to stop the deposition, concluding that it would be inappropriate to deny the questioning of Mr. Goniea concerning his involvement in the decision to terminate. This is why some franchisors do not have potential trial counsel sign letters to franchisees.

The court did grant AAMCO's motion to strike the franchisee's jury demand, relying upon the jury trial waiver provision set out in the franchise agreement. The court found that the right to a jury trial can be waived as long as that waiver is properly deemed to be knowing and voluntary. Here, the court stated that the franchisee had a high level of sophistication, had carefully vetted the business opportunity, and it was an opportunity he wanted to pursue. The court determined that the franchisee knowingly and voluntarily waived a trial by jury.

## FRANCHISE CONTRACTS

### ELEVENTH CIRCUIT HOLDS EXCLUSIVITY OF FRANCHISE AGREEMENT LIMITED TO SERVICES DESCRIBED IN AGREEMENT

In *AAA Abachman Enterprises, Inc. v. Stanley Steemer Intern., Inc.*, 2008 WL 624040 (11th Cir. March 10, 2008), the plaintiff's franchise agreement granted exclusive rights to use the Stanley Steemer trademarks in the carpet and upholstery cleaning business, within a specified territory. The franchisor later granted exclusive rights in the same territory to other companies to operate a "Stanley Steemer Duct Cleaning Business." The plaintiff alleged that this grant of rights in connection with duct cleaning violated the exclusivity provision of plaintiff's franchise agreement. A federal district court in Florida granted the franchisor's motion for summary judgment, holding that the franchise agreement between the parties only provided exclusivity as to carpet and upholstery cleaning.

The plaintiff appealed, but the Eleventh Circuit affirmed. After a *de novo* review of the contract language, the court concluded that the contract language was unambiguous. The agreement gave the franchisee the exclusive right "to own and operate a Stanley Steemer carpet and upholstery business (hereinafter referred to as a 'Stanley Steemer Business'). . . in the 'Franchisee's Area' and to use the trademarks . . . solely in a Stanley

Steemer Business in that area and in no other manner." Although the royalty provision required that royalties be paid on all sales resulting from or "associated with the name Stanley Steemer," the court held that the language "in no other manner" in the first provision clearly limited the exclusive grant of rights to only carpet and upholstery cleaning.

### FRANCHISOR WINS ON LIABILITY ISSUES BUT MUST PROVE DAMAGES

A Pennsylvania federal court in *Khan v. GNC Franchising LLC*, 2008 WL 612749 (W.D. Pa. March 3, 2008), granted a partial victory to franchisor GNC Franchising seeking to terminate franchisees based on non-payment. The court, however, denied the franchisor's summary judgment motion requesting breach of contract damages because they were not proved with certainty. The franchisees presented evidence showing that they paid some of the outstanding amount owed, although it was not clear how much they had paid. The decision is a reminder that damages even in non-payment cases must be proved with certainty to succeed on a breach of contract claim.

The court also denied, among other things, the franchisees' counterclaims alleging that the franchisor had wrongfully terminated them in breach of the implied covenant of good faith and fair dealing. The court sided with the franchisor that Pennsylvania law only recognizes the covenant when a franchisor terminates for reasons not explicitly set forth in the franchise agreement. Requiring the franchisees to pay the franchisor's royalty fees and other fees were clearly required under the contract.

## CLASS ACTIONS

### WITH NO CLASS REPRESENTATIVE REMAINING, COURT DISMISSES PUTATIVE CLASS ACTION ON RECONSIDERATION

In Issue 103 of *The GPMemorandum*, we reported that a federal court had granted a motion for class certification in *Quadrel v. GNC Franchising, L.L.C.*, 2007 WL 4241839 (W.D. Pa. Nov. 29, 2007). On February 20, 2008, however, that court granted the defendant's motion for reconsideration and dismissed the purported class action. *Quadrel v. GNC Franchising, L.L.C.*, 2008 WL 474260 (W.D. Pa. Feb. 20, 2008). GNC's motion for reconsideration of the class certification order argued that, after the court had certified the class, the single named class representative had settled his claims against GNC and entered into a full release of claims. GNC argued that the class representative's release barred him from serving as a class representative. Without a class representative, GNC argued that the case against it could not proceed.

The court agreed, finding that the named representative's release barred him from serving as a class representative. The court also found that the named representative lacked standing to seek leave to substitute an alternative class representative as no live claim existed before the court. Without a valid pending claim by any existing plaintiff, the court found that the case was required to be dismissed due to lack of jurisdiction.

## ARBITRATION

### FOURTH CIRCUIT VACATES AWARD BECAUSE FRANCHISOR FAILED TO PROVIDE PROPER NOTICE OF ARBITRATION PROCEEDING

In *Choice Hotels Int'l, Inc. v. SM Property Management, LLC*, 2008 WL 518807 (4th Cir. Feb. 28, 2008), the franchisor had sought in federal court to confirm an arbitration award that it obtained by default against one of its franchisees. In response, the franchisee moved to vacate the arbitration award on the ground that it did not receive proper notice of the arbitration proceeding because no notice was ever sent to the franchisee's designated representative, as required by the franchise agreement. The federal district court vacated the arbitration award upon determining that the franchisor failed to serve the franchisee with the arbitration demand at the correct address and, thus, failed to properly notify the franchisee of the arbitration.

On appeal, the franchisor argued that the district court lacked authority to second guess the arbitrator's finding that the franchisee had been properly notified of the arbitration proceeding. The Fourth Circuit rejected the franchisor's argument and affirmed the district court on the grounds that: (1) there was no evidence to suggest that the arbitrator ever was asked to resolve the issue of whether the franchisee's designated representative was served, as required by the franchise agreement; (2) there was no evidence suggesting that the franchisee had received notice of the arbitration proceeding until after the arbitration award had been issued; and (3) the franchisor had explicitly acknowledged, through its past conduct, that it was aware of the name and address of the franchisee's designated representative.

Ultimately, the Fourth Circuit determined that the plain language of the franchise agreement required the franchisor to provide notice of the arbitration hearing to the franchisee's designated representative. Because the franchisor failed to do so, the court determined that the franchisee had not received proper notice of the arbitration hearing, which was grounds for the federal courts to vacate the arbitration award.

## VICARIOUS LIABILITY

### COURT UPHOLDS SUMMARY JUDGMENT IN FAVOR OF FRANCHISOR DUE TO PLAINTIFF'S FAILURE TO MEET NOTICE PLEADING REQUIREMENTS

In *Youngblood v. Higbee*, 2007 WL 427765 (Idaho Feb. 19, 2008), the trial court had granted summary judgment in favor of the defendant franchisor on a negligence claim based on a franchised repair shop's alleged service of the plaintiff's vehicle brake system prior to an automobile accident. The plaintiff claimed that the franchisor failed to exercise due care when repairing the brake system, which caused the plaintiff's injury. On appeal, the Idaho Supreme Court affirmed the summary judgment to the franchisor.

The high court noted that it could not sustain the plaintiff's complaint "if it fails to make a short and plain statement of a claim upon which relief may be granted." In this case, the court found it was undisputed that the franchisor did not directly perform any work on the plaintiff's brakes, but found no allegations in the complaint that the franchisee had acted as an agent of the franchisor. The court concluded that the failure to allege that the franchisor was responsible for the franchisee's actions, coupled with the failure to properly name and describe the franchisor in the complaint, amounted to a failure to put the franchisor on notice of the claim brought against it under notice pleading standards. The court further held that the suit was brought "unreasonably or without foundation," and awarded the franchisor its attorneys' fees with the victory.

GRAY PLANT MOOTY

Minneapolis, MN Office

| | |
|---|---|
| **John W. Fitzgerald, Co-Chair (612-632-3064)** | **Kirk W. Reilly, Co-Chair (612-632-3305)** |
| Megan L. Anderson (612-632-3004) | Gregory R. Merz (612-632-3257) |
| Wade T. Anderson (612-632-3005) | * Craig P. Miller (612-632-3258) |
| Phillip W. Bohl (612-632-3019) | Bruce W. Mooty (612-632-3333) |
| * Jennifer C. Debrow (612-632-3357) | John W. Mooty (612-632-3200) |
| Elizabeth S. Dillon (612-632-3284) | Kevin J. Moran (612-632-3269) |
| Collin B. Foulds (612-632-3388) | Max J. Schott II (612-632-3327) |
| * Michael R. Gray (612-632-3078) | Daniel R. Shulman (612-632-3335) |
| Laura J. Hein (612-632-3097) | * Jason J. Stover (612-632-3348) |
| Kelly W. Hoversten (612-632-3203) | Michael P. Sullivan, Sr. (612-632-3351) |
| Franklin C. Jesse, Jr. (612-632-3205) | Michael P. Sullivan, Jr. (612-632-3350) |
| Cheryl L. Johnson (612-632-3271) | Henry Wang (612-632-3370) |
| * Jeremy L. Johnson (612-632-3035) | Lori L. Wiese-Parks (612-632-3375) |
| Gaylen L. Knack (612-632-3217) | * Quentin R. Wittrock (612-632-3382) |

Washington, D.C. Office

| | |
|---|---|
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| * Jimmy Chatsuthiphan (202-295-2217) | * Stephen J. Vaughan (202-295-2208) |
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| * Iris F. Rosario (202-295-2204) | * Eric L. Yaffe (202-295-2222) |

**** Wrote or edited articles for this issue.***

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**GRAY, PLANT, MOOTY, MOOTY & BENNETT, P.A.**

**500 IDS Center**
**80 South Eighth Street**
**Minneapolis, MN 55402-3796**
**Phone: 612-632-3000**
**Fax: 612-632-4444**

**2600 Virginia Avenue, N.W.**
**Suite 1111 – The Watergate**
**Washington, DC 20037-1905**
**Phone: 202-295-2200**
**Fax: 202-295-2250**

franchise@gpmlaw.com