# 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:** May 6, 2008 – No. 107

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

## RICO

### COURT REJECTS APPLICATION OF RICO STATUTE TO FRANCHISE SYSTEM

A recent decision by the United States District Court for the Northern District of Illinois in *Wooley v. Jackson Hewitt, Inc.*, 2008 WL 836010 (N.D. Ill. March 25, 2008), granted in part a franchisor's motion to dismiss a class action suit brought against a tax service franchisor under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1961, *et seq.*

The plaintiff engaged a franchisee of Jackson Hewitt, Inc. to prepare his taxes for 2003. The taxpayer paid an extra fee for Jackson Hewitt's "Gold Guarantee," which was supposed to provide the taxpayer with a reimbursement for any additional taxes owed if there was an error on the return. And, indeed, the plaintiff alleged that the tax preparer included false charitable and other deductions on his return that were caught by a subsequent Internal Revenue Service audit. When the franchisor refused to pay on the guarantee, the plaintiff brought a class action suit against Jackson Hewitt and the franchisee, claiming that he and other taxpayers were induced to pay extra for the Gold Guarantee when the franchisor knew that the returns "would not stand up to an audit and for which no guarantee would be paid . . . ." Jackson Hewitt moved to dismiss.

The most important aspect of the opinion for franchisors was the rejection of the plaintiff's contention that Jackson Hewitt was liable under the RICO statute for engaging in a pattern of racketeering activity involving the wire transmissions of allegedly fraudulently prepared tax returns and processing of credit card charges for the Gold Guarantee. Specifically, the court found broadly that the franchise system was not a RICO "enterprise" as defined by the statute because it is not the typical kind of organization to which the Act was intended to apply, *i.e.*, a criminal organization with an aim toward conducting illegal activities behind the façade of an otherwise legitimate business. Even if a franchisee's employees engaged in illegal acts, the court held that where a "large, reputable" business entity is involved and the illegal acts are "entirely incidental," then Jackson Hewitt and its franchisees "cannot constitute a RICO enterprise . . . ." The court also concluded that even if the franchise system was an "enterprise," the plaintiff failed to raise an allegation that there was any sort of outside "command structure" that was separate and distinct from the franchisor itself.

## DAMAGES TO FRANCHISOR

### COURT AWARDS LOST FUTURE PROFITS AND ATTORNEYS' FEES TO FRANCHISOR UNDER DEVELOPMENT AGREEMENT

In *Bennigan's Franchising Company v. Swigonski*, 2008 WL 648936 (N.D. Tex. Feb. 26, 2008), the U.S. District Court for the Northern District of Texas awarded a franchisor, Bennigan's Franchising Company, over $1.2 million in lost future profits and attorneys' fees following a bench trial regarding a contractual dispute between the parties. In doing so, the court held that Bennigan's proved by a preponderance of the evidence that the franchisees had materially breached a development agreement between the parties. It should be noted that the defendants were not represented at trial and appeared pro se.

The development agreement contained a schedule for opening six new restaurants. Bennigan's terminated the franchisees' development agreement after the franchisees failed to open the fourth restaurant. After the expiration of the notice and cure period and termination of the development rights, Bennigan's commenced a lawsuit seeking payment of the past due initial fee and of future continuing and production fees pursuant to the development agreement. From the reported decision, it appears that Bennigan's submitted evidence of its damages only with respect to the fourth restaurant, since only the fourth unit was scheduled to open before the date Bennigan's terminated the development agreement and, presumably, any obligation to open the fifth and sixth restaurants. Bennigan's also sought and was awarded its attorneys' fees and costs incurred in the lawsuit.

In awarding damages of $25,000 for the unpaid initial fee, $1,005,452 in future continuing fees and $251,363 in future production fees, the court noted that the continuing fees and production fees, both of which were based on percentages of projected gross revenue (4% and 1%, respectively), were calculated for the unopened Bennigan's restaurant using the middle one-third of average restaurant sales for Bennigan's restaurants, as reported in Bennigan's most recent UFOC. The court apparently believed such calculation to be reasonable.

## FRANCHISOR WINS LIQUIDATED DAMAGES AND TREBLE DAMAGES FOR TRADEMARK INFRINGEMENT

In *Days Inn Worldwide, Inc. v. BFC Management, Inc.*, 2008 WL 619210 (D.N.J. March 4, 2008), the court awarded the hospitality franchisor treble damages for trademark infringement claims and also awarded full liquidated damages in accordance with the franchise agreement. Even after it was terminated, the franchisee continued to use the franchisor's trademarks on its exterior signage as well as on the cups, toiletries, and other items in the facility for almost three months. The court held that the franchisee's unauthorized use of the marks created a likelihood of confusion and awarded treble damages as allowed by federal trademark law for lost gross room revenue during the period of infringement. Further, the court awarded liquidated damages in the full amount as contemplated by the franchise agreement. In evaluating the reasonableness of the liquidated damages clause, the court held that the parties were of comparable bargaining power, and that the parties intended for the franchisor to receive liquidated damages in the event of a breach by the franchisee.

## COURT AWARDS ATTORNEYS' FEES TO FRANCHISOR THAT PREVAILED ON MOTION FOR PRELIMINARY INJUNCTION

In *Novus Franchising, Inc. v. Oksendahl*, 2008 WL 835681 (D. Minn. March 27, 2008), the court awarded attorneys' fees to a franchisor that prevailed on a motion for preliminary injunction against a former franchisee. Gray Plant Mooty represented the franchisor. The parties' franchise agreement provided that the "prevailing party" on a motion for injunctive relief would be awarded its attorneys' fees. Relying on that language, the franchisor sought an award of fees from the court. The franchisee claimed, however, that it actually was the prevailing party, as the court had not awarded the franchisor all the relief sought through its motion for preliminary injunction. The franchisee claimed that the court must determine who was the prevailing party under Idaho law, not under the definition supplied by the contract.

The court rejected the franchisee's argument and found the franchisor to be the prevailing party as defined by the franchise agreement. The court found that the parties' contract unambiguously defined the phrase "prevailing party" as the party that obtained injunctive relief. The court declined the franchisee's request to interpret Idaho law to trump the parties' clear contractual intent. The court did, however, reduce the amount of fees awarded to the franchisor to reflect the court's previous decision to grant only a portion of the injunctive relief sought.

## ANTITRUST

### FORMER GASOLINE STATION FRANCHISEE'S CLAIMS DENIED

In *Partner & Partner, Inc. v. ExxonMobil Oil Corp,* 2008 WL 896052 (E.D. Mich. March 31, 2008), the court dismissed the plaintiff's breach of contract and antitrust claims. The plaintiff was a direct ExxonMobil gasoline dealer until the defendant decided to stop selling gasoline directly to dealers and opted to work with distributors who would purchase gasoline from ExxonMobil and then sell it to individual dealers. ExxonMobil then allowed plaintiff and other dealers to purchase the stations they were leasing previously. The plaintiff purchased its station and entered into a distributorship agreement with one of ExxonMobil's distributors. Subsequently, an ExxonMobil branded station that purchased gasoline from another of ExxonMobil's distributors opened within a mile of the plaintiff's station.

The plaintiff alleged a breach of its previous franchise agreement claiming ExxonMobil made oral promises that it would continue to honor the exclusive territory language in the franchise agreement and antitrust claims alleging a vertical conspiracy to restrain trade. The court dismissed the breach of contract claims because the plaintiff was not operating under a franchise agreement. In addition, the court pointed to an integration clause in the sales agreement that excluded any assertion of verbal promises in interpreting the contract.

The court also dismissed the antitrust claims because the plaintiff failed to assert facts to show that ExxonMobil's actions created an adverse market-wide effect that hurt competition, as required for vertical conspiracy claims. The plaintiff claimed that the distributor's requirement that it purchase a certain amount of gasoline from it every year was an antitrust violation. The court found that this requirement was not an antitrust violation because the plaintiff was unable to show an injury to the market, only an injury to plaintiff personally. Similarly, the plaintiff's claims that ExxonMobil had a dangerous probability of monopolization were dismissed because the plaintiff presented no facts to show that ExxonMobil had a monopoly in the relevant market, or any power to exclude competition.

**DISTRICT COURT DISMISSES FRANCHISEES' FEDERAL AND STATE ANTITRUST CLAIMS BASED ON RELEVANT MARKET DEFINITION**

The United States District Court for the Northern District of Illinois recently dismissed federal and state antitrust claims brought by a class of Quizno's franchisees against Quizno's Franchise Company and related entities. *Siemer v. Quizno's Co. LLC*, 2008 WL 904874 (N.D. Ill. March 31, 2008). The plaintiffs alleged that the defendants violated federal and Illinois antitrust laws by exercising substantial economic power within the "Quick Service Toasted Sandwich Restaurant Franchises market" to coerce franchisees to purchase essential goods from Quizno's affiliates and approved vendors. The plaintiffs claimed that these alleged tying arrangements were either illegal per se, or an unreasonable restraint of trade. The district court granted the defendants' motion to dismiss, holding that plaintiffs' market definition was too narrow. The district court also dismissed plaintiffs' federal civil RICO claim.

Citing United States Supreme Court antitrust precedent, the district court noted that the relevant product market must include all products that have reasonable interchangeability for the purposes for which they are produced – price, use, and qualities considered. The court further pointed to an almost identical case filed in the Eastern District of Wisconsin, *Westerfield v. Quizno's Franchise Co.*, 527 F. Supp. 2d 840 (E.D. Wis. 2007), in which the court, as reported in Issue 101 of *The GPMemorandum*, dismissed the plaintiffs' identical market definition as "patently absurd." The court in Illinois held that even assuming a franchise can be a tying product, the market in question should include all franchise opportunities any potential buyer would consider, not simply toasted submarine sandwich franchises. Finally, relying on the *Queen City* case from the Third Circuit, the district court held that when a plaintiff alleges "a proposed relevant market that clearly does not encompass all interchangeable substitute products even when all factual inferences are granted in plaintiffs' favor, the relevant market is legally insufficient and a motion to dismiss may be granted."

## PROCEDURE

**THREE COURTS ADDRESS JURISDICTION ISSUES IN FRANCHISING CONTEXT**

A trio of recent decisions addresses issues of personal jurisdiction in the franchise context. In *Noble Roman's, Inc. v. French Baguette, LLC*, 2008 WL 975078 (S.D. Ind. April 8, 2008), Noble Roman's brought suit against terminated franchisees in Indiana, which was franchisor Noble Roman's home state. The franchisees sought to dismiss that action, arguing that they were Florida residents with no contacts with the state of Indiana. The court disagreed and found that Noble Roman's had demonstrated that defendants had sufficient contacts with Indiana to justify the exercise of jurisdiction over them in that state.

The court found that the defendants had purposefully availed themselves of the privilege of conducting business in Indiana by entering into a long-term franchise agreement with an Indiana corporation. The court also found persuasive defendants' ongoing communications with Noble Roman's in Indiana through telephone and fax. Moreover, the franchise agreement provided that it would be construed under Indiana law, putting the defendants on notice of the possibility that they might be required to defend a suit in that state. Because the defendants had an ongoing business relationship with an Indiana company, the court found that they could not demonstrate that forcing them to litigate in Indiana would be so inconvenient as to violate traditional notions of fair play and substantial justice. Finally, the court rejected the defendants' argument that the federal venue statute required the case to be brought in Florida, where they resided. The court noted that for venue purposes a corporation is deemed to reside in any district in which it is subject to personal jurisdiction. Because defendants were subject to personal jurisdiction in Indiana, venue there was appropriate as well.

In *JTH Tax, Inc. v. Liberty Services Title, Inc.*, 2008 WL 1699801 (E.D. Va. April 10, 2008), however, the court found that it lacked personal jurisdiction over an out-of-state defendant that had allegedly infringed upon a Virginia franchisor's trademark. JTH Tax brought suit in Virginia against a Florida company that had allegedly displayed its trademarks without consent. JTH Tax argued that the defendant's infringement constituted a tortious injury directed toward Virginia, thus permitting the Virginia court to exercise jurisdiction. The court disagreed and ordered the case to be transferred to Florida. The court found that the defendant had no contacts with the state of Virginia that would provide jurisdiction. The court also rejected JTH Tax's argument that the defendant's tortious conduct was felt by JTH Tax in Virginia, finding that any business lost by JTH Tax or its franchisees as a result of the alleged trademark infringement would have been in Florida, where the alleged infringement occurred. The mere presence in Virginia of the owner of the trademarks provided insufficient contacts to permit the court to exercise jurisdiction.

In *R&K Lombard Pharmacy Corp. v. Medicine Shoppe International, Inc.*, 2008 WL 648509 (E.D. Mo. March 5, 2008), the court rejected an attempt by a group of franchisees to bring suit against their franchisor's parent corporation in Missouri. The plaintiffs named as a defendant Cardinal Health, Inc., the parent company of franchisor Medicine Shoppe International, Inc. The plaintiffs claimed that Cardinal Health was subject to jurisdiction in Missouri based on Medicine Shoppe International's contacts with that state. The court disagreed, holding that it could not assert jurisdiction over Cardinal Health. Among other things, the court rejected the plaintiffs' argument that the use of Cardinal Health's name on business cards and job postings made by Medicine Shoppe

International was sufficient to provide a basis for jurisdiction. Accordingly, the court granted Cardinal Health's motion to dismiss.

**MISSOURI DISTRICT COURT GRANTS MOTION FOR A MORE DEFINITE STATEMENT**

In a separate order in *R&K Lombard Pharmacy Corp. v. Medicine Shoppe International,* 2008 WL 648506 (E.D. Mo. March. 5, 2008), the court sided with defendant Medicine Shoppe International, the franchisor of the "Medicine Shoppe" system, and granted its motion for a more definitive statement regarding the allegations contained in the complaint filed against it by 25 franchisees. The plaintiffs' complaint contained roughly 20 pages of general allegations, which were then incorporated by reference into each of the 19 counts asserted against the defendant. The franchisor argued that it was unable to frame an answer or other response to the asserted counts due to the failure of the complaint to comply with Rule 8 and Rule 10 of the Federal Rules of Civil Procedure.

The court found that the complaint contained a lengthy recitation of general allegations that were not tailored to the individual plaintiffs and, therefore, did not allow the defendant to determine whether the allegations applied to all or only some of the plaintiffs. Furthermore, the court determined that the plaintiffs incorporated by reference all of the general allegations into the individual counts, regardless of whether any of the allegations were material to the claim asserted in the count, making it extremely difficult to identify the factual basis for each claim. Accordingly, the court held that the defendant could not reasonably be expected to frame a responsive pleading.

## NON-COMPETES

**COURT UPHOLDS TWO-YEAR BAN ON POST-TERM COMPETITION**

In late March, the United States District Court for the District of New Jersey denied a defendant-franchisee's motion for reconsideration of a grant of summary judgment, finding the court's previous decision that the franchisee had violated its post-termination covenant not to compete was correct as a matter of law. *Jackson Hewitt Inc. v. Childress*, 2008 WL 834386 (D.N.J. March 27, 2008). The court's initial ruling granting plaintiff-franchisor Jackson Hewitt Inc.'s ("JHI") motion for summary judgment and enjoining the franchisee from further competition for a period of 24 months was discussed in detail in Issue 104 of *The GPMemorandum*.

The franchisee had operated two JHI franchises for four years before opening his own accounting business in the same location where he had previously run his JHI franchise. This was held to violate the franchise agreement's non-compete clause restricting former franchisees from competing within a 10-mile radius of their former JHI business and requiring them to return manuals and other trade secret information.

The decision on the motion for reconsideration is important because in it, the court held that its previous rulings enforcing covenants not to compete in employment and other contract areas should also be applied in the franchise relationship context. It reiterated that JHI's covenant not to compete validly protected its trade secrets, confidential information, and customer relationships, imposed no undue hardship, and was not injurious to the public.

## GOOD FAITH AND FAIR DEALING

### COURT HOLDS THAT FRANCHISEES' ALLEGATIONS OF INDIRECT TERMINATION WERE SUFFICIENT TO STATE A CLAIM FOR BREACH OF THE DUTY OF GOOD FAITH AND FAIR DEALING UNDER PENNSYLVANIA LAW

In *Cottman Transmission Systems, LLC v. Kershner*, 2008 WL 583894 (E.D. Pa. March 3, 2008), several former franchisees sued their franchisor alleging that it failed to make a good faith effort to establish a chain of successful franchise stores and, instead, engaged in a nefarious scheme to "churn" franchises and profit at the franchisees' expense. Based upon the franchisor's alleged conduct, the franchisees filed a lawsuit claiming, among things, that the franchisor violated the covenant of good faith and fair dealing.

In response to the lawsuit, the franchisor moved to dismiss the franchisees' claim on the ground that Pennsylvania law imposes a duty of good faith and fair dealing on franchisors only in the context of a termination of a franchise agreement and not in the performance of such an agreement. In rejecting the franchisor's argument, the court held that even if the franchisor is correct as to the limitations on a good faith claim, the franchisees had asserted that the franchisor had conducted itself in such a way that it was impossible for the franchisees to operate their stores, which put them in the position of having to sell their stores back to the franchisor at a severe loss. The court concluded that such allegations, if proved, constitute an indirect termination of the franchise agreement and are sufficient to state a claim for breaching the duty of good faith and fair dealing imposed on franchisors under Pennsylvania law. Accordingly, although the court dismissed several of the franchisees' other claims, it denied the franchisor's request to dismiss the good faith and fair dealing claim.

GRAY PLANT MOOTY

## DISTRICT COURT DENIES FRANCHISOR'S MOTION TO DISMISS FRANCHISEES' FRAUD, BREACH OF CONTRACT AND ECONOMIC DURESS CLAIMS

The United States District Court for the District of Colorado recently denied The Quizno's Franchise Company LLC's motion to dismiss claims brought by a class of Quizno's franchisees under Colorado statutory and common law. *Bonanno v. The Quizno's Franchise Co. LLC*, 2008 WL 638367 (D. Colo. March 5, 2008). Plaintiffs allege that Quizno's, its affiliated entities, and individuals who control and operate the Quizno's franchise system fraudulently induced plaintiffs to "purchase franchises for between $20,000 - $25,000 per franchise when they knew that the franchisees would never receive anything in return for their franchise fees." The plaintiffs further allege that "Quizno's took the franchise fee from more than 3,000 franchisees and has failed to provide a store for them." In denying defendants' motion to dismiss, the district court held that plaintiffs had standing to assert and sufficiently pleaded the following claims: (1) violation of the Colorado Consumer Protection Act; (2) fraudulent inducement; (3) breach of contract; (4) breach of implied covenant of good faith and fair dealing; (5) unjust enrichment; (6) economic duress; and (7) judgment declaring the Quizno's Franchise Agreement unconscionable.

## Minneapolis, MN Office

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

## Washington, D.C. Office

* **Robert Zisk, Co-Chair (202-295-2202)**
* Jimmy Chatsuthiphan (202-295-2217)
* Ashley M. Ewald (202-294-2221)
* Jeffrey L. Karlin (202-295-2207)
* Iris F. Rosario (202-295-2204)
Stephen J. Vaughan (202-295-2208)
* Katherine L. Wallman (202-295-2223)
David E. Worthen (202-295-2203)
* Eric L. Yaffe (202-295-2222)

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

For more information on our Franchise and Distribution Practice and for recent back issues of this publication, visit the **Franchise and Distribution** practice group at http://www.gpmlaw.com/practiceareas/franchise.htm.

**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

*The GPMemorandum* is a periodic publication of Gray, Plant, Mooty, Mooty & Bennett, P.A., and should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult your own franchise lawyer concerning your own situation and any specific legal questions you may have.