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The GPMemorandum

TO: **OUR FRANCHISE CLIENTS AND FRIENDS**

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

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DATE: **June 11, 2008 – No. 108**

This section of *The GPMemorandum* addresses non-judicial developments, trends, and best practices of interest to franchisors. Reports of recent judicial developments begin on page 3.

FRANCHISE TRANSACTIONS

ADJUSTING TO LIFE UNDER THE AMENDED FTC FRANCHISE RULE

It has now been well over a year since the Federal Trade Commission released its amended FTC Franchise Rule ("Amended Rule") in January 2007. At this point, it is fair to assume that most franchisors have already converted their UFOCs to the new Franchise Disclosure Document format under the Amended Rule and have addressed, or are in the process of addressing, comments received from state franchise examiners. No doubt, however, there are other franchisors who are racing to meet the fast-approaching July 1 conversion deadline. After this deadline, franchisors may only use FDDs to disclose new prospects. In addition, to be safe, franchisors will in most cases want to provide their new FDD to those active prospects who previously received a UFOC (and not an FDD), and who did not sign a franchise agreement by July 1.

Based on our experience, the overall conversion process has been relatively smooth. The registration states have done an admirable job in processing a large volume of filings under trying circumstances. That being said, the Amended Rule is still new to all of us (the FTC staff, franchise examiners, franchisors and franchise attorneys alike) and, as a consequence, we are still working through certain open issues, ambiguities, and remaining questions.

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To help address some of these items, the FTC staff recently released its Compliance Guide and posted several new FAQs on its website. The North American Securities Administrators Association has also moved one step closer to adopting its replacement to the UFOC Guidelines. These developments are briefly described below.

FTC Release of Compliance Guide. In what could be described as somewhat odd timing, the FTC finally released its much-anticipated Compliance Guide last month. You may obtain a copy of it at http://www.ftc.gov/bcp/franchise/franchise-rule-compliance-guide.pdf. True to its name, the Compliance Guide is intended to help franchisors comply with the Amended Rule and to give franchisors insight as to the FTC staff's view of what the Amended Rule requires. The FTC goes out of its way, however, to make clear that the Compliance Guide does not modify the Amended Rule. While there are no major surprises, the Compliance Guide offers helpful sample disclosure items, clarification on certain open issues and ambiguities, and further guidance as to FDD preparation and the disclosure process. We plan to follow this issue of *The GPMemorandum* with a Special Issue summarizing in more detail what each franchisor should know about the Compliance Guide. Stay tuned.

FTC Posts New FAQs. In addition to releasing the Compliance Guide, the FTC staff also updated its "Amended Franchise Rule FAQs" by adding FAQs 18 and 19. All of the FAQs, which have proven to be quite informative, can be found at http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml. In responding to FAQ 18, the FTC staff states that franchisors need only disclose in Item 8 those suppliers in whom an officer of the franchisor has a "material" interest. The question of what is "material," however, will have to be determined on a case-by-case basis given that the FTC staff intentionally did not establish any sort of a set threshold. On a related note, FAQ 18 also confirms that franchisors are not required to disclose in Item 8 the identity of those officers who have a "material" interest in a supplier, nor the amount of that interest.

In its response to FAQ 19, the FTC staff clarifies that the list of franchisees included as part of the FDD must include those franchisees who have signed a franchise agreement but not yet opened an outlet. Since those franchisees may not yet have an address or telephone number, the disclosure can be made by listing the name of the franchisee, the city and state where the outlet is to be located, and a business telephone number and email address. The franchisor also must note that the outlet is not yet open. The same also holds true for those franchisees whose franchise agreements were terminated before they ever opened an outlet. These franchisees must appear on the list of terminated franchisees included in the FDD. The clarifications offered by the FTC staff in FAQ 19 are counter to the practice of many franchisors who have historically focused on open outlets in preparing their lists of franchisees. As a result, these franchisors should consult with their attorneys to determine whether any necessary FDD changes need to be made immediately, or they can wait until the next amendment or renewal filings.

NASAA Publishes Revised, Proposed 2008 Guidelines. On February 26, 2008, NASAA disseminated for comment a proposal for its 2008 Franchise Registration and Disclosure Guidelines (Amended and Restated UFOC Guidelines) (the "Amended Guidelines"). The Amended Guidelines are intended as a permanent replacement to NASAA's UFOC Guidelines, in light of the FTC's Amended Rule. Like the former UFOC Guidelines, the Amended Guidelines serve as an instruction manual for preparation of FDDs in compliance with state franchise registration laws. The Amended Guidelines adopt nearly verbatim the language of the Amended Rule, but also require the addition of a state cover page. The state cover page must contain certain general disclosures and also serves as a place for states to impose franchisor-specific risk factors. The state cover page also includes a state effective dates page on which the applicable effective dates of the FDD in the various registration states are listed. In addition to the cover pages, the Amended Guidelines include revised, uniform registration forms for the completion of state filings.

NASAA accepted comments to the Amended Guidelines for a 30-day period, beginning on February 26. Gray Plant Mooty submitted comments to the Guidelines, including suggested revisions to certain of the form risk factors on the state cover page and comments geared toward limiting state imposition of broker disclosure requirements. Following this comment period, NASAA has made available a further revised version of the Amended Guidelines, which is thought to be in close to final form. We will know soon enough if this is the case, as NASAA is expected to release its final version of the Amended Guidelines before the end of this month.

RECENT CASES

Here are reports on recent court decisions of interest to franchisors:

SYSTEM CHANGE

APPEALS COURT REVERSES SUMMARY JUDGMENT, REQUIRING TRIAL ON CLAIMS BY FORMER MAIL BOXES ETC. FRANCHISEES

A California appellate court ruled late last month that United Parcel Service ("UPS) and Mail Boxes Etc., Inc. ("MBE") should not have prevailed on summary judgment on some of the franchisee claims brought against them after UPS acquired MBE. *G.I. McDougal, Inc., et. al. v. Mail Boxes Etc., Inc. et al.*, 2008 WL 2152911 (Cal. App. 2 Dist.

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May 23, 2008). The essence of the plaintiffs' 33-count complaint is that MBE franchisees were harmed by the 2001 acquisition and the alleged subsequent emphasis on "The UPS Store" units. The trial court granted the defendants' summary judgment motion on all claims in November of 2006.

On appeal, the court held there are "multiple triable issues of fact" regarding some of the claims. For example, the court held that the MBE owners can go to trial on claims for interference with their customer relationships, breach of the duty to provide marketing material for MBE stores, misuse of MBE marketing funds to support The UPS Store units, and improper competition by UPS in MBE franchisees' territories.

ARBITRATION

UNCONSCIONABILITY ARGUMENTS FAIL IN CALIFORNIA AND WASHINGTON FRANCHISE CASES

Two more courts have weighed in on the unconscionability of arbitration clauses. *In Sammy Enterprises v. O.P.E.N. America, Inc.*, 2008 WL 2010357 (Wash. App. Div. 1 May 12, 2008), the Washington Court of Appeals upheld enforcement of an arbitration provision despite the franchisee's challenge. And in *Smith v. Paul Green School of Rock Music Franchising, LLC.*, 2008 WL 2037721 (C.D. Cal. May 5, 2008), a federal district court in California refused a California franchisee's request to stop an arbitration from being conducted in Pennsylvania, the home state of the franchisor.

In the *Sammy Enterprises* case, the Washington court rejected pleas that the lack of English proficiency of the plaintiff's representatives rendered enforcement of the clause procedurally unconscionable. Although the arbitration provision was in paragraph 11.7 of a 33-page franchise agreement (which in turn was part of a 200-page offering circular), the court noted that the cover page of the offering circular highlighted the arbitration requirement in bold, capital letters. The franchisees also had 10 days to analyze the document and have it reviewed by others.

As to alleged substantive unconscionability, the Washington Court of Appeals found important that the contract expressly stated the "business realities" that create a special need for the franchisor to enforce certain rights in a court, whereas the franchisee had to arbitrate. Even if any part of the arbitration clause was one-sided, the appeals court emphasized, the trial court had found such language "severable" from the overall requirement to arbitrate. So long as Washington statutory remedies (including punitive damages) could be pursued in the arbitration, the agreement could be enforced.

The *Smith* case was a fight about where arbitration proceedings would be held. The court did find at least "minimal" evidence of procedural unconscionability in that the

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arbitration clause may have been offered on a "take it or leave it basis," and that the parties' bargaining power was "unequal." But this "minimal indeed" showing was not backed up by the required "significant showing" of substantive unconscionability needed to invalidate the choice of a Pennsylvania forum. Importantly, the court found that the franchisor had conceded that the franchisee would be allowed to assert California statutory rights and remedies in the Pennsylvania forum.

Both courts applied and interpreted *Nagrampa* and other recent unconscionability decisions.

ILLINOIS FEDERAL COURT REFUSES TO VACATE ARBITRATION AWARD

In *Jimmy John's Franchise, LLC v. Kelsey*, 2008 WL 1722188 (C.D. Ill. Apr. 10, 2008), Jimmy John's sought to vacate an arbitration award on the ground that the arbitrator had exceeded his authority under the Federal Arbitration Act and had disregarded the law in awarding damages to the franchisee's guarantor. More specifically, Jimmy John's argued that the arbitrator either did not read the agreement in dispute between the parties or disregarded the agreement entirely and implemented his notion of what was fair and reasonable.

In denying Jimmy John's motion, an Illinois federal district court held that its review of an arbitration award is limited under Section 10 of the FAA. In so holding, the court noted that, under applicable law, it could not "vacate an arbitrator's award [merely] where the contract interpretation is 'incorrect or even wacky' but rather [it could only do so] where 'the arbitrators had failed to interpret the contract at all.'" In this case, even though the arbitrator made no specific findings of fact and conclusions of law as part of his arbitration award, the court inferred that the arbitrator had "interpreted" the contract between the parties and, therefore, did not exceed his authority.

DAMAGES TO FRANCHISOR

COURT DECLINES TO AWARD PROSPECTIVE DAMAGES

In *Meineke Car Care Centers, Inc. v. L.A.C. 1603 LLC, et al.*, 2008 WL 1840779 (W.D.N.C. April 23, 2008), the federal court in the Western District of North Carolina declined to grant franchisor Meineke lost prospective fees due to the early termination of the franchise. Meineke originally terminated the franchise for failure to pay fees, then sued the former franchisee to recover unpaid fees and lost prospective fees for three years. Meineke was awarded over $100,000 for past-dues fees, but did not fare as well on the claim for prospective fees.

The court held that Meineke's claim that it would take three years to re-franchise the location, thus entitling it to three years of prospective fees, was too speculative. In addition, the court determined that the plain language of the franchise agreement did not contemplate Meineke's recovery of prospective fees in the event of early termination. It further held that any claim for loss profits stemming from the defendants' breach and subsequent termination were not contemplated by the language in franchise agreement and were too speculative.

POST-TERMINATION INJUNCTIONS

BANKRUPTCY COURT GRANTS FRANCHISOR'S MOTION FOR RELIEF FROM AUTOMATIC STAY TO ENFORCE POST-TERMINATION OBLIGATIONS AGAINST TERMINATED FORMER FRANCHISEE

In *PuroSystems, Inc. v. John Fralc (In re Fralc),* 2008 WL 1932311 (Bankr. D. Ariz. April 28, 2008), PuroSystems made a motion to the bankruptcy court seeking relief from the automatic stay in order to enforce injunctive relief, granted through arbitration, against its former franchisee. The bankruptcy court granted PuroSystems' motion for relief from the automatic stay so that it could seek confirmation of its arbitration award in federal district court.

In 2006, PuroSystems terminated John Fralc after he failed to pay royalties due under the franchise agreement. Following termination, an arbitration panel entered an award in favor of PuroSystems. The franchisee did not participate in the arbitration proceeding, so the award was taken by default. Subsequently, PuroSystems filed an action in the federal district court seeking to confirm the arbitration award and to gain jurisdiction over the franchisee to enforce the award. In response, the franchisee filed a Chapter 7 bankruptcy proceeding.

PuroSystems brought a motion for relief from the automatic stay imposed by the Bankruptcy Code, and it requested that the automatic stay be lifted so that it could return to the federal district court in order to enforce the injunctive relief provisions of the arbitration award. The bankruptcy court questioned whether it was appropriate for the arbitration panel to have moved the two-year non-compete period from "time of termination" (as described by the franchise agreement) to "time of the arbitration award." The franchisee argued that under the terms of the franchise agreement, the two-year period following termination had already passed and therefore the arbitration panel did not have the power to extend the length of a non-compete provision in the parties' franchise agreement. There was no testimony or evidence on this issue before the bankruptcy court because the arbitration award was taken by default. There was also no indication that the franchisee had complied with the non-compete provision at any time.

The bankruptcy court, while it questioned the authority for the arbitration panel to grant relief beyond the scope of the parties' franchise agreement, held that these issues would be properly before the federal district court. As a result, relief from the automatic stay was appropriate.

FRAUD

NEW YORK STATE COURT HOLDS THAT QUESTIONNAIRES CONTAINING DISCLAIMERS ARE NOT DISPOSITIVE OF CLAIMS UNDER THE NEW YORK FRANCHISE ACT

In *Emfore Corp. v. Blimpie Associates, Ltd.,* 2008 WL 1946657 (N.Y.A.D. 1 Dep. May. 6, 2008), the court recalled and vacated its December 20, 2007, order in which it had held that disclaimers in questionnaires do not bar franchisee claims for fraud under the New York Franchise Act. The court, however, did not change the holding of its original order. Under New York's Franchise Act, it is unlawful for a franchisor to require a franchisee to waive any duty or liability imposed on the franchisor by the Act. The questionnaire at issue asked the franchisee, among other things, to affirm that the franchisor had made no representations about actual or projected profits, sales, or expenses. It its original opinion, the court had reversed the trial court's holding that the disclaimers in the questionnaire were beyond the scope of the anti-waiver sections of the Franchise Act because they were not simply inserted as boilerplate in the parties' franchise agreement. The court held that the franchisee's statutory fraud claim remained viable, and that the disclaimers only created an issue of fact as to the extent and reasonableness of the franchisee's reliance on the alleged earnings claims.

In its opinion recalling and vacating the December 2007 order, the court reached the same result, but went into greater detail regarding the validity and usefulness of questionnaires and held that the questionnaire provided to the franchisee did not violate the Franchise Act on its face. The court found that by requesting franchisees to disclose whether a franchisor's representatives made statements concerning the financial prospects for the franchise during the sales process, franchisors can effectively root out dishonest sales personnel and avoid sales secured by fraud. However, the court rejected the franchisor's argument that the franchisee's statement in the questionnaire that no financial representations had been made constituted a waiver of the statutory fraud claims. The court held that such waivers are barred by the Franchise Act, and reiterated that the questionnaire created an issue of fact as to the reasonableness of the franchisee's reliance.

The court did hold that the franchisee's common-law fraud claims were properly dismissed because the disclaimers in the questionnaire were not merely boilerplate exclusions but were contained in a separate rider, read and signed by the franchisee, specifically stating that the franchisee was not relying on any representations by the franchisor. It is hard to reconcile the court's rulings on the statutory and common law fraud claims, since both require a showing of reasonable reliance by the franchisee. The court gave no explanation for distinguishing between the two. Finally, the court held that the franchisee's breach of contract claims were properly dismissed, as it was uncontroverted that the franchisee failed to provide written notice of any breach as required by the franchise agreement.

VICARIOUS LIABILITY

FOURTH CIRCUIT UPHOLDS SUMMARY JUDGMENT IN FAVOR OF FRANCHISOR DUE TO PLAINTIFFS' FAILURE TO ESTABLISH DIRECT LIABILITY FOR NEGLIGENCE

In *Allen v. Choice Hotels Intern., Inc.*, 2008 WL 1925110 (4th Cir. May 1, 2008), the United States District Court for the District of South Carolina had granted summary judgment in favor of defendant franchisor on a negligence claim asserting both direct and vicarious liability in a case involving a deadly fire at a Comfort Inn and Suites facility. The fire killed six hotel guests and injured twelve others. The plaintiffs filed suit against franchisor, alleging that Choice failed to exercise due care by not requiring the franchisee to retrofit the hotel with sprinklers. The district court granted summary judgment to Choice, concluding that, as a franchisor, Choice was neither directly nor vicariously liable for the alleged negligent acts. The plaintiffs only appealed the district court's ruling as to the franchisor's direct liability.

On appeal, the Fourth Circuit affirmed the trial court's grant of summary judgment. In so doing, the court found certification of particular questions to the Supreme Court of South Carolina unnecessary because sufficient case law existed in South Carolina or other jurisdictions to resolve all the issues in this case. In denying the plaintiffs' negligence claim, the court determined that franchisor did not control franchisee's life safety systems. The court held that the terms of the franchise agreement and franchisor's rules and regulations did not establish Choice's control over franchisee sufficient to create a duty of care, but rather served as mere guidelines to ensure consistency throughout franchisor's system. As to the plaintiffs' argument that the injuries and deaths were foreseeable, the court found that Choice did not owe a common-law duty of care to franchisee's guests as foreseeable persons. Even so, the court determined that Choice did not in any way create a risk or increase the likelihood of injury at the Comfort Inn and Suites. The court also noted that the plaintiffs offered no basis to support the assertion that a hotel franchisor has a duty to require a hotel franchisee to retrofit its building with sprinklers, when the hotel complies with all applicable fire codes. Finally, the court found that the franchisor's acts were not voluntarily undertaken to regulate safety and security issues and created no duty of care owed to franchisee's guests. Rather, the court determined that Choice merely guarded its trademark by assuring uniformity of operation and appearance, including its required fire safety systems and hotel renovations and its recommended installation of sprinklers.

FOOD SAFETY

WENDY'S OBTAINS JUDGMENT AGAINST SUPPLIER THAT FAILED TO NAME FRANCHISOR AS ADDITIONAL INSURED

A produce supplier breached its contractual obligation to name Wendy's International, Inc. as an insured party, according to a Utah federal court in *Cohron v. Wendy's International, Inc.*, 2008 WL 2149386 (D. Utah. May 20, 2008). The case arose out of a personal-injury claim alleged to stem from contaminated lettuce provided by the supplier. Wendy's filed a third-party claim and sought summary judgment against the produce supplier.

One issue raised by the supplier was whether Wendy's waived the right to be named as an additional insured. The supplier's theory was that Wendy's received and did not object to certificates of insurance that apparently did not protect the franchisor. The court found, however, that it was the supplier's clear obligation to provide the insurance; it "was not Wendy's obligation to determine the extent of (the supplier's) insurance."

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