The GPMemorandum

TO: OUR FRANCHISE CLIENTS AND FRIENDS
FROM: GRAY PLANT MOOTY’S FRANCHISE AND DISTRIBUTION PRACTICE GROUP

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DATE: July 23, 2008 – No. 109

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

FRANCHISE CONTRACTS

EIGHTH CIRCUIT REVERSES DISTRICT COURT AND DIRECTS JUDGMENT IN FAVOR OF DOMINO’S PIZZA FRANCHISOR

A three-judge panel of the Eighth Circuit Court of Appeals has ruled that Domino’s Pizza may specify a particular new computer system developed by Domino’s for system-wide use under the terms of its franchise agreement. Bores, et al. v. Domino’s Pizza, LLC, 2008 WL 2467983 (8th Cir. June 20, 2008). By reversing and instructing the district court to enter judgment in favor of Domino’s, the appellate court decided the last remaining claim in the case. A Domino’s motion for summary judgment dismissing all of the franchisees’ other claims had been granted in May of 2007.

The Eighth Circuit ruling turned on its interpretation of the language in the Domino’s standard franchise agreement, which states that the franchisor “will provide … specifications for … computer hardware and software…. You may purchase items meeting our specifications from any source.” The Eighth Circuit held that this language gives Domino’s the right to “specify” a single computer system called “Domino’s PULSE,” which was developed by Domino’s and is available only from Domino’s and IBM. Rejecting the arguments made by the franchisees, the court held that the language in the franchise agreement does not obligate Domino’s to reveal the detailed inner workings of its proprietary PULSE software so franchisees can attempt to locate a different system with the
same or similar capabilities. Instead, the court interpreted the franchise agreement to allow Domino’s to specify a particular system, in this case Domino’s PULSE. The franchisees’ petition for re-hearing en banc is pending.

ENGLISH LANGUAGE PROFICIENCY TEST AS A CONDITION OF TRANSFER HELD NOT UNREASONABLE

In *De Walsche v. Togo’s Franchised Eateries LLC*, No. CV-07-2901 (C.D. Cal. July 21, 2008), a federal court in California granted a defense motion for summary judgment on the franchisee’s claims that Togo’s had breached the franchise agreement and the implied covenant of good faith and fair dealing in requiring an English Language Proficiency Assessment (“ELPA”) as a condition for the transfer of his shop to two buyers. The franchisee also claimed that Togo’s ELPA discriminated against the buyers in violation of California’s Civil Rights Act. (Gray Plant Mooty represented the franchisor in this case.)

The franchisee presented the buyers to Togo’s for its approval of the transfer of the shop. Togo’s evaluated the buyers and gave them an ELPA test, which the buyers failed. After Togo’s rejected the transfer, the franchisee closed the shop and thereafter sued, claiming, among other things, that the ELPA imposed terms and conditions of transfer that did not appear in the franchise agreement and that passing the ELPA was an unreasonable requirement for a transfer. In its motion for summary judgment, Togo’s provided substantial evidence showing that it required the ELPA to ensure that its franchisees could communicate (both in writing and orally) with Togo’s, suppliers, customers, and employees. Further, the franchisee had acknowledged that Togo’s could require the ELPA under various provisions of the franchise agreement and a rider to the franchisee’s and buyers’ purchase agreement. Also, since the express terms of the franchise agreement gave Togo’s absolute discretion to mandate the ELPA, the franchisee’s claim of breach of the implied covenant of good faith and fair dealing failed as a matter of law. Finally, as to the statutory claim, the court found that the franchisee had no standing to assert such a claim since the buyers testified that Togo’s had not discriminated against them.

ANTITRUST

DISTRICT COURT DENIES FRANCHISEES’ ANTITRUST CLAIMS FOR FAILURE TO PLEAD A PROPER RELEVANT MARKET

The plaintiffs alleged that: (1) the defendants violated Sherman Act § 2 by maintaining a monopoly in a “conglomeration of unique products, trade dress, services, methods, ingredients, recipes, menus and packaging, quality and quantity control strategies, layouts, style, signage, service marks, and image,” and that defendants were the only ones who provided this unique combination of products and services; (2) the defendants violated Sherman Act § 1 in that they conspired with suppliers and sellers by forcing plaintiffs to purchase supplies, furniture, equipment, fixtures, and signs from sources designated by defendants; and (3) the defendants engaged in improper tying under the Clayton Act in conditioning the sale of the franchise on the plaintiffs’ agreement to sell products within the provision of the franchise agreement. As the court noted, “Plaintiffs’ argument boils down to the contention that Defendants have a monopoly power over their own ‘Unique Services’ which, taken together, constitute their franchise system.”

The district court granted the defendants’ motion to dismiss, holding that plaintiffs’ market definition was too narrow. The district court noted that the Third Circuit Court of Appeals in Queen City Pizza, Inc. v. Domino’s Pizza, Inc., 124 F.3d 430 (3d Cir. 1997), held that “antitrust claims predicated upon a ‘relevant market’ defined by the bounds of a franchise agreement are not cognizable.” Rejecting the plaintiffs’ attempts to distinguish their case from Queen City, the district court held that the defendants’ own franchise system cannot be deemed a relevant market because the defendants do not offer truly unique products or services, because customers (the plaintiffs and other potential franchisees) have reasonably equivalent alternatives for franchise investments in the market, and because the plaintiffs are bound by contract (not by uniqueness) to purchase certain mandated supplies, no relevant antitrust market exists. Since the plaintiffs’ antitrust claims all required them to plead a relevant market, the court dismissed all three claims.

**FRANCHISOR’S DESIGNATION OF CREDIT CARD PROCESSING SERVICE DOES NOT CONSTITUTE UNLAWFUL TYING ARRANGEMENT**

In Sheridan v. Marathon Petroleum Co., LLC, 2008 WL 2486581 (7th Cir. June 23, 2008), a Marathon gasoline dealer filed suit against Marathon to challenge a provision of the dealer’s franchise agreement. The franchise agreement required the dealer to process credit card purchases made on credit cards issued by Marathon through specified credit card processing equipment. The franchisee remained free to process payments made by other credit cards through a different processing system if he so chose. The franchisee claimed that Marathon had effectively tied the processing of all credit card payments to the Marathon franchise, thus violating the Sherman Act. The district court disagreed and granted Marathon’s motion to dismiss.
On appeal, the Seventh Circuit affirmed the district court. The court noted that the Sherman Act required the franchisee to show that Marathon had market power in the market for the tying product. The court found that the franchisee’s complaint failed to adequately allege that Marathon exercised market power in the market for petroleum products. The court agreed that Marathon does exercise a “monopoly” over Marathon franchises, but found that such franchises do not constitute a relevant market. As the court explained, “the exploitation of the slight monopoly power thereby enabled does not do enough harm to the economy to warrant trundling out the heavy artillery of federal antitrust law.”

The court also found that the facts did not support even the claim that Marathon had tied its franchises to the credit card processing system. The court noted that franchisees remained free to implement a different processing system for purchases made on cards other than those issued by Marathon. The court found that Marathon could not be held responsible for its franchisees’ economic decision not to purchase two such systems. Merely employing a system that creates economic incentives to run all credit card purchases through one system does not constitute unlawful tying.

SETTLEMENT

EIGHTH CIRCUIT UPHOLDS SETTLEMENT

In Bath Junkie Branson, L.L.C. v. Bath Junkie, Inc., 2008 WL 2330749 (8th Cir. June 9, 2008), the Eighth Circuit Court of Appeals affirmed a federal court’s enforcement of the parties’ settlement agreement. Franchisor Bath Junkie, Inc. had appealed the district court’s decision to enforce a settlement agreement on the grounds that the court had erred in refusing to hold an evidentiary hearing as to whether there was a “meeting of the minds” on that settlement. Applicable case law provides for an evidentiary hearing when there is a dispute as to settlement. The Eighth Circuit found no error because the franchisor had simply failed to request a hearing prior to the district court making its decision. The case, however, exemplifies the perils of notifying the court of settlement prior to reducing it to a writing.

The franchisee and franchisor had reached a settlement on the eve of trial. The “salient” terms of settlement were recited on the record to the district court. Neither party suggested that there were any additional material terms, other than the fact that the parties would execute a written settlement agreement. Thereafter, after exchanging several drafts, the parties could not finalize a written settlement agreement. The court issued a motion to show cause why it should not dismiss the case. The franchisee replied requesting that the court enforce the terms of settlement that the parties had initially reached. The franchisor responded with several affidavits that provided for additional terms of settlement, but the franchisor never requested an oral
hearing on its reply. On the papers, the court enforced the settlement recited to it by the parties. Thereafter, the franchisor requested an evidentiary hearing, which the court denied. The franchisor appealed, contending that the court had erred in refusing the franchisor’s request for a hearing. The majority of the Eighth Circuit disagreed, holding that the franchisor had simply failed to timely request an evidentiary hearing.

TRADEMARKS

FRANCHISEE’S ADOPTION AND USE OF TRADEMARK INURES TO FRANCHISOR

In *Pinnacle Pizza Co., Inc. v. Little Caesar Enterprises. Inc.*, 2008 WL 2381678 (D.S.D. June 5, 2008), a Little Caesar’s® pizza franchisee sued the franchisor for claims related to the franchise system’s use and federal registration of the trademark HOT N’ READY. The franchisee began using the mark HOT N’ READY in 1997 to advertise promotional offers for ready-to-takeaway pizza. Based on the success of the promotion, the franchisee shared the promotional concept with other franchisees. In 2000, the franchisor began distributing an implementation guide for the promotion and, in 2002, it filed an application for federal registration of the mark, claiming a date of first use of 1997. The franchisee filed this lawsuit, asserting that the wider adoption of the mark in the system, and the federal registration of the mark by the franchisor, constituted breach of contract, breach of fiduciary duty and violation of South Dakota trademark law.

The federal district court in South Dakota granted the franchisor’s motion for summary judgment on each of the franchisee’s claims. The court noted that the franchise agreement defined trademarks to include all marks “presently existing or to be acquired in the future” and that use of trademarks by the franchisee inures to the benefit of the franchisor. As such, the court held that the franchisor’s use of the mark HOT N’ READY throughout the franchise system and its application for registration based on the franchisee’s use in 1997 were permissible under the franchise agreement.

COURT ENJOINS FORMER FRANCHISEE’S CONTINUED USE OF FRANCHISOR’S TRADEMARKS AND ASSOCIATED TELEPHONE NUMBER

In *Molly Maid v. Carlson*, 2008 WL 2620109 (E.D. Mich. July 1, 2008), the United States District Court for the Eastern District of Michigan recently granted Molly Maid’s motion for preliminary injunction to restrain its former franchisee from infringing on Molly Maid’s trademarks. This decision provides good support to franchisors who wish to avoid customer confusion when a former franchisee, in operating a competing business, continues to use a telephone number that had been associated with the terminated franchise.
In granting the franchisor’s motion, the court first noted that where a former franchisee continues to use a franchisor’s trademarks, the franchisor’s burden to demonstrate that the infringement is likely to confuse consumers is significantly lessened. The court then found a likelihood of confusion in this case because the Molly Maid name continued to be associated with the telephone number in phone listings. That led customers who called the former franchisee’s Molly Maid phone number to reach the former franchisee’s new business (called “Mega Maids”), which offered the same services as a Molly Maid business. The court cited evidence showing that the former franchisee attempted to secure business from consumers who called the telephone number in search of a Molly Maid business.

The court rejected the former franchisee’s defenses that: (1) the parties had agreed to allow Mega Maids to continue using the telephone number after the Franchise Agreement expired; and (2) the telephone company, not Mega Maids, was the party at fault for the continued association between Molly Maid and the phone listing. In that regard, the court found that an enforceable modification of the franchise agreement allowing Mega Maids to retain use of the phone number would have required Molly Maid to receive some consideration in return, which was not the case here. The court further found that Mega Maids did very little to effectuate the required disassociation of the telephone number from Molly Maid and its trademarks, and that it actually benefited from this continued association. Finding that the franchisor would be irreparably harmed in the absence of injunctive relief, the court enjoined the franchisee from using Molly Maid’s trademarks and ordered the telephone number of the former Molly Maid franchise transferred immediately to Molly Maid.

**ARBITRATION**

**RIGHT TO ARBITRATE NOT WAIVED BY FRANCHISEE WHEN PREVIOUS CLAIM FOR ARBITRATION WITHDRAWN FOR GOOD CAUSE**

In June the United States District Court for the Eastern District of Louisiana held that a franchisee who had initiated an arbitration and later withdrew the proceeding had not waived his right to compel another arbitration after the franchisor filed an action against him in federal district court. The case is *Planet Beach Franchising Corp. v. Richey*, 2008 WL 2598907 (E.D. La. June 25, 2008).

The franchisee in this action initiated the arbitration proceedings pursuant to the arbitration clause in the franchise agreement three years into the relationship with Planet Beach Franchising Corporation, a tanning salon franchisor, alleging that Planet Beach had fraudulently induced him to enter into the franchise agreement and that it had later breached the agreement. Planet Beach answered the claims in arbitration and filed its own counterclaims alleging breach of contract for nonpayment, failure to
submit business reports, and failure of the franchisee to upgrade his computer system. In accordance with the terms of the arbitration clause in the franchise agreement, each party chose one arbitrator for the panel, and the two arbitrators jointly selected a third. The franchisee objected to Planet Beach’s choice because of the arbitrator’s relationship with a former Planet Beach director. The panel formed despite the franchisee’s objection and directed that the hearing take place within 60 days. The franchisee then formally withdrew his claims, citing both lack of time to prepare his case and the conflict of interest between Planet Beach and one of the members of the arbitration panel. After the withdrawal, the American Arbitration Association (AAA) agreed with the franchisee that there actually was such a conflict, but by then the franchisee had already withdrawn. Planet Beach thereafter filed suit in federal court against the franchisee for nonpayment of fees, trademark law violations, and for violating the franchise agreement’s post-term covenant not to compete by opening a new tanning salon in the same location. In response, the franchisee moved to compel arbitration.

The court granted the motion, finding that the franchisee had not waived his right to arbitrate Planet Beach’s claims despite the fact that he had withdrawn his previous arbitration. The Court held that the franchisee had validly withdrawn from the earlier arbitration due to the conflict of interest and unreasonable schedule and gave considerable weight to the fact that the AAA had found that Planet Beach’s original arbitrator had a conflict of interest. Therefore, the court concluded, the franchisee did not default on the arbitration and had not waived his rights under the arbitration clause. The court further noted that the franchisee’s withdrawal from the earlier arbitration had not prejudiced Planet Beach because the parties had not engaged in any pretrial activity with respect to any of the arbitrable claims and the motion to compel had been filed shortly after the case had commenced.

**ARBITRATION AWARD FOR FRANCHISOR VACATED IN FEDERAL DISTRICT COURT**

Choice Hotels International, Inc.’s arbitration award against a franchisee was recently vacated by the United States District Court for the District of New Jersey. In *Bapu Corp. v. Choice Hotels Int’l, Inc.*, 2008 WL 2559306 (D.N.J. June 24, 2008), a hotel franchisee filed suit against Choice Hotels requesting relief from an arbitration award and relief under the franchise agreement.

Choice Hotels in 2006 had won an arbitration award of $142,560 in liquidated damages against the franchisee after the franchisee had been terminated for failing to make renovations to its hotel by a certain date in 2000, as required by the franchise agreement. In the interim, there had been various communications from Choice Hotels to notify the franchisee of its first failure to make renovations and to offer extensions. When the franchisee failed to act on these communications, Choice Hotels began the
process of termination. Again, the franchisee did not respond to default notices, and, over six years after the initial default, Choice Hotels ultimately sent a "Notice of Termination."

The district court granted the franchisee's motion to vacate the arbitration award, finding that the arbitrator lacked jurisdiction over the dispute because Choice Hotels' claims were barred by the three-year statute of limitations clause in the franchise agreement. The court found that contractual time limits in which to commence arbitration are generally enforceable. In this case, the court found that Choice Hotels failed to initiate arbitration within three years from the date that the franchisee first missed its deadline to renovate its hotel. The court did not agree with Choice Hotels' argument that the franchisee was not in default until it sent the franchisee a final "Notice of Termination" because the franchisee's failure to renovate by the initial deadline constituted a material breach of the franchise agreement.

This case is a powerful reminder to franchisors not to sit on their rights when franchisees default under the franchise agreement.

**CALIFORNIA STATE COURT UPHOLDS DENIAL OF MOTION TO COMPEL ARBITRATION ON UNCONSCIONABILITY GROUNDS**

In a non-franchise case, the court in *Liebrand v. Brinker Rest. Corp.*, 2008 WL 2445544 (Cal. App. 4 Dist. June 18, 2008), upheld the trial court's denial of Brinker's motion to compel arbitration, concluding it had failed to meet its burden of proving Liebrand agreed to arbitrate an employment dispute. The trial court determined that the arbitration agreement was void because it was both procedurally and substantively unconscionable, specifically because it was an adhesion contract that mandated arbitration take place in Texas and required that Liebrand share the costs. On appeal, the court affirmed, holding that the agreement was an oppressive and adhesive arbitration agreement and was essentially a condition of employment.

**ARBITRATOR MAY APPLY EQUITABLE DEFENSES TO EXCUSE A PARTY FROM PERFORMING A MATERIAL CONDITION OF A FRANCHISE AGREEMENT**

Franchisee Celine Gueyffier's attempted opening of an Ann Summers store in Los Angeles was a failure, leading each party to file an arbitration claim asserting that the other had breached the parties' franchise agreement. The arbitrator found for Gueyffier, concluding that Ann Summers did not provide promised training, guidance, and assistance. In his written award, the arbitrator held that Gueyffier's failure to give Ann Summers notice of the breach and an opportunity to cure was immaterial because the breaches were incurable.
In *Gueyffier v. Ann Summers, Ltd.*, 2008 WL 2331046 (Cal. June 9, 2008), the Superior Court for Los Angeles County, reversing an intermediate court of appeals, held that absent an express and unambiguous limitation, an arbitrator has the authority to find the facts, interpret the contract, and award any relief rationally related to his or her factual findings and contractual interpretation. Since the parties did not include any such limitation in their contract, the arbitrator did not exceed his powers by interpreting the agreement to allow for equitable excusal of the notice-and-cure condition or by making a factual finding that notice would have been an idle act.

**NON-COMPETES**

**GEORGIA COURT REFUSES TO ENFORCE IN-TERM AND POST-TERM NON-COMPETE**

In *Atlanta Bread Company International, Inc. vs. Lupton-Smith et al.*, 2008 WL 2264863 (Ga. Ct. App. June 4, 2008), the Georgia Court of Appeals affirmed the trial court’s grant of summary judgment holding that the in-term and post-term non-compete covenants in the franchise agreements between Atlanta Bread Company International, Inc. (“ABCI”) and various companies owned by Sean Upton-Smith were unenforceable. The in-term non-compete covenant prohibited Upton-Smith from owning or engaging in any “bakery/deli business whose method operation is similar to that employed by store units within the System”. The post-term non-compete covenant prohibited Smith from engaging in a “Competing Business” within 20 miles of any Atlanta Bread Company® store for one year.

In January 2006, Smith opened a “PJ’s Coffee & Lounge” franchise under a franchise agreement with PJ’s Coffee USA. A month later, ABCI terminated Smith’s franchise agreements alleging a breach of the in-term non-compete covenant by operating the “PJ’s Coffee & Lounge” store. ABCI then sought to enforce the post-termination non-compete covenant.

The court of appeals affirmed the lower court’s ruling that the in-term non-compete was not enforceable because it was not limited to a specific territory and “Competing Business” was not described with sufficient particularity. Further, the court held that because the in-term non-compete covenant was invalid, the post-termination non-compete covenant was also invalid. Under Georgia law, if one part of a non-compete provision is unenforceable, the entire non-compete provision is unenforceable. Even if the in-term non-covenant was valid, it is unlikely that the court would have found the post-term non-compete valid because it prohibited Upton-Smith from competing within 20 miles of any Atlanta Bread Company® store. Since the location of the stores was not known at the time Smith signed the franchise agreement, the non-compete lacked the required specificity under Georgia law.
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