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: September 26, 2008 – No. 111

ANNOUNCEMENT

GRAY PLANT MOOTY WELCOMES CARL ZWISLER TO ITS FRANCHISE & DISTRIBUTION GROUP

Carl Zwisler has joined Gray Plant Mooty’s Washington, D.C. office as a principal in our Franchise & Distribution practice group.

Zwisler represents franchisors, manufacturers, and investors in structuring, negotiating, and enforcing domestic and international franchise, licensing, distribution, and acquisition agreements. With more than 33 years of intensive franchising experience, Zwisler has worked with clients in every phase of domestic and international franchising, licensing, and distribution programs, frequently advising companies entering the U.S. market and U.S. companies expanding abroad.

A leading authority on international master franchising, since 1992 Zwisler has chaired two-day symposia on that topic at the annual International Franchise Expos, and he authored the book Master Franchising: Selecting, Negotiating, and Operating a Master Franchise (Commerce Clearing House, 1999). He has also authored scores of articles and presentations on international franchising.

Zwisler served as the International Franchise Association’s chief staff counsel or general counsel from 1975-1983 and later chaired the IFA’s Supplier Forum and served on the IFA’s board of directors. In 2005, he was the first lawyer to receive the IFA’s Distinguished Service Award. He also was a founding member of the American Bar Association Franchising Forum’s International Franchising and Distribution Law Division.
Here are some of the most recent legal developments of interest to franchisors:

SYSTEM CHANGE

**FRANCHISOR HAD NO CONTRACTUAL DUTY TO SUPPLY A “WELL RECOGNIZED” BRAND**

In *Klosek v. American Express Co.*, 2008 WL 4057534 (D. Minn. Aug. 26, 2008), the United States District Court for the District of Minnesota addressed issues arising from the American Express Company’s decision to spin off its subsidiary, American Express Financial Advisors, and the spin-off’s subsequent adoption of a new brand name—“Ameriprise”. The plaintiffs, former American Express Financial Advisors (now Ameriprise) franchisees, brought a putative class action asserting claims for breach of contract, breach of the implied covenant of good faith and fair dealing, violations of the Minnesota Franchise Act, and tortious interference with contract. The plaintiffs based their claims on the contention that any brand substitution authorized by the parties’ franchise agreements required that the new brand be “well-recognized.” The court granted the defendants’ motions to dismiss and ruled that the franchise agreements unambiguously indicate that Ameriprise had no obligation to supply a “well recognized” brand, and that the franchise agreements expressly reserved Ameriprise’s right to substitute new marks at its discretion.

The court rejected the plaintiffs’ argument that because Ameriprise did not supply a well-established brand, it breached the implied covenant of good faith and fair dealing. Rather, the court found that because Ameriprise had no obligation to provide a well-established brand, its purported failure to do so could not be a basis for breach of the implied covenant. The court further rejected the plaintiffs’ argument that American Express wrongfully interfered with the franchise agreements when it deprived Ameriprise of the American Express brand.

TRADEMARKS AND INJUNCTIVE RELIEF

**FRANCHISEE’S FRAUD CLAIM DOES NOT BAR ENTRY OF PRELIMINARY TRADEMARK INJUNCTION**

In *Jay Bharat Developers, Inc. v. Minidis*, 2008 WL 4173626 (Cal. App. 2 Dist. Sept. 11, 2008), the California Court of Appeals this month upheld the trial court’s entry of a preliminary injunction prohibiting a former master franchisee of the Red Brick Pizza franchise system from continuing to display the franchisor’s trademarks after the termination of its franchise rights. The master franchisee sued Red Brick Pizza’s co-founders, alleging that those individuals had fraudulently induced the franchisee to enter its franchise agreement. While that action was pending, Red Brick Pizza
terminated the plaintiff’s master franchise agreement due to the failure to pay fees owed thereunder. When the franchisee continued to display Red Brick Pizza’s trademarks and otherwise disregarded its post-termination obligations, Red Brick Pizza sought a preliminary injunction against the franchisee. The trial court granted that injunction.

On appeal, the franchisee argued that the franchisor could not show the required likelihood of success on the merits of its claim, as the franchisee had alleged that the franchise agreement itself was induced by fraud. The court of appeals rejected that argument, finding that the franchisor had presented ample evidence that the franchisee had breached its franchise agreement by failing to pay required fees. The court noted that if the franchisee believed the franchisor had breached the franchise agreement, it was required to elect either to treat the contract as abandoned or continue performing and sue for damages. What the franchisee could not do was stop performing under its contract yet continue to accept the benefits of that contract. Finding that the franchisee had continued to operate its business under the Red Brick Pizza trademarks without paying any of the fees owed under the franchise agreement, the court concluded that the franchisee had not properly elected a remedy for the fraud it claimed. Thus, even if the franchisee had been able to prove its fraud claim, that claim would have entitled it to recover only monetary damages, not to continue using the franchisor’s trademarks.

SEVENTH CIRCUIT UPHOLDS JUDGMENT OF CONTEMPT DUE TO FRANCHISEE’S FAILURE TO COMPLY WITH PRELIMINARY INJUNCTION

In *Pearle Vision, Inc. v. Romm*, 2008 WL 4059793 (7th Cir. Sept. 3, 2008), the United States Court of Appeals for the Seventh Circuit reviewed the lower court’s decision holding a former multi-unit franchisee in contempt for failing to comply with a preliminary injunction, and awarding a judgment on the contempt in favor of the plaintiff franchisor in the amount of $321,000.

The defendant is an optometrist and former franchisee who had operated (by himself and through his companies) four Pearle Vision stores, pursuant to separate franchise agreements. After the plaintiff had terminated his franchise agreements and filed suit against him, the defendant made an attempt late at night to haul away equipment and records from one of the stores. The franchise agreements required the defendant to provide copies of all patient records. They also required a terminated franchisee to “cooperate in an orderly change of management,” and gave the franchisor the right to purchase the store equipment upon termination. Although the district court issued an injunction ordering all records and equipment to be made available to the plaintiff, the defendant repeatedly failed to produce patient files and comply with the court’s other directives. For example, after producing computers containing no patient data and
testifying that the computers were all he had to produce, the defendant then admitted that he had maintained patient data on his store computers. The court ultimately sanctioned the former franchisee $1,000 per day until he produced patient records and equipment. After the court awarded summary judgment to the franchisor and subsequent bankruptcy proceedings had concluded, the court reinstated the case to determine whether to enter judgment on the contempt. The defendant then made further missteps, which included failing to appear at court hearings and refusing to produce tax returns. In light of all this, the court concluded that the defendant had willfully disregarded the court’s injunction order and entered judgment against him.

On appeal, the Seventh Circuit affirmed the full amount of sanctions that the trial court imposed against the defendant. In so doing, the court noted that the defendant had been given several opportunities to contest the sanctions and purge the contempt through compliance, but that he failed to take advantage of those opportunities.

ARBITRATION

CALIFORNIA COURT OF APPEALS AFFIRMS THAT THERE WAS NO MEETING OF MINDS IN DRAFTING OF ARBITRATION CLAUSE DUE TO UFOC STATE ADDENDA

In *Ron Winter, et al. v. Window Fashions Professionals, Inc.*, 2008 WL 3845229 (Cal. App. 5 Dist., August 19, 2008), the California Court of Appeals affirmed the trial court’s decision that there was no meeting of the minds on an arbitration clause in a franchise agreement due to a state addendum to the franchisor’s Uniform Franchise Offering Circular (“UFOC”).

Ron Winter and Window Fashions Professionals, Inc. (“WFP”) entered into a franchise agreement that required the parties to submit claims to binding arbitration in Dallas County, Texas and provided that the franchise agreement would be governed by Texas law. The California Addendum to WFP’s UFOC stated that these provisions “may not be enforceable under California law.” The trial court held, and the court of appeals affirmed, that there was no meeting of the minds on the arbitration and choice of law provisions in the franchise agreement due to the disclaimer in the UFOC. In reaching its decision, the court relied on *Laxmi Investment, LLC v. Golf USA*, 193 F3d 1095 (9th Cir. 1999). Even though the *Laxmi* franchise agreement specified arbitration in Oklahoma, because the UFOC stated that this provision may not be enforceable under California law, the Ninth Circuit held that there was no clear agreement as to forum.

This new case, like *Laxmi*, is troubling for franchisors since a state examiner may require that franchisors use similar language in state addenda whenever the examiner believes that a provision in a franchise agreement may contradict state law. Under a technical
reading of both Winter and Laxmi, the fact that the UFOC or FDD states that a provision “may not” be enforceable could be enough to negate the parties’ meeting of the minds even if the examiner was wrong about the law.

SIXTH CIRCUIT OVERTURNS ARBITRATION DECISION FOR MANIFEST DISREGARD OF THE LAW

The Sixth Circuit Court of Appeals has taken the relatively rare step of vacating an arbitration award on the grounds of “manifest disregard for the law.” In Coffee Beanery, LTD. v. WW, L.L.C., 2008 WL 3838010 (6th Cir. Aug. 8, 2008), an unsuccessful franchisee sued its franchisor alleging, among other claims, fraud, negligent misrepresentation, breach of contract, and violation of several franchise disclosure laws. The franchisor successfully moved to dismiss the court action and compel arbitration, based on the franchise agreement’s arbitration clause. At arbitration, the franchisee presented undisputed evidence that the franchisor had failed to disclose its vice president’s prior felony conviction for grand larceny.

The Maryland Franchise Registration and Disclosure Law (which the parties agreed applied to the case) requires franchisors to disclose whether any person identified in Item 2 “has been convicted of a felony…if the felony…involved fraud, embezzlement, fraudulent conversion, or misappropriation of property.” The arbitrator, however, found in favor of the franchisor on all counts, concluding that grand larceny is not the type of felony conviction required to be disclosed under the Maryland law. The arbitration decision was confirmed by the United States District Court for the Eastern District of Michigan. The Sixth Circuit, however, found that the statute “could not be any more clear” that felony convictions involving misappropriation of property must be disclosed. By definition, grand larceny is a felony involving misappropriation. Moreover, the arbitrator’s conclusion that the non-disclosure did not directly cause damages to the franchisee was of no import, because the technical violation of the disclosure law itself entitled the franchisee to rescission. Finally, because the franchisee’s execution of the franchise agreement was preceded by a defective franchise disclosure, the franchisee was not bound by the terms of the franchise agreement—including the arbitration clause. Therefore, the franchisee could not be compelled to arbitrate its claims on remand.

COURT RECONSIDERS PRIOR VACATION OF ARBITRATION AWARD

The federal district court in New Jersey has changed its mind and has now confirmed an arbitration award won by a franchisor. Bapu Corp. v. Choice Hotels International, Inc., 2008 WL 4192056 (D.N.J. Sept. 8, 2008). The court’s earlier decision, as reported in Issue 109 of The GPMemorandum, had vacated the award based on the court’s belief that the applicable statute of limitations had expired before the franchisor commenced
the arbitration. In reconsidering that decision, the court realized that the statute of limitations evaluation was for the arbitrator, not the court, to decide. The court now also rejected the franchisee’s other arguments to overturn the award, such as that the arbitrator had been biased, that the arbitration hearing should have been postponed, and that hearsay evidence had been improperly admitted.

COURT DECLINES TO ENFORCE CHOICE OF LAW, CHOICE OF FORUM, OR ARBITRATION PROVISIONS IN FRANCHISE AGREEMENTS WITH CALIFORNIA FRANCHISEES

In Bridge Fund Capital Corporation v. Fastbucks Franchise Corporation, 2008 WL 3876341 (E.D. Cal. Aug. 20, 2008), the court dismissed a franchisor’s motion to dismiss or stay the action pending the outcome of arbitration because it declined to enforce the choice of law, choice of forum, and arbitration clauses in the franchise agreements at issue. This case demonstrates how careful franchisors must be, especially in cases where courts would apply California law, with respect to contractual provisions in franchise agreements that create one-sided legal rights in their favor.

The franchisees in this case operated payday loan and check cashing franchises located in California. The franchisor was a Nevada corporation with its principal place of business in Texas, and it provided training to the franchises at its headquarters in that state. The franchise agreements at issue contained choice of law and choice of forum provisions requiring any dispute to take place in Texas in accordance with Texas law. In addition, the franchise agreements required all disputes arising between the parties to be resolved through arbitration in Texas. However, the UFOCs contained an addendum pertaining to the enforcement of the franchise agreements under California law. The franchisees sued Fastbucks in state court, alleging that the franchisor had made material misrepresentations and omissions of fact regarding the franchise system and that it had failed to comply with state franchising laws. After the case was removed to federal court, Fastbucks filed a motion to dismiss or stay the action pending the outcome of arbitration.

The federal court denied the motion to dismiss. Turning first to the choice of law and choice of forum clauses, the court found that California had a “materially greater interest” than Texas in the case, and, therefore, the latter state’s laws should apply to any dispute between the parties. For the most part, the court reached this conclusion because applying Texas law would bar the franchisees from the protections provided by the California Franchise Investment Law. The court rejected the franchisor’s suggestion that the arbitration could be brought in Texas because they could not show any prior case in which a Texas court or arbitrator had applied the CFIL with respect to a California franchisee. Therefore, the court concluded, the franchisor had failed to show
that the franchisees’ rights “would not be diminished” if the choice of law and choice of forum clauses were enforced.

The court also declined to enforce the arbitration provisions finding that the provisions were both procedurally and substantively unconscionable. Specifically, the court found that the franchise agreements were contracts of adhesion because the franchisees had no real negotiating power when they entered into the agreements, citing to a handful of California cases holding that franchisees have no real power to negotiate the terms of arbitration provisions. Further, the court deemed the arbitration provisions substantively unconscionable because they lacked mutuality, as the arbitration clauses allowed only the franchisor to seek injunctive relief, limited the franchisees’ recoverable damages, shortened the applicable statute of limitations, imposed place and manner restrictions, and waived the franchisees’ rights to participate in class action litigation against the franchisor.

PROCEDURE

TIMELY VOLUNTARY DISMISSAL HELD SUFFICIENT TO AVOID SUMMARY JUDGMENT IN CALIFORNIA

A panel of the California Court of Appeals has reversed a summary judgment and award of $270,000 in attorney’s fees that had been won by a franchisor in Gogri v. Jack In The Box, Inc., 166 Cal. App. 4th 255 (Cal. App. 4 Dist. August 25, 2008). The basis of the reversal was that the plaintiff-franchisee had voluntarily withdrawn his claims prior to the summary judgment ruling. The appellate court found that the voluntary dismissal was timely under California state procedures even though the summary judgment motion had been pending at the time of the franchisee’s withdrawal of claims. The court did remand the fees issue for further proceedings to determine whether the franchisor should be awarded anything as to a portion (i.e., only the non-contract claims) of the plaintiff’s original lawsuit.

THIRD CIRCUIT FINDS FRANCHISEE’S CLAIMS NOT PRECLUDED BY PREVIOUS SUIT

In Hopkins v. GNC Franchising, Inc., 2008 WL 3845375 (3d Cir. Aug. 19, 2008), the Third Circuit Court of Appeals overturned a Pennsylvania federal court’s decision dismissing a terminated franchisee’s second lawsuit against franchisor GNC for breach of contract and tortious interference with contract. The Third Circuit allowed both claims to proceed against the franchisor.

The district court had found that the terminated franchisee’s claims were barred by the doctrine of issue preclusion, which bars a subsequent action from being decided when
there previously has been a final judgment on the merits involving the same parties and the same causes of action. In overturning the district court’s opinion, the Third Circuit held that there had not been a final determination on the merits relating to the franchisee’s previous tortious interference claim because that claim had been dismissed without prejudice. The appellate court also held that the franchisee’s breach of contract claim was different from the claims for breach of the covenant of good faith and fair dealing and common law fraud, which had previously been brought against GNC. Finally, the Third Circuit held that the district court erred in its alternate grounds for dismissal—that the franchisee had failed to state a claim for which relief can be granted. In reviewing the elements of both breach of contract and tortious interference, the Third Circuit held that the franchisee had alleged sufficient facts to bring both claims.

**FEDERAL COURT DISMISSES FRANCHISEE’S DECLARATORY JUDGMENT LAWSUIT ON RIPENESS GROUNDS**

In *Casual Dining Development, Inc. v. QFA Royalties, LLC*, 2008 WL 4186692 (E.D. Wis. Sept. 5, 2008), the plaintiffs, Quiznos franchisees, filed a complaint for declaratory relief related to the Area Director Marketing Agreement between the parties. The plaintiffs sought a declaratory judgment excusing them from their development quota obligations under the development agreement. The plaintiffs argued that their failure to develop additional franchises was the result of unfavorable press and negative customer attitudes toward the franchisor. However, as the Court noted, the plaintiffs filed their lawsuit even though Quiznos had not taken any action against them for their non-compliance with the development agreement. Quiznos had neither defaulted nor terminated them. Because the plaintiffs’ claims were entirely contingent on a series of future events and there was no “substantial controversy between parties having adverse legal interests,” the court held that the request for declaratory judgment was not ripe and dismissed the claims.

**RELEASE UPON TRANSFER BARRED FRANCHISEE’S $8.5 MILLION WIN**

In *Blockbuster, Inc. v. C-Span Entertainment, Inc.*, 2008 WL 3318882 (Tex. App. Aug. 12, 2008), a Texas Court of Appeals overturned a huge judgment that had been won by a franchisee on breach of warranty, conversion, and fraudulent inducement claims. The provision at issue was a broad release in a transfer agreement, through which agreement the franchisor had been released from all claims by the franchisee.

Sunil Dharod purchased a number of Blockbuster® shops in Tyler, Texas. At closing, Dharod signed the franchise agreement for the shops in his individual capacity. Blockbuster and Dharod subsequently executed a transfer agreement, whereby Dharod transferred his interests in the franchise agreements to his company, C-Span.
Entertainment. The transfer agreement contained release language whereby Dharod released “broadly” all claims arising under the franchise agreements or “under federal, state, or local law.” When the shops failed to perform, Dharod and C-Span Entertainment sued Blockbuster for breach of warranty, conversion, and fraudulent inducement. At trial, the trial court found in favor of Dharod and C-Span Entertainment on all claims and awarded them damages in the amount of $8.5 million. It also awarded them attorneys’ fees and costs. Blockbuster appealed.

In overturning the judgment, the appeals court held that the trial court had incorrectly ignored the release language. Under Texas law, “[a] valid release is a complete bar to any action based on matters covered by the release.” The appeals court also overturned the award of attorneys’ fees and costs in favor of the franchisee, and, instead, awarded Blockbuster $2.5 million in attorneys’ fees as the prevailing party under the parties’ agreement.

NEW JERSEY FEDERAL COURT TRANSFERS CASE TO CALIFORNIA, AT FRANCHISEES’ REQUEST

A franchisor’s lawsuit against the operators of two franchises in California was transferred this month to that state despite contractual forum selection clauses that had specified venue in the franchisor’s home state of New Jersey. *Elite Sports Enterprises, Inc. v. Lococo*, 2008 WL 4192045 (D.N.J. Sept. 5, 2008). Noting that the forum selection clauses “may be considered” in the court’s analysis of a transfer motion, the parties’ choice of venue is “not dispositive,” the New Jersey court held. In this case, the court found more significant that the “operative facts” of the dispute had occurred in California, where the corporate franchisees were headquartered, where the principals of the franchisees lived, where the franchised stores were located, and where the alleged trademark violations occurred. Witnesses and other evidence also were located primarily in California, the court found. Lastly, the court upheld what it viewed as the strong “public interest” of California in having franchisees located there governed by California law and California courts.
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