The GPMemorandum

TO: OUR FRANCHISE CLIENTS AND FRIENDS

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

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

NONCOMPETES

NINTH CIRCUIT REAFFIRMS THAT IN-TERM COVENANT NOT TO COMPETE WAS ONLY PARTIALLY ENFORCEABLE UNDER CALIFORNIA LAW

One year after issuing its original opinion, the Ninth Circuit has reaffirmed its order vacating that portion of an arbitrator's award that enforced a broad covenant against competition in the franchise context. In *Comedy Club, Inc. v. Improv West Associates*, 553 F.3d 1277 (9th Cir. Jan. 29, 2009), the Ninth Circuit considered again its previous decision in light of an order from the United States Supreme Court vacating its prior opinion.

As previously reported in Issue 100 of *The GPMemorandum*, the arbitrator in this dispute enforced a broad in-term covenant against competition that prohibited a franchisee from opening competing comedy clubs. The Ninth Circuit reversed that portion of the arbitrator's decision, finding that the arbitrator had manifestly disregarded California law with respect to the noncompete issue. The Supreme Court vacated that opinion after its decision in *Hall Street Associates, LLC v. Matel, Inc.*, in which it held that the Federal Arbitration Act provided exclusive grounds to modify or vacate an arbitration award. The Supreme Court remanded this case to the Ninth Circuit to determine whether "manifest disregard of the law" constituted a permissible basis on which to vacate an arbitration award given its absence from the provisions of the FAA.

On remand, the Ninth Circuit affirmed its previous decision. The court stood by its holding that the manifest disregard of the law standard was "shorthand" for the statutory ground in the FAA permitting an award to be vacated where an arbitrator exceeds his or her powers. The court found again that the arbitrator had displayed a manifest disregard for the law by enforcing a restrictive covenant that applied geographically to the contiguous United States and extended until the year 2019. The court also affirmed its previous holding that the franchisor was entitled to enforce its restrictive covenant only in counties where the franchisee was already operating a franchised location.

TERMINATIONS

CALIFORNIA COURT HOLDS THAT A FRANCHISOR'S IMMEDIATE TERMINATION FOR SALE OF UNAPPROVED PRODUCTS WAS NOT UNLAWFUL UNDER THE CALIFORNIA FRANCHISE RELATIONS ACT

In *Baskin-Robbins Franchising LLC v. Mihranian*, No. 2:08-cv-07022 (C.D. Cal. Jan. 23, 2009), a California federal district court last month denied a motion by franchisees to dismiss their franchisor's complaint and held that Baskin-Robbins' immediate termination of the franchise did not violate the California Franchise Relations Act ("CFRA"). Gray Plant Mooty represented the franchisor in this case. Baskin-Robbins had immediately terminated after finding the franchisees were using and selling nonfat frozen yogurt at their ice cream shop, a product specifically prohibited for sale by the franchisor. At issue were Sections 20020 and 20021 of the CFRA and whether Baskin-Robbins needed to provide a cure period. Section 20020 of the CFRA prohibits a franchisor from terminating a franchise without good cause and without first providing a reasonable opportunity to cure. Section 20021, however, provides for a number of circumstances in which a franchisor may terminate immediately.

The franchisees contended that Baskin-Robbins was required to provide an opportunity to cure under Section 20020. Baskin-Robbins argued, in turn, that the sale of unapproved products is harmful to a franchisor's goodwill and reputation. Such conduct, Baskin-Robbins argued, fulfills the statutory description of "conduct which reflects materially and unfavorably upon the operation and reputation of the franchise business and system" under the exceptions found in Section 20021(d) of the CFRA. The court agreed with Baskin-Robbins and held that the sale of unapproved products reflects negatively upon the franchisor's name and business reputation. The court denied the franchisees' motion to dismiss the franchisor's case.

PENNSYLVANIA SUPREME COURT ALLOWS IMMEDIATE TERMINATION OF FRANCHISEE DESPITE CONTRACTUAL PERIOD TO CURE

In a case of first impression under Pennsylvania law, that state's highest court has held that there are some situations in which a franchisor can terminate its franchisee without any right to cure even if a franchise agreement provides otherwise. *LJL Transportation, Inc. v. Pilot Air Freight Corp.*, 2009 WL 144561 (Pa. Jan. 22, 2009). The egregious circumstances in this case were that the franchisee in bad faith was diverting business to a competitor of the franchisor. In that situation, the Pennsylvania court held, immediate termination was warranted because the breach "was serious and incurable" in that it went "directly to the essence of the contract, which is so exceedingly grave as to irreparably damage the trust between the contracting parties."

COLORADO FEDERAL COURT REJECTS FRANCHISOR'S BASES FOR TERMINATION

In what will likely become one of the most quoted franchise opinions of the year, a Colorado federal district judge has ruled against Quizno's in a case the franchisor brought against a terminated former franchisee for injunctive relief and breach of contract. *Quizno's Franchising II LLC v. Zig Zag Rest. Group, LLC,* Case No. 06CV10765, Bus. Franchise Guide (CCH) ¶14,046 (D. Colo. Dec. 31, 2008). The court found Quiznos' "whole charade of 'terminating' and 'defaulting' franchisees who failed [a] field test was just that—a charade—driven not by Quiznos' genuine concern about whether its franchisees were making sandwiches to spec, but rather by its overriding public relations desire to be able to proceed with its national advertising campaign targeting Subway."

In this case, the defendant franchisees, a husband and wife owning a single Quizno's shop, received an automatic non-curable termination notice after a mystery shopper determined the franchisee's sandwiches contained less than four ounces of meat when the system standard was five ounces for the new menu item. In what the court called the "Post-Termination Shadow Land," the franchisee then was invited to continue running the Quizno's franchise, but was simultaneously removed from the chain's store locators system and cut off from non-food supplies. The court concluded that "by permitting [the franchisee] to continue to operate as a Quizno's outlet, when the notice of termination and [the Franchise Agreement] specifically required [the franchisee] to cease operating, Quizno's waived its right to terminate [the franchisee] and to seek damages for breach, and is in any event estopped from making those claims." Another interesting tidbit from this case is the court's determination that it was Quizno's, and not the franchisee, that should have mitigated damages "over an agonizing period of 14 months of slow kill."

It is the sensational writing style of this opinion that will likely put it high on "most cited" list, but the lesson here is that the system-wide practices of franchisors need to be well documented in each case and followed carefully, lest they end up the centerpiece of litigation.

CLASS ACTIONS/AMERICANS WITH DISABILITIES ACT

CALIFORNIA FEDERAL COURT REFUSES TO DISMISS ADA CLASS CLAIM AGAINST BURGER KING CORPORATION

A plaintiff alleging access violations at approximately 90 Burger King restaurants in California will be allowed to proceed with the case under a decision issued last week. *Castaneda v. Burger King Corp.*, 2009 WL 398489 (N.D. Cal. Feb. 18, 2009). The plaintiff's legal standing and specificity of allegations survived the defendant's motion to dismiss on the pleadings, according to the decision of the United States District Court for the Northern District of California. This is the first reported major case against a franchisor under the Americans with Disabilities Act ("ADA") in several years.

The California federal court's opinion was focused only on the sufficiency of the plaintiff's pleadings and did not go to the merits of the case. Importantly, however, the court held that the plaintiff had standing to allege claims challenging ADA compliance at restaurants the plaintiff had never visited. The allegation that all of the challenged stores were built pursuant to "architectural design prototypes developed by Burger King" was found to be adequate at the pleadings stage for the plaintiff to bring his case on behalf of individuals who use wheelchairs or electronic scooters. The allegedly offending building features included parking lots, restroom doors, dining areas, restrooms, and queue lines near the order counters. The court held that even the generalized allegations were sufficient to allow the case to survive under federal and state disability law, at least into the discovery stage.

The court did note that other ADA cases have ultimately been won by restaurants and hotels at the summary judgment stage. For now, however, the complaint adequately pleads the existence of common discriminatory barriers or policies, this court ruled.

COURT DENIES MOTION TO REMAND CLASS ACTION, FINDING NO EXCEPTION TO CLASS ACTION FAIRNESS ACT APPLIED

In *Moua et al. v. Jani-King of Minnesota, Inc.*, 2009 WL 212425 (D. Minn. Jan. 27, 2009), the United States District Court for the District of Minnesota denied a group of class action plaintiffs' motion to remand the case to state court, finding that federal jurisdiction was proper under the Class Action Fairness Act (CAFA). The plaintiffs, a group of franchisees of the Jani-King cleaning and janitorial system, initially brought suit in Minnesota state court against their franchisor, claiming Jani-King did not have enough cleaning and janitorial accounts to provide the minimum level of monthly business each had been promised, among other allegations. Jani-King removed the case to federal court under CAFA's mandate that gives federal courts jurisdiction over class actions based on state law when (1) there is "minimal" diversity, meaning that at least one plaintiff and one defendant are from different states; (2) the amount in controversy exceeds $5 million, and (3) the action involves at least 100 class members. The court found that all three grounds were met here.

The franchisee plaintiffs argued that the case fell within one of CAFA's exceptions to federal jurisdiction, the so-called "home state controversy exception." That exception requires a federal district court to decline jurisdiction over a class action in which at least two-thirds of the members of the class and the primary defendants are citizens of the state in which the action was originally filed. Two-thirds of the class here were Minnesota citizens, and the franchisees argued that the primary defendant, Jani-King of Minnesota, Inc., was as well. Jani-King countered that Jani-King International, one of the named defendants, was a Texas citizen and thus the exception did not apply. The court agreed, finding that Jani-King International was alleged to be directly liable in a significant number of the asserted claims and thus constituted one of the primary defendants for purposes of the exception. The court went on to dismiss several of the claims, finding some of the franchisees were barred from bringing certain claims by the statute of limitations and other claims were not pleaded with sufficient particularity, including fraud and false statements in advertising.

ARBITRATION

CALIFORNIA COURT COMPELS ARBITRATION BUT STRIKES PORTIONS OF ARBITRATION CLAUSE AS UNCONSCIONABLE

In *IJL Dominicana S.A. v. It's Just Lunch Int'l, LLC*, 2009 WL 305187 (C.D. Cal. Feb. 6, 2009), the United States District Court for the Central District of California this month enforced an arbitration clause in a franchise agreement and granted in part a franchisor's motion to compel arbitration, but severed a significant portion of the clause on unconscionability grounds in accordance with the Ninth Circuit *Nagrampa* decision, which continues to have broad implications for franchisors.

In the new case, the plaintiff franchisees filed suit against the defendant-franchisor, It's Just Lunch. The franchisor then filed a motion to compel arbitration based on an arbitration provision in the franchise agreement. The franchisees, in turn, contended that the arbitration clause was unconscionable and unenforceable under California precedent, namely *Nagrampa*. In compelling arbitration, the court first acknowledged the general validity of arbitration clauses, and the liberal federal policy favoring them.

The court then evaluated the arbitration clause to determine whether it was procedurally or substantively unconscionable. The court found that the clause was substantively unconscionable in that it barred punitive damages, exemplary damages, class action arbitration, and consolidated arbitration. As in *Nagrampa*, these provisions favored the franchisor. This court, however, noted that the arbitration clause was not procedurally unconscionable because the clause was "set out in the same manner" as every other provision in the franchise agreement, the arbitration was identified in the index to the franchise agreement, and the franchisee admitted that she had read the entire contract.

The court then evaluated the other provisions of the franchise agreement to determine whether to sever the unconscionable portions or strike the entire arbitration clause. The franchisee pointed to clauses that set out a one-year limitations period on virtually all claims and granted the franchisor exclusive rights to bring certain claims. Although the court agreed that these clauses were one-sided, it found that the franchise agreement was not "permeated" with unconscionability. Concluding that it would uphold the arbitration clause while severing the unconscionable portions, the court granted in part the franchisor's application to compel arbitration.

FIRST CIRCUIT HOLDS THAT COURT – NOT ARBITRATOR – SHOULD DECIDE WHETHER ARBITRATION PROVISION IS UNCONSCIONABLE

In *Awuah v. Coverall North Am., Inc.,* 2009 WL 159423 (1st Cir. Jan. 23, 2009), several franchisees filed a class action against the franchisor in Massachusetts federal district court alleging fraud, breach of contract, and violations of various minimum wage, overtime, and consumer protection laws. In response to the lawsuit, the franchisor moved to compel arbitration and stay the pending litigation, based upon arbitration provisions contained in three of the applicable franchise agreements. The franchisees responded that the arbitration clauses were unconscionable and that the court should decide whether the agreements to arbitrate are enforceable.

Relying on the rules of the American Arbitration Association, which rules had been incorporated by reference into the arbitration agreements, the franchisor argued that the franchisees' challenge to the validity of the arbitration provisions was a matter for the arbitrator to decide. The federal district court disagreed with the franchisor and held that the franchisees' claims of unconscionability should be addressed by the court because the applicable franchise agreements "did not clearly and unmistakably" state that claims challenging the validity or unconscionability of the arbitration clause should be heard by an arbitrator.

On appeal to the First Circuit, the appellate court disagreed with the lower court and determined that the AAA rules requiring the arbitrator to decide the validity of an arbitration agreement were clear and unmistakable and that the rules had, unequivocally, been incorporated into the franchise agreements. Notwithstanding that determination, the appeals court expressed concern that if the terms for getting an arbitrator to decide the issue of unconscionability are unduly burdensome due to the expense associated with arbitration, then the arbitration remedy becomes "illusory" and arbitration is no longer a valid alternative to litigation. Based upon this concern, the First Circuit remanded the issue to the district court to determine whether, under the facts of the case, the arbitration clause effectively deprived the franchisees of a remedy.

CALIFORNIA APPELLATE COURT CONFIRMS ARBITRATION AWARD AGAINST FRANCHISOR

In *Doctor's Associates, Inc. v. Nat,* 2009 WL 162680 (Cal. App. 2 Dist. Jan. 26, 2009), the California Court of Appeals upheld a lower court ruling affirming an arbitrator's decision that a franchisor breached its obligations to assist a Subway franchisee in the sale of his franchises. Franchisor Doctor's Associates, Inc. ("DAI") had originally filed an arbitration seeking to terminate the franchisee's two locations in Southern California for underreporting of sales and other breaches of the franchise agreements. During the course of this initial arbitration, the parties reached a settlement agreement, the terms of which were set forth in a consent award. The agreement required franchisee Nat to sell his franchises by a certain date and obligated DAI to "assist [the franchisee] in finding a buyer in good faith." The stores, however, were not sold by the deadline. DAI then filed a petition in state court to confirm the consent award as a final judgment and terminate the franchises. The trial court found for DAI.

The franchisee next filed a new demand for arbitration, claiming that DAI's refusal to consent to the transfer of his stores had breached the franchisor's obligations under the consent award to assist him in the sale of the restaurants. The arbitrator in this second arbitration found that while DAI acted in good faith before the deadline, it had waived the deadline by failing to object to the franchisee's continued efforts to sell the stores after that date had passed. In fact, the arbitrator found that DAI had encouraged the franchisee to continue his efforts to sell the stores (and to continue to operate the locations) after the deadline because DAI would have had to pay a landlord significant penalties if one of the stores had been allowed to go dark.

After this second round of arbitration, DAI failed in its effort to vacate the award before the state trial court. In affirming that decision, the court of appeals now has found that there was no merit to DAI's contention that the second arbitrator had exceeded his powers. The court also rejected DAI's argument that the arbitration could not have been brought because it had been based on a breach of a consent award, which did not mandate arbitration.

COURT UPHOLDS AWARD IN FAVOR OF FRANCHISOR, FINDING THAT ARBITRATOR DID NOT MANIFESTLY DISREGARD THE LAW

In *Ahluwalia v. QFA Royalties, LLC*, 2009 WL 262466 (Colo. App. Feb. 5, 2009), a franchisee appealed a district court decision affirming an arbitration award of over $600,000 against him in a dispute with Quizno's. The franchisee claimed, first, that the arbitration award was invalid because two of the three franchise agreements in dispute did not contain arbitration provisions and, second, that the district court erred in applying the "manifest disregard" standard to the arbitrator's decision. The franchisee lost on both counts.

The court found persuasive authority to conclude that "incorporating the AAA Commercial Arbitration Rules into [one of the] agreement[s]…authorized the arbitrator to decide arbitrability issues, including whether all three franchise agreements were subject to the 2001 arbitration clause." Therefore, the arbitrator in this case had jurisdiction to apply the decision to disputes under all three agreements. On the issue of the appropriate standard of review, the court also ruled against the franchisee, finding that the FAA, not Colorado law, applied, and that the arbitrator's decision could be overturned only if the arbitrator manifestly disregarded the law.

FRAUD

SIGNED UFOC RECEIPT TRIGGERS STATUTE OF LIMITATION; FRANCHISEE'S FAILURE TO DISCLOSE CLAIM DEFEATS OWN FRAUD IN THE INDUCEMENT CLAIM

In *Guesthouse International Franchise Systems, Inc. v. British American Properties MacArthur Inn, LLC*, 2009 WL 278214 (M.D. Tenn. Feb. 5, 2009), a hotel franchisor terminated its defaulting franchisee and then sued to collect past due royalties, reservation fees, and liquidated damages due as a result of the early termination. In response, the franchisee asserted affirmative defenses (doubling as counterclaims) that Guesthouse violated the Tennessee Consumer Protection Act (TCPA) and fraudulently induced the franchisee to sign franchise agreement. The franchisee claimed that Guesthouse violated the TCPA by failing to provide a UFOC and by making deceptive oral statements during the negotiation process. These claims, however, were barred under the TCPA's one-year limitations period, the court held. The franchisee had admittedly signed a receipt for delivery of the UFOC before executing the franchise agreement and therefore, as a matter of law, should have discovered the lack of UFOC delivery within one year of the receipt date. The franchisee also should have discovered the falsity of Guesthouse's oral statements as soon as Guesthouse failed to deliver on the alleged promises when the hotel opened, the court found.

In support of its fraud claim, the franchisee had asserted that Guesthouse falsely promised to provide a high level of marketing and training support to the franchisee and that Guesthouse's UFOC disclosures were misleading as to the amount of litigation involving Guesthouse. The court held that the franchise agreement's clear and unambiguous integration clause (stating that no promises or representations existed outside of the written agreement) precluded the franchisee's fraud claim, particularly where, as here, the franchisee is a sophisticated and experienced hotelier who admitted to having read and understood the integration clause. Moreover, the franchisee could not claim reasonable reliance on statements in the UFOC, since the franchisee did not assert that it had ever read the UFOC and even asserted that no UFOC was delivered.

PRELIMINARY INJUNCTIONS: TRADEMARKS

CITING FRANCHISE AGREEMENT, COURT GRANTS INJUNCTION AGAINST OPERATION OF GRIPE SITE

The United States District Court District for the District of Utah has granted a franchisor's preliminary injunction motion to enjoin a derogatory Web site, even though the actual Web site operator had not signed the franchise agreement enforced by the court. *Homeworx Franchising, LLC v. Meadows*, 2009 WL 211918 (D. Utah Jan. 26, 2009). The franchise agreement involved in this case precluded any unauthorized use of the franchisor's trademarks and any business or marketing practice injurious to the franchisor's business and goodwill associated with franchisor's marks.

The defendant Web site operator refused to take down the site, arguing that he was not bound by the terms of the franchise agreement because the franchise agreement was signed by another individual. The contract, however, referenced the Web site operator by name as a franchisee. Further, the Web site operator had testified that he was involved with the franchised business as a manager and was also a business partner of the individual who signed the franchise agreement. As a result, the court held the Web site operator was bound by the terms of the franchise agreement because the evidence clearly demonstrated he was in fact a franchisee, either as a partner or a joint venturer.

The defendants then argued that even if the Web site operator was bound by the franchise agreement, the agreement itself would infringe on his First Amendment rights. The court disagreed, finding that the defendants voluntarily surrendered some of their rights when they entered into the franchise agreement. The court cited language from a prior case that "[t]he forum for protecting [their] free speech rights was the bargaining table, not the courtroom."

PROCEDURE

FRANCHISOR'S CHAIRMAN AND EX-CEO NOT REQUIRED TO GIVE DEPOSITION TESTIMONY REGARDING PERSONAL FINANCIAL GAINS

In a putative class action suit, *Bonanno v. Quizno's Franchise Co., LLC*, 2009 WL 137211 (D. Colo. Jan. 20, 2009), the plaintiffs recently brought a motion to compel the franchisor's chairman and ex-CEO to answer deposition questions concerning his personal financial gain from a 2006 transaction in which an affiliate of JP Morgan acquired 49% of Quizno's stock. The plaintiffs argued that the testimony would show the motive behind and the fruits of "Quizno's fraudulent scheme to turn its owners . . . into billionaires by selling the company after inflating its value by defrauding Quizno's franchisees." The court denied the plaintiffs' motion. The information sought and its purpose, that is, the amount and specifics of the chairman's personal financial gain to be used as evidence of motive and intent, was not relevant to any of the claims at issue since neither motive or intent was a required element of any of the plaintiffs' claims, the court held. The court's added that the plaintiffs failed to demonstrate a "compelling need" for this confidential, personal financial information because they failed to show that it was needed to prove an element of any of their claims.

VICARIOUS LIABILITY

FRANCHISOR HELD NOT LIABLE FOR FRANCHISEE'S ALLEGED DISCRIMINATORY ACTS

The United States District Court for the Eastern District of Louisiana recently issued an opinion in *Matthews v. International House of Pancakes, Inc.*, 2009 WL 211788 (E.D. La. Jan. 23, 2009), that serves as a reminder that franchisors should take care not to establish or control their franchisees' day-to-day employment policies, practices, or decisions. Two plaintiffs sued various International House of Pancakes franchisor entities, claiming racial discrimination, gender discrimination, and/or sexual harassment by a manager of a restaurant owned by an IHOP franchisee. The federal district court dismissed the plaintiffs' claims against the franchisor entities on the grounds that those entities had not engaged in any conduct that might make them an "employer" under employment discrimination laws.

In reaching this conclusion, the court observed that, in deciding whether a franchisor's actions may give rise to a legal duty to a franchisee's employees, courts have generally distinguished between whether the franchisor has *recommended* as opposed to *required* certain employment practices. If the franchisor has merely made recommendations, liability typically does not arise. Liability may arise, however, if the franchisor has required a franchisee to adopt certain policies, *i.e.,* to train, hire, or supervise employees

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in a certain way, or has reserved the right to be involved in employment decisions. Applying this standard, the court held that the IHOP entities had presented unrefuted evidence that they did not establish or control the franchisee's day-to-day employment policies or activities, and, therefore, they were not the plaintiffs' "employer." For essentially the same reasons, the court also held that the plaintiffs had failed to establish that the franchisor and franchisee could be aggregated together and treated as a "single employer" for liability purposes.

PRACTICE OF FRANCHISE LAW

COURT UPHOLDS DISCIPLINE AGAINST ATTORNEY WHO FAILED TO PROVIDE COMPETENT FRANCHISE LAW ADVICE TO A FRANCHISOR

In *State of Nebraska v. Orr*, 2009 WL 212966 (Neb. Jan. 30, 2009), the Nebraska Supreme Court affirmed a disciplinary finding that an attorney violated his oath of office because he failed to provide competent representation to a franchisor.

Orr was engaged to represent a Nebraska start-up franchisor. The lawyer drafted a franchise agreement and disclosure statement, but failed to draft a complete Uniform Franchise Offering Circular. After the franchisor already had sold 21 franchises, it received a request for a UFOC from a prospective franchisee. The attorney then told the franchisor that the disclosure statement he had prepared was sufficient and could be used anywhere, but that the UFOC was a requirement of federal law such that the franchisor was "probably going to have to get" one if it sold franchises outside of Nebraska. Franchises were sold in Colorado and Iowa, and litigation with franchisees in those states ensued, with the franchisees correctly claiming that the disclosures they had received were not sufficient. The franchisees prevailed, and one of them even obtained a personal judgment against the owners of the franchisor. As a result, Orr made certain changes to the disclosure statement and assured the franchisor that the disclosure statement was now complete. The franchisor then sold seven additional franchises. Ultimately, however, the Federal Trade Commission notified the franchisor that it was under investigation for failing to provide proper disclosure. At that time, the franchisor hired an attorney specializing in franchise law, who determined that the disclosure statement the franchisor had been using contained major deficiencies.

Formal charges were filed against Orr, and the referee in the disciplinary proceeding found that the attorney had failed to provide competent representation to the franchisor because he provided counsel in an area of law in which he lacked expertise. The Nebraska Supreme Court affirmed the decision of the referee that the attorney should receive a public reprimand, and cautioned "general practitioners against taking on cases in areas of law with which they have no experience."

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