TO: OUR FRANCHISE CLIENTS AND FRIENDS
FROM: GRAY PLANT MOOTY’S FRANCHISE AND DISTRIBUTION PRACTICE GROUP
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This issue of The GPMemorandum focuses primarily on topics of interest to companies that use distributors and dealers rather than manage a business format franchise system. The distribution-related topics this quarter include dealer and distributor termination, antitrust, application of state statutes, and more. We do begin, however, with a special report regarding the important identity theft issue that may impact both franchisors and manufacturers. Summaries of recent legal developments of interest to manufacturers and others who supply products through dealers and distributors begin on page 2.

IDENTITY THEFT

RED FLAGS RULE UPDATE

As discussed in Issue No. 115 of The GPMemorandum (Jan. 21, 2009), the new federal “Red Flags Rule” requires certain businesses to establish written programs to detect, identify, and respond to signs of possible identity theft. The rule is aimed at reducing identity theft by making it more difficult for thieves to use stolen identity information to purchase goods or services. Enforcement by the Federal Trade Commission was set to begin November 1, 2009, but has now been delayed (again) until June 1, 2010.


Application of the Red Flags Rule. The Red Flags Rule applies to “creditors” with “covered accounts.” Businesses are considered “creditors” under the rule if they regularly extend credit, for example, by deferring payments owed, by allowing purchase of items on credit, or by arranging or providing financing. Under the rule, however, businesses are required to have a written identity theft program only if they have “covered accounts,” which include accounts with

individuals for personal or household purposes or any accounts that have risk of identity theft. The FTC has issued guidance to assist in evaluating whether a franchisor is subject to the Red Flags Rule: http://www.ftc.gov/bcp/edu/pubs/articles/art14.shtm

In some franchise systems, while the franchisor may not be subject to the rule, the franchisees are covered (for example, franchise businesses that provide services on Net 30 payment terms). The FTC recently issued a “do-it-yourself” Identity Theft Prevention Program for use by companies that have a low risk of identity theft, and this online tool may be useful for franchisees covered by the rule: http://www.ftc.gov/bcp/edu/microsites/redflagsrule/get-started.shtm

**Compliance with the Red Flags Rule.** If a business has covered accounts, the rule requires it to develop a written program to detect, prevent, and mitigate identity theft by noting “Red Flags” indicating possible theft. The warning signs may include forged or altered photo identifications or documents, invalid Social Security numbers, the use of an account that has been inactive for a long period, or signals of possible identity theft discovered during a credit check, such as fraud alerts, address discrepancies, and credit freezes. The rule is flexible in that the compliance programs should be tailored to the nature and risk of the business.

**RECENT CASES**

Here are summaries of recent court decisions of interest to companies that sell through dealers and distributors:

**STATE LAWS**

**NINTH CIRCUIT HOLDS THAT GAP IS NOT A FRANCHISOR UNDER CALIFORNIA FRANCHISE RELATIONS ACT**

In *Gabana Gulf Dist., Ltd. v. Gap Int’l Sales, Inc.*, 2009 WL 2585678 (9th Cir. Aug. 24, 2009), Gap prevailed over Gabana, a United Kingdom distributor. Gap had terminated Gabana’s distribution agreement for the Middle East. Gabana sued, claiming that its arrangement with Gap constituted a franchise under the California Franchise Relations Act and, therefore, that Gap needed good cause to terminate the distribution agreement. The Ninth Circuit disagreed, finding that the trademark element of a franchise under California law was not present. While Gabana was a distributor or wholesaler of Gap products, it was not “substantially associated” with Gap’s trademarks. Indeed, the court noted that Gabana was “expressly prohibited from associating itself with Gap’s trademarks beyond selling its merchandise.” The court also concluded that the franchise fee element had not been satisfied because Gabana merely purchased Gap’s products at fair market value.
In an interesting dissenting opinion, focusing on non-California cases from the Third Circuit, one judge argued that in determining whether the trademark element of a franchise was present, the appropriate question to ask was whether Gabana’s customers “associated” Gabana’s business operation with Gap’s reputation and goodwill. Such a connection was perceived by Gabana’s direct customers because the retailers had to be approved by Gap and were required to sell Gap products in specified “store-within-store” displays. The dissenting judge also noted that the retailers’ stores were inspected by Gap personnel and received instructions on how they were to achieve the “Gap look.” The dissent therefore did not understand how Gabana could be viewed merely as a “source of products.” The dissenting judge also pointed out that Gabana’s purchase of excessive amounts of inventory could be a franchise fee.

NEW JERSEY STATE COURT FINDS CONSTRUCTIVE TERMINATION OF DEALER VIOLATES NEW JERSEY FRANCHISE PRACTICES ACT

A New Jersey appeals court has held that the constructive termination of a dealer agreement violates the New Jersey Franchise Practices Act. Maintainco, Inc. v. Mitsubishi Caterpillar Forklift Am., Inc., 2009 WL 2365960 (N.J. Super. A.D., July 30, 2009). Plaintiff Maintainco signed an agreement that, it believed, made it the exclusive Mitsubishi dealer in a designated territory in New Jersey. Mitsubishi subsequently appointed Mid-Atlantic as a dealer in the plaintiff’s territory, under terms that gave Mid-Atlantic a competitive advantage over the plaintiff.

The New Jersey appeals court agreed that the parties’ course of dealing, including their contracts, supported the conclusion that the plaintiff was the exclusive Mitsubishi dealer in the territory and that the appointment of Mid-Atlantic constituted a breach of the plaintiff’s exclusivity rights. The appellate court also agreed that stripping the plaintiff of its exclusivity rights constituted constructive termination and violated the statute.

HONDA DID NOT VIOLATE RHODE ISLAND DEALER LAW BY BANNING CERTAIN INTERNET SALES

In Saccucci Auto Group, Inc. v. Am. Honda Motor Co., Inc., 2009 WL 2175762 (D.R.I. July 21, 2009), the court granted Honda’s motion for summary judgment, finding that Honda did not violate a Rhode Island dealer law by banning internet sales of Honda vehicle service contracts (VSCs). After dealers and customers complained about price differences between VSCs sold online and at dealerships, Honda enacted a policy temporarily banning dealers from selling VSCs over the internet.

The plaintiff, a Honda dealer who had set up a Web site of its own to sell VSCs, alleged that the policy violated the Rhode Island dealer law because it was coercive and
predatory. The court found that the law was aimed specifically at adhesive agreements involving “little real choice.” The dealer agreement was not a contract of adhesion, the court found. The contract did not require the dealer to sell VSCs and only obligated the dealer to offer VSCs upon a customer’s request. As a result, the dispute was not subject to the Rhode Island dealer law.

CONNECTICUT FRANCHISE ACT FOUND INAPPLICABLE, BUT COURT RELIES ON UNFAIR TRADE PRACTICES STATUTE TO BLOCK DISTRIBUTOR TERMINATION

A trial court preliminarily enjoined termination of a distributor based on the Connecticut Unfair Trade Practices Act (CUTPA) in *Walker Indus. Prods. v. Intelligent Motion Sys., Inc.*, 2009 WL 3417438 (Conn. Super. Ct. Oct. 1, 2009). The distributor-plaintiff brought wrongful termination claims under both the Connecticut Franchise Act and CUTPA. The court held that the plaintiff failed to show a likelihood of success on the merits of its claim under the Connecticut Franchise Act because its business was not “substantially associated” with the manufacturer’s trademarks, as required under the franchise act.

But the CUTPA claim was deemed to be broader and to have sufficient evidentiary support to block the termination. The court found that the manufacturer had engaged in bad-faith practices. It had taken customer and market information from the distributor under false pretenses and used the information to lure customers away from the distributor. It also told customers that the distributor was about to be terminated in an attempt to redirect customers. The court therefore enjoined the termination.

ANTITRUST

FEDERAL COURT CERTIFIES CLASS ACTION AGAINST BABIES “R” US


The case involved antitrust claims brought by purchasers of baby products that BRU was engaged in a price restriction conspiracy concerning six major brands in its stores. All of the plaintiffs seeking class status claimed that BRU demanded that manufacturers, as a condition of having their products carried in its stores, eliminate or drastically reduce the number of discounted products available through internet retailers. The
plaintiffs alleged that BRU went so far as to cancel contracts with manufacturers that would not eliminate lower price internet sales of their products.

The main question under Rule 23 was whether issues common to the proposed class predominated over individual issues. Relying on expert testimony, and applying the rule of reason standard, the court found that there was enough evidence that BRU’s prices were supra-competitive and that all class members paid inflated prices. As to whether “non-price factors,” such as service, selection, and product displays, were unique so as to bar common proof and defeat the class, the court found that such factors do not carry weight when the case involves a dominant retailer coercing manufacturers to abandon lower-price distributors.

COURT DENIES AMAZON.COM’S MOTION TO DISMISS TYING CLAIM BROUGHT BY PUTATIVE CLASS OF “PRINT ON DEMAND” PUBLISHERS

A Maine federal court recently denied Amazon’s motion to dismiss an antitrust tying claim brought by a putative class of print on demand (POD) publishers. Booklocker.com, Inc. v. Amazon.com, Inc., 2009 WL 2709396 (D. Me. Aug. 26, 2009). The court held that Booklocker.com sufficiently pled that Amazon’s policy of refusing to allow POD books to be sold through its Direct Amazon Sales Channel unless those books were printed by a wholly owned subsidiary of Amazon constituted a per se tying violation under Section 1 of the Sherman Act.

After Amazon acquired BookSurge, a company that provides printing services to POD publishers, Amazon gave POD publishers a choice: either agree to use BookSurge for printing services (BookSurge charged 20 percent more than a major competitor) or lose access to the Direct Amazon Sales Channel.

The court denied Amazon’s motion to dismiss, finding that Booklocker had sufficiently pled that: (1) the Direct Amazon Sales Channel (the alleged tying service) and BookSurge’s POD book printing service (the tied service) were two distinct services, even though POD publishers did not make an out-of-pocket payment for the Direct Amazon Sales Channel service; (2) a tying agreement existed since Amazon coerced at least four POD publishers into agreeing to use BookSurge; (3) Amazon had sufficient economic power; and (4) Amazon’s tie foreclosed a substantial amount of commerce in POD book printing services.

What is interesting for manufacturers and franchisors about the Booklocker case is that the enhanced scrutiny of the adequacy of complaints required under the Supreme Court’s decisions in Twombly in 2007 and Iqbal this year did not lead to dismissal. While Twombly and Iqbal certainly will give ammunition to defendants seeking early
dismissal of “implausible” claims, they do not amount to a free pass, even for alleged antitrust violations.

TERMINATIONS

NO DISMISSAL OF TERMINATED DEALER’S TORTIOUS INTERFERENCE CLAIM AGAINST NEW DEALER

An Illinois federal court denied a motion to dismiss a tortious interference claim, finding that the facts as alleged could sustain such a claim. In *Echo, Inc v. Timberland Machines and Irrigation, Inc.*, 2009 WL 2746725 (N.D. Ill. Aug. 26, 2009), a Timberland dealership agreement was terminated by an outdoor power equipment manufacturer, Echo. In addition to claims against Echo for wrongful termination, Timberland asserted a claim of tortious interference with contract against a neighboring dealer (LEPCO) that took over Timberland’s former sales territory on the effective date of the termination.

Timberland alleged that LEPCO “induced” Echo to terminate Timberland’s distribution agreement as a means of acquiring its territory, in violation of the Connecticut Franchise Act. The court found Timberland’s allegation that LEPCO knowingly persuaded Echo to violate the Connecticut law could plausibly amount to tortious interference. The motion to dismiss was therefore denied. On the same facts the court refused to dismiss claims against LEPCO for unjust enrichment and violation of the Connecticut Unfair Trade Practices Act.

COURT DENIES TEMPORARY RESTRAINING ORDER TO PREVENT TERMINATION OF DEALERSHIP

In *Tolle Furn. Group, LLC v. La-Z-Boy Inc.*, 2009 WL 2160981 (W.D. Wash. July 17, 2009), a Washington federal court denied a motion for a temporary restraining order and refused to stop the termination of a furniture retailer who alleged that La-Z-Boy had violated the Washington Franchise Investment Protection Act (FIPA). The court rejected the plaintiff’s contention that La-Z-Boy did not have good cause to terminate the retailer agreement under the FIPA. The court noted that even if it were to consider La-Z-Boy a franchisor under the FIPA, the plaintiff did not dispute that it owed over $5 million in past-due invoices to La-Z-Boy, a violation of the retailer agreement.

The court also rejected the plaintiff’s other argument, that the parties had an oral understanding that La-Z-Boy had promised its financial support while the plaintiff acquired and improved stores in Seattle. The plaintiff alleged that, based on that promise, it believed that it could defer payment of the debt—presumably in perpetuity—until it was able to repay La-Z-Boy with store profits. The court held that the merger clause in the parties’ agreement foreclosed plaintiff’s claim of an oral
agreement. In denying the motion, the court characterized the plaintiff’s debt as “significant” and noted that it is “loath to require parties to continue a business relationship that is not working.”

TRANSFERS

REFUSAL TO APPROVE TRANSFER DOES NOT GIVE RISE TO TORTIOUS INTERFERENCE

In Pasqualetti v. Kia Motors Am., 2009 WL 3245439 (N.D. Ohio Sept. 30, 2009), the court rejected Pasqualetti’s claim that Kia Motors’ refusal to approve the transfer of a dealership to him constituted tortious interference. The court stated that a tortious interference claim will not lie “where the defendant was the source of the business opportunity allegedly interfered with” and that “[a]s a matter of public policy . . . franchisors should not fear potential tort liability for simply deciding not to contract with a prospective franchisee.” Citing decisions from other jurisdictions, the court ruled that “where a sale of a franchise is subject to the approval of a franchisor pursuant to a contract between the seller and the franchisor, the franchisor cannot be characterized as an ‘outsider’ to the proposed transaction and thus is not subject to a claim of tortious interference.”

TRADEMARKS

MICHIGAN FEDERAL COURT ENJOINS FORMER DEALER FROM USING VALVOLINE SIGNAGE

After an oil change shop’s contract to purchase Valvoline products ended, the shop no longer can display the brand’s signs and other trademarked items, the United States District Court for the Eastern District of Michigan ruled last week. Valvoline Co. v. Magic Quick Lube, 2009 WL 3497805 (E.D. Mich. Oct. 29, 2009). The ruling was based on federal trademark law, which prohibits the use of trademarks without permission in such circumstances.

In enjoining the former dealer, the court found that the trademark use became “unauthorized” when the shop’s contract to buy the products ended. Without a supply contract, the former dealer could not possibly meet Valvoline’s criteria for using its trademarks, which criteria included the meeting of various requirements specified in the contracts themselves. The unauthorized use of the Valvoline signage, in turn, led to a likelihood of confusion and irreparable injury that support the preliminary injunction.
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