The GP Memorandum

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:

TERMINATION AND RENEWAL

SUPREME COURT DECIDES FOR FRANCHISOR ON PMPA CLAIMS FOR CONSTRUCTIVE TERMINATION AND NONRENEWAL

The United States Supreme Court has held that claims of "constructive" termination and nonrenewal under the Petroleum Marketing Practices Act will not lie when the franchisee continues to operate under the franchisor's marks. *Mac's Shell Service, Inc. v. Shell Oil Products Co.*, No. 08-240, and *Shell Oil Products Co. v. Mac's Shell Service, Inc.*, 2010 U.S. LEXIS 2203 (March 2, 2010). As reported in Issue 128 of *The GP Memorandum*, this was the first Supreme Court decision to interpret the PMPA. This decision could also help business format franchisors in similar cases.

After a joint venture between Shell and Texaco notified Shell franchisees that a volume-based program would be discontinued, the franchisees sued, claiming constructive termination and nonrenewal of their franchise agreements. The essence of the Supreme Court ruling is that – at least under the PMPA – a franchisee cannot hold onto its franchise "under protest" while claiming damages for wrongful termination or nonrenewal. If the franchisee still has the franchise, it simply cannot claim to have been terminated in violation of the federal statute, and it cannot claim wrongful nonrenewal when it signs a renewal agreement. It remains to be seen, however, if this same logic will apply in all franchise cases, as one of the bases for the Supreme Court's ruling was that state law rights (such as those available to all franchisees both in and out of the PMPA context) remain available to the franchisees. The Court also held open the possibility of injunctive relief being available to a franchisee as an alternative to accepting a change "under protest." Nevertheless, it does appear that the rationale underlying this month's high court ruling should apply in any case in which a franchisee is claiming damages for "termination" or "nonrenewal" despite having retained its franchise.

NINTH CIRCUIT AFFIRMS SPECIFIC PERFORMANCE
TO RENEW FRANCHISE AGREEMENT

The Ninth Circuit has affirmed a district court's order for specific performance requiring the franchisor to renew the franchise agreement at the existing royalty rate. *Prudence Corp. v. Shred-It America, Inc.*, 2010 U.S. App. LEXIS 3214 (9th Cir. Feb. 11, 2010). Although the court does not fully explain, it appears to have based its decision on findings that Shred-It breached the franchise agreement by waiting over a year to "timely submit proposed renewal terms" to Prudence. The court also held that specific performance was an appropriate remedy because the franchise agreement called for it whenever a party "improperly withholds its approval of any action."

FRAUD

COLORADO COURT VACATES DISMISSAL OF FRANCHISEES' CLAIMS OF
FRAUDULENT NONDISCLOSURE

A Colorado appellate court recently vacated (with a remand for further proceedings) the trial court's dismissal of claims against a franchisor and its parent, two officers, and its lawyers, alleging fraudulent nondisclosure of the parent's material financial losses each year since its inception in 1990. The case is *Colorado Coffee Bean, LLC v. Peaberry Coffee, Inc.,* 2010 LEXIS 210 (Col. App. Feb. 18, 2010). The appellate court found that the trial court erred in finding the franchisees' reliance on the nondisclosure of the parent's losses was unreasonable. The appellate court analyzed the specific wording of each of the exculpatory clauses in the document and found that they only addressed nonreliance on *affirmative* representations made outside of the transactional documents, but did not address the failure to disclose material information. The appellate court pointed out that none of the exculpatory clauses referred to information about the parent's financial condition or negated reasonable inferences that could be drawn about this information.

The appellate court also concluded that while the FTC's Franchise Rule permits disclosure of a parent's financial statements only if the parent serves as a guarantor of the franchisor's obligations, the Franchise Rule does not preempt common law. The appellate court found that the Franchise Rule dealt only with "financial statements" and did not preclude a general comment, somewhere in the FDD, regarding the negative financial condition of the parent, such as, "The franchisor is the wholly owned subsidiary of ____, which has not shown a profit during its __ years of operation."

CLASS ACTIONS

COURT HOLDS THAT IT HAS JURISDICTION UNDER THE CLASS ACTION FAIRNESS ACT OVER FRANCHISEES' COMPLAINT

A Minnesota federal court has denied a motion to remand a class action lawsuit to state court, holding that the federal court had jurisdiction over the action under the Class Action Fairness Act (CAFA). In *Green et al. v. SuperShuttle Int'l, Inc. et al.*, 2010 U.S. Dist. LEXIS 7456 (D. Minn. Jan. 29, 2010), a putative class of current and former franchisees sued various SuperShuttle entities that provide shared-ride airport shuttle services, claiming the entities had mischaracterized them as franchisees rather than as employees. The plaintiff-franchisees originally sued in state court for back wages and a return of franchise fees. SuperShuttle removed the case to federal court on the basis of federal question jurisdiction.

In seeking a remand to state court, the plaintiffs contended that their case fell within CAFA's exceptions. CAFA requires federal courts to decline jurisdiction when the dispute is a "local controversy" within the state in which the action was filed and does not reach into multiple states. The federal court rejected the plaintiffs' argument, finding that a significant portion of the relief would, if awarded, be paid by non-Minnesota defendants SuperShuttle International, Inc. and SuperShuttle Franchise, Inc. The only Minnesota defendant, SuperShuttle Minnesota, was not the primary defendant or the target of a request for significant relief, because its financial situation made it unlikely that it could satisfy any judgment.

REMAINING CLAIMS AGAINST MAIL BOXES ETC. AND UPS STORE DISMISSED

A federal court in California has dismissed the claims of the remaining franchisee classmembers in *Samica Enterprises, LLC, et al. v. Mail Boxes Etc. USA, Inc., et al.*, 2010 U.S. Dist. LEXIS 21343 (C.D. Cal. Feb. 26, 2010). In granting summary judgment against these more than 200 putative plaintiffs, the court rejected their attempts to circumvent the prior decisions dismissing claims of two representative subclasses. The claims all arose out of the efforts of the defendants to convert Mail Boxes Etc. franchisees to UPS Store franchisees, which the plaintiffs claimed to be a fraud and a violation of other state laws. On mostly procedural grounds, the court upheld its prior rulings under California law.

RICO/CLASS ACTIONS

COURT DISMISSES CLASS CLAIMS AGAINST PET STORE FRANCHISOR

In *Jones v. Petland Inc.*, 2010 U.S. Dist. LEXIS 12538 (S.D. Ohio Feb. 11, 2010), franchisees sued franchisor Petland, asserting in a class action complaint numerous claims of fraud and misrepresentation as well as a RICO claim. Petland moved to dismiss all claims. The court granted Petland's motion and dismissed all of the franchisees' claims with prejudice. The court found that the plaintiffs had failed to plead their fraud and misrepresentation claims with particularity as required under the Federal Rules of Civil Procedure. The court also found the franchisees' RICO claim deficient for want of an identified "enterprise."

DAMAGES TO FRANCHISOR

FRANCHISOR OBTAINS JUDGMENT AGAINST GUARANTORS

In *Century 21 Real Estate LLC v. Perfect Gulf Properties, Inc.*, 2010 U.S. Dist. LEXIS 13438 (M.D. Fla. Feb. 17, 2010), a Florida federal court recently granted the franchisor's motion for partial summary judgment on its breach of contract claims against the individual guarantors, and held that the franchisor was entitled to almost $1.4 million in damages. The franchisor sued the terminated franchisees and the individual guarantors to recoup unpaid royalties and advertising fees, as well as the remaining balance due on a promissory note that accelerated upon the termination of the franchise agreements. The guarantors asserted several unsuccessful defenses. For example, the court rejected their defense that the franchisor had failed to mitigate its damages by allegedly funding the promissory note knowing that the franchisees could not meet the franchise performance conditions. The court held that the doctrine of mitigation applies *after* a contract has been breached, but not before.

ADVERTISING

COURT DENIES QUIZNOS' MOTION FOR SUMMARY JUDGMENT
ON FALSE ADVERTISING CLAIMS BROUGHT BY DOCTOR'S ASSOCIATES

In *Doctor's Associates, Inc. v. QIP Holder LLC, et al.,* 2010 U.S. Dist. LEXIS 14687 (D. Conn. Feb. 19, 2010), the franchisor of the Subway system sued Quiznos for deceptive advertising under the Lanham Act and the Connecticut Unfair Trade Practices Act and for commercial disparagement under Connecticut law. At issue were a number of ads that depicted a Quiznos sandwich next to a purportedly comparable Subway sandwich, which ads claimed that the sandwiches were not really comparable because the Quiznos sandwich had twice the amount of meat contained in the Subway sandwich.

DAI alleged that the ads were false and misleading for a number of reasons, including that its business model is different from Quiznos' in that all sandwiches at Subway are made to order, the ads did not disclose that Subway offered sandwiches that were more comparable to the Quiznos sandwiches than those that were used for comparison purposes, the Quiznos and Subway sandwiches looked respectively better and worse than what customers experienced in stores, and some of the Subway sandwiches in the ads had been discontinued. The case also involved a contest by Quiznos that invited consumers to submit online videos comparing a Quiznos sandwich to a Subway sandwich and stating why they preferred Quiznos. DAI alleged that the videos also unfairly compared its sandwiches with Quiznos' sandwiches.

Quiznos filed a motion for summary judgment on DAI's claims. The court denied the motion, finding that there were numerous issues of fact as to whether Quiznos had made false representations about Subway's products. The court also found that there were genuine issues of material fact as to whether Quiznos was responsible for creating or developing the contestant videos. The court stated that a reasonable jury could conclude that Quiznos did not merely post disparaging videos, which would be a defense under Section 230(c)(1) of the Communications Decency Act, but actively solicited disparaging representations and could be held liable for them.

ARBITRATION

COURT VACATES AWARD BECAUSE OF ARBITRATOR'S BIAS

Despite the heavy presumption in favor of the enforceability of final arbitration awards, a federal court in Michigan recently vacated a final award upon finding that one member of the arbitration panel had displayed evident bias. In *The Thomas Kinkade Co. v. Lighthouse Galleries, LLC*, 2010 U.S. Dist. LEXIS 6443 (E.D. Mich. Jan. 27, 2010), the issue was whether an arbitrator's late disclosure of his conflicts of interest and law partners' association with the defendants prejudiced the parties' arbitration. At arbitration, one of the arbitrators disclosed that certain of his law partners had represented or were representing the defendants. Following this untimely disclosure, the arbitrators found in favor of the defendants on their counterclaims, awarding them substantial damages.

Thomas Kinkade filed a motion to vacate the award, arguing that the arbitrator had displayed evident partiality. The court agreed, finding that the untimely disclosure of potential conflicts raised an issue concerning the arbitrator's neutrality. While the conflicts alone were insufficient to vacate the award, the court found that those conflicts, along with what the court described as repeated "irregularities" in defendants' favor, cast a "dark shadow over the parties' arbitration proceeding."

NONCOMPETES

SPLIT RESULTS FOR FRANCHISORS IN EASTERN DISTRICT OF MICHIGAN

Two judges in the same Michigan federal district court issued different rulings in non-compete cases recently. In the first case, *Domino's Pizza Franchising, LLC v. Yeager*, 2:09-cv-14704 (E.D. Mich. Jan. 25, 2010), the court handed Domino's a victory in its efforts to enforce its post-term rights. Domino's had sued after the defendants breached their obligations by continuing to operate pizza restaurants using the franchisor's marks and failing to return proprietary information. The defendants denied liability. After Domino's provided photographic evidence that the defendants continued to display Domino's marks, the court granted it a preliminary injunction. Applying Nevada law, the court also found that the covenant not to compete was reasonable in time (one year) and territory (ten miles). Gray Plant Mooty represents Domino's in this case.

In the second case, *Victory Lane Quick Oil Change, Inc. v. Hoss et al.*, 2010 U.S. Dist. LEXIS 16441 (E.D. Mich. Feb. 24, 2010), the court denied the franchisor's request to enforce its franchise agreement's noncompete provision. The court held that the franchisor did not establish that the ten-mile geographic limitation was reasonable after it conceded in a hearing that its shops normally draw business from within a three-mile radius. Just as it had denied a preliminary injunction to the franchisor earlier in the case, the court denied summary judgment to Victory Lane on its noncompete claim.

FEDERAL COURT ISSUES PRELIMINARY INJUNCTION ENFORCING NONCOMPETE UNDER MONTANA LAW

A Montana federal court has granted H&R Block's motion for a preliminary injunction to enforce a covenant not to compete. The case is *H&R Block Tax Services LLC* v. *Kutzman*, 2010 U.S. Dist. LEXIS 12837 (D. Mont. Jan. 26, 2010). At issue was whether the covenant's geographic 45-mile restriction and one-year prohibition were reasonable under Montana law. The franchisee, who continued to provide tax preparation services after the expiration of the franchise agreement, claimed that the covenant violated a Montana statute. The court disagreed, finding that while noncompete restrictions are not favored under Montana law, they are enforceable.

The court found that the noncompete provision in Kutzman's franchise agreement was reasonably restricted; that H&R Block provided consideration by giving Kutzman training, a trade name, access to its business methods, and territorial exclusivity; and that the restrictions allowed H&R Block a fair opportunity to retain its goodwill in the territory. The case is in line with those in a growing number of jurisdictions that have distinguished franchise noncompete covenants from those in employment agreements.

VICARIOUS LIABILITY

CALIFORNIA FEDERAL COURT GRANTS JUDGMENT AGAINST PLAINTIFF

The parent companies of a hotel chain prevailed against personal injury claims brought in *Reider v. Radisson Hotels Int'l et al.*, No. 3:08-cv-02328 (S.D. Cal. March 8, 2010). The case arose out of serious injuries suffered by the plaintiffs when they fell through a glass door in a sports bar located within a Radisson hotel in Japan. The hotel was operated under a management agreement between the hotel owner and a subsidiary of the defendants based in Singapore. The plaintiffs failed to name the subsidiary as a defendant, bringing suit instead against the two parent companies in the United States. In granting summary judgment, the court rejected the plaintiffs' "agency" theory that any liability of the subsidiary in operating the hotel should be imputed to the parent companies because they allegedly had a "right to control" the subsidiary. The California federal court rejected the plaintiffs' argument and held that they had presented insufficient evidence of the parent companies exerting any "day to day" control over the subsidiary, which was the correct legal test for determining agency under California law. Gray Plant Mooty represented the parent companies in this case and represents the franchisor of the system.

DAMAGES TO FRANCHISEE

DISGORGEMENT NOT PROVIDED BY NEW JERSEY FRANCHISE ACT

A car dealership that had prevailed against a manufacturer under the New Jersey Franchise Practices Act has been denied summary judgment on damages. In *Liberty Lincoln-Mercury, Inc. v. Ford Motor Co.*, 2010 U.S. Dist. LEXIS (D.N.J. Feb. 22, 2010), the plaintiff had prevailed on its claim that Ford's warranty service and repair parts surcharges to dealers violated the NJFPA. But that did not mean that the plaintiff could automatically obtain disgorgement of the surcharges. The court held, instead, that "damages sustained" by the franchisee had to be proved under the statute. The court was unwilling to read "disgorgement" or "reimbursement" into the NJFPA and denied summary judgment on the car dealership's claim for damages.

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