GRAY PLANT MOOTY

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*

Iris F. Rosario, Assistant Editor

DATE: **May 5, 2010—No. 130**

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

PRACTICE OF FRANCHISE LAW

MASSACHUSETTS FEDERAL COURT COMPARES FRANCHISING TO A "PONZI SCHEME" AND LABELS FRANCHISEES AS EMPLOYEES

In a ruling that already has sent shock waves through the franchisor community, a Massachusetts federal judge ruled in March that Coverall, a janitorial services franchisor, could not classify its franchisees as independent contractors. *Awuah v. Coverall North America*, 2010 U.S. Dist. LEXIS (D. Mass. Mar. 23, 2010). Instead, in granting the franchisees' motion for partial summary judgment, the court found Coverall's franchisees must be classified as employees. The opinion hinged on a single prong of Massachusetts's employee classification test—whether or not the franchisees' services were "performed outside the usual course of the [franchisor's] business" and "independent, separate, and distinct [] from that of the [franchisor]."

In response to Coverall's argument that it is in the *franchising* business, and not in the direct *cleaning* business, the court compared Coverall's description of franchising to "a modified Ponzi scheme—a company that does not earn money from the sale of goods and services, but from taking in more money from unwitting franchisees to make payments to previous franchisees." The court found that since "Coverall is the party billing all customers for the cleaning services performed," "receives a percentage of the revenue earned on every cleaning service," and "sells cleaning services, the same services provided by [franchisees,]" it "fails to establish that the franchisees are independent contractors."

While this case addresses a very specific set of circumstances (plaintiff franchisees are individuals and not entities, and the franchisor, for the most part, controlled all aspects of the franchisees' relationship with their customers), it may arguably apply to other systems. Franchisors should analyze their activity in Massachusetts carefully, and may want to consider revisions to their disclosure documents and agreements to better position themselves. The best solution, however, will likely be through legislation. The Massachusetts Attorney General has been working with the legislature to clarify the independent contractor law. The International Franchise Association is concerned that even the suggested approach will not completely protect franchise systems in Massachusetts from the argument that their franchisees are employees.

ENCROACHMENT

BANKRUPTCY COURT ALLOWS CONTRACT CLAIM TO PROCEED AGAINST FRANCHISOR THAT GRANTED FRANCHISE 2.17 MILES FROM PLAINTIFF

In *Black Angus Holdings, LLC v. Back Yard Burgers, Inc. (In re Black Angus Holdings, LLC)*, 2010 Bankr. LEXIS 995 (Bankr. D. Kan. Mar. 24, 2010), a Kansas federal bankruptcy court declined to dismiss a franchisee's breach of contract claim arising out of the opening of a restaurant in an area that overlapped with the franchisee's protected area. The franchise agreement between the parties prevented the franchisor from establishing another restaurant within an "exclusive radius" of two miles from the franchisee's restaurant. After the franchisor established a new franchise 2.17 miles away, the franchisee alleged it could no longer sustain its business and was forced into bankruptcy. Although the parties agreed the new restaurant was located outside the protected area, the franchisee argued that its area overlapped with that of the new restaurant. In denying the franchisor's motion, the court held the use of the phrase "exclusive radius" in the franchise agreements could be read to suggest that franchisees' protected areas would not overlap with each other.

ARBITRATION

SUPREME COURT STOKES CONTROVERSY OVER CLASS ARBITRATION

The United States Supreme Court likely ignited an intense battle in state and federal courts around the country with its decision last week that a class action arbitration may not be imposed on a party who has not agreed to it. In *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.* (U.S. April 27, 2010), a 5-3 majority reversed the Second Circuit's decision that had upheld an arbitration panel decision to allow a price-fixing case to proceed on a class basis in arbitration. (Justice Sotomayor, a former judge on the Second Circuit, did not participate) The specific issue addressed by the court was "whether imposing class arbitration on parties whose arbitration clauses are 'silent' on that issue is consistent with the Federal Arbitration Act (FAA), 9 U.S.C. § 1 *et seq.*" "In this case, we must conclude that what the arbitration panel did was simply to impose its own view of sound policy regarding class arbitration," Justice Alito wrote for the majority. Justice Ginsburg dissented, joined by Justices Stevens and Breyer.

There are predictions that defendants in more than 100 class action arbitration cases will seek supplemental briefing to argue that the Supreme Court's ruling preempts all state laws that have been used to allow class arbitrations.

THIRD CIRCUIT CONFIRMS ARBITRATION AWARD, RULING FRANCHISEE HAD WAIVED STATUTORY AND CONTRACTUAL LIMITATIONS ARGUMENTS

In *Bapu Corp. v. Choice Hotels Int'l, Inc.*, 2010 U.S. App. LEXIS 5540 (3d Cir. Mar. 16, 2010), Choice Hotels terminated its franchisee after it failed to renovate. Early in arbitration proceedings the franchisee contended that the termination was time-barred under Maryland law and the limitations period in the franchise agreement. The arbitrator addressed this issue preliminarily, ruling that the issue was premature, and allowed the franchisee to renew its defense later. The franchisee stopped participating in the arbitration and, instead, tried to challenge the termination in a New Jersey federal court. The court rejected that effort. The arbitrator then awarded Choice Hotels over $150,000 in damages and costs.

The franchisee went back to court and sought to vacate the award, asserting that Choice Hotels' claims were time-barred by the three-year limitations period in the franchise agreement. But the court confirmed the award. On appeal to the Third Circuit, the court reviewed whether the arbitrator had "manifestly disregarded" whether he had jurisdiction over Choice Hotels' claims in light of the applicable statutory and contractual limitations periods. Citing the federal court's findings that the franchisee failed to act on a later opportunity to renew its objection to jurisdiction, the Third Circuit concluded that the issues of jurisdiction and arbitrability had been waived.

ARKANSAS SUPREME COURT HOLDS CLAIMS UNDER ARKANSAS FRANCHISE PRACTICES ACT ARE SUBJECT TO ARBITRATION

After juggling three separate federal and state statutes, the Arkansas Supreme Court determined last month that a statutory franchise claim is subject to arbitration. In *Gruma Corp. v. Morrison,* 2010 Ark. LEXIS 182 (Ark. April 1, 2010), the parties had entered into a distribution agreement that contained a clause requiring the arbitration of all claims relating to the agreement. After Gruma terminated the agreement, Morrison sued in Arkansas state court alleging various tort claims and violations of the Arkansas Franchise Practices Act (AFPA). In response, Gruma moved to compel arbitration in accordance with the agreement and the Federal Arbitration Act. Morrison contended that arbitration could not be compelled under the Arkansas Uniform Arbitration Act because, under that statute, tort claims were not subject to arbitration. He also argued that his AFPA claims were not subject to arbitration because it would limit his substantive rights. The trial court granted Morrison's motion.

On appeal, the Arkansas Supreme Court was asked to determine whether the Federal Arbitration Act or the Arkansas Uniform Arbitration Act applied and whether a cause of action under the AFPA is subject to arbitration. The court held that the Federal Arbitration Act applied and, therefore, claims sounding in tort were subject to arbitration. The court also determined that the parties' agreement to arbitrate their disputes did not limit or waive any substantive rights that Morrison had under the AFPA, but that issues regarding arbitration rights were to be decided by the arbitrator.

COURT GRANTS FRANCHISOR'S MOTIONS TO COMPEL ARBITRATION OF CLAIMS ON AN INDIVIDUAL BASIS AND TO DISMISS CLASS ACTION

In *Reid v. SuperShuttle Int'l Inc.,* 2010 U.S. Dist. LEXIS 26831 (E.D.N.Y. Mar. 22, 2010), a New York federal court granted a franchisor's motion to compel arbitration and, in doing so, upheld a waiver in the arbitration clause of the affected plaintiffs' rights to bring class action claims. A group of SuperShuttle franchisees had brought a class action suit, claiming that they were employees of SuperShuttle rather than franchisees and that they were owed wages and employee benefits under various federal and New York state laws. SuperShuttle filed a motion to compel individual arbitrations and moved to dismiss those plaintiffs' class action claims.

The court granted SuperShuttle's motion to compel individual arbitrations, finding that the plaintiffs each had signed a franchise agreement containing an arbitration clause and that the litigation fell within its scope. The court also rejected the plaintiffs' challenge to class action waiver language in the arbitration provision.

TRADEMARKS

FRANCHISEE'S CLAIMS TO TRADEMARK REJECTED

The United States Court of Appeals for the Eighth Circuit has affirmed the rejection of a franchisee's claims for breach of contract and violation of the South Dakota Franchise Act in an interesting case involving trademark rights. *Pinnacle Pizza Co., Inc. v. Little Caesar Enterprises, Inc.,* 2010 U.S. App. Lexis 5801 (8th Cir. Mar. 22, 2010). A Little

Caesar franchisee had brought suit over use of the HOT-N-READY trademark. The franchisee alleged that it originated the phrase "Hot-N-Ready" in advertising ready-to-pick-up pizzas, and that the later adoption of the phrase by the franchisor as part of a national program used throughout the franchise system was not permitted. It filed claims for breach of contract and violations of the South Dakota Franchise Act, and it also sought to cancel the HOT-N-READY trademark. Little Caesar filed counterclaims contending that the franchisee had breached the franchise agreement by disputing the validity of its trademarks.

On appeal, the Eighth Circuit affirmed and held that the franchisee's claims were time-barred by the statute of limitations, as the alleged breach should be considered a single incident occurring in 1997. The court also held that the lower court had properly denied the franchisee's claim seeking cancellation of the trademark registration. Under the franchise agreement, the trademark rights created by the franchisee's use vested with the franchisor and, thus, the franchisee could not show fraud by the franchisor in the trademark application. Finally, in an interesting twist, the court also affirmed the finding of summary judgment for the franchisor on its counterclaim for breach of contract against the franchisee. The franchise agreement prohibited the franchisee from contesting the validity or ownership of the franchisor's trademarks. The court held that the franchisee had violated this covenant not to sue, that there is no "good faith" exception to such a covenant, and that enforcement is not "unfair or inequitable."

CLASS ACTIONS

COURT DENIES CLASS CERTIFICATION FOR ALLEGED FALSE REPRESENTATIONS

In *Moua v. Jani-King of Minnesota, Inc*, 08-4942 (D. Minn. Mar. 12, 2010), a Minnesota federal court denied a motion for class certification filed by franchisees who alleged that Jani-King falsely promised them a certain amount of monthly business while knowing that the promised amount was unattainable. The franchisees further alleged that the business accounts Jani-King offered to them were unprofitable and that Jani-King took accounts away from them. The court found that the claims required individualized determinations of Jani-King's conduct vis-a-vis each franchisee.

BANKRUPTCY

FRANCHISOR'S MOTION TO ANNUL AUTOMATIC STAY IS DENIED BASED UPON CONSIDERATION OF DEBTOR'S OTHER CREDITORS

In *In re All American Properties, Inc.,* 2010 Bankr. LEXIS 687 (Bankr. M.D. Pa. Mar. 10, 2010), a franchisor sought to annul the automatic stay following a former franchisee's bankruptcy filing. Franchisor Petro Franchise Systems had sued its franchisee for trademark infringement. Petro obtained an injunction prohibiting the franchisee from using Petro's trademarks and brands. The franchisee ignored the injunction order and continued to operate the infringing business. After a hearing on an order to show cause for the franchisee's non-compliance with its orders, the court entered another injunction order that, among other things, awarded money damages to Petro and enjoined the franchisee from violating the noncompete agreement. Before this order was actually entered by the court, the franchisee filed for bankruptcy.

Petro sought to annul the automatic stay in bankruptcy to validate the injunction order. To do so, a movant must demonstrate "cause" to receive relief or annulment of the stay. The bankruptcy judge noted that unsecured creditors often are granted relief from the automatic stay when two factors are present: (1) the debtor has engaged in "morally culpable conduct" that the moving party is seeking to undo in another forum; and (2) the movant is not pursuing assets of the estate. While the bankruptcy court judge found the franchisee's conduct to be "reprehensible" and in "flagrant disregard" of the federal court's orders, the judge noted that the interests of the franchisee's other creditors would be harmed by an annulment of the automatic stay, which would allow Petro to obtain a sizable judgment against the franchisee to the detriment of its other creditors. While the bankruptcy court reluctantly denied Petro's motion to annul the automatic stay, it left open the possibility of a subsequent motion if the issues concerning the other creditors could be addressed adequately.

DISCRIMINATION

FRANCHISOR PREVAILS ON SUMMARY JUDGMENT AGAINST APPLICANT'S DISCRIMINATION CLAIMS

In *Halloum v. DFO, Inc.,* 2010 Cal. App. Unpub. Lexis 2558 (Cal. Ct. App. Apr. 8, 2010), a California Court of Appeal considered various claims by a franchise applicant against DFO, Inc., the franchisor for Denny's restaurants, including claims of unlawful race and national origin discrimination. The plaintiff, a Palestinian Arab, claimed Denny's was motivated to deny his franchise application by his race and ethnicity following the events of September 11, 2001. The court first affirmed the trial court's dismissal of claims for breach of an oral contract, promissory estoppel, negligent misrepresentation, and unfair business practices under the Federal Trade Commission Act and the California Franchise Investment Law. Those claims were largely based on theories of actual and apparent authority that failed because Denny's had provided the applicant with a written description of the application process and had made clear that an application could only be approved in writing.

The appellate court did not disturb the trial court's finding that the franchise applicant had established a prima facie case of discrimination, which essentially required the plaintiff to show membership in a class protected by state or federal discrimination law, and his basic qualification to be considered for the award of a franchise. However, the discrimination claim failed because Denny's provided unrebutted evidence of its legitimate, nondiscriminatory reason for denying the application. Denny's showed that the application was denied because of the plaintiff's repeated and continuing failure to submit a complete site approval package. In addition, the court considered statistical evidence that Denny's had awarded 84 franchises to Middle Eastern applicants after 9/11. The court affirmed summary judgment in favor of the franchisor.

FRAUD

COURT DENIES FRANCHISEE'S FRAUD CLAIMS AGAINST FRANCHISOR

In *Qdoba Rest. Corp. v. Taylors, LLC*, 2010 U.S. Dist. LEXIS 27394 (D. Colo. Mar. 23, 2010), a Colorado federal court granted summary judgment to Qdoba on a multi-unit franchisee's allegations of fraud in the inducement. The fraud allegations were made in connection with affirmative defenses and counterclaims to Qdoba's breach of contract suit for the closure of several restaurants. The franchisee alleged that Qdoba committed fraud when: (a) an agent of Qdoba provided the franchisee with a map of projected sales, which showed potential sales ranges based on site characteristics and sales at existing restaurants, to assist the franchisee in site selection for new restaurants; and (b) Qdoba's CEO stated that certain existing restaurants the franchisee was purchasing had been poorly managed and underperforming.

Qdoba was granted summary judgment on the franchisee's counterclaims and on its own claims for breach of the franchise agreements. Under Florida law, sales projections are considered to be opinions. An opinion cannot be a fraudulent misrepresentation unless the party giving the opinion has superior knowledge and knows the opinion to be wrong at the time it was made. Because the franchisee offered evidence only that the high-end sales projections on the map did not match average existing store sales in the Qdoba system, it had not shown the projections were false or that Qdoba knew they were false. Neither was the fact that the franchisee was unable to improve his performance evidence that the CEO had been wrong or that he knew he was wrong.

JURY DEMAND

COURT GRANTS MOTION TO STRIKE JURY DEMAND IN CONNECTICUT FRANCHISE ACT CASE

A Connecticut federal court granted a franchisor's motion to strike a jury demand in *Sherman Street Associates, LLC, et al. v. JTH Tax, Inc., et al.* 2010 LEXIS 29402 (D. Conn. Mar. 22, 2010). Although the franchise agreements contained a jury waiver provision, the franchisee demanded a jury trial on its claims under the Connecticut Franchise Act and for tortious interference.

The franchisor moved to strike the jury demand, pointing to the jury waiver provisions in the franchise agreements, which the franchisee contended were not enforceable under the CFA. The court found that since there was no express statutory provision prohibiting a jury trial waiver for CFA claims, the franchisee could waive its right to a trial by jury if there was evidence that it knowingly and voluntarily waived such right. In finding for the franchisor, the court noted several factors, including the franchisee's educational and professional background, the franchisee had signed 20 franchise agreements with jury waiver provisions, and the franchisee had the opportunity to negotiate the agreements. The court found that the franchisee knowingly and voluntarily waived its right to a trial by jury and granted the franchisor's motion to strike the jury demand.

JURISDICTION AND PROCEDURE

FRANCHISEES' MOTION TO DISMISS BASED ON IMPROPER VENUE DENIED

A Missouri federal court denied a motion to dismiss for improper venue filed by a group of franchisees , finding the franchisor had properly filed in Missouri, where its home offices are based. The case is *Hardee's Food Systems, Inc. v. Hallbeck, et al.*, No. 4:09-cv-664 (E.D. Mo. Mar. 22, 2010). Gray Plant Mooty assisted Hardee's in opposing the motion. Hardee's sued for breach of contract and of personal guarantees after the franchisees, all residents of Wisconsin, closed one of their restaurants in Ottawa, Illinois, before the expiration of its term. The franchisees filed a motion to dismiss or to transfer venue of the case to the Northern District of Illinois, contending that the counterclaims they intended to assert all relate to Hardee's performance in Illinois and involve Illinois witnesses.

The court rejected the franchisees' argument, noting that there is a substantial connection between the Eastern District of Missouri and the claims, as there were numerous communications between the parties that originated in or were directed to Hardee's home office in St. Louis, Missouri. The court also found that the franchisees' proposed counterclaims alleging lack of business support and poor business and advertising decisionmaking on Hardee's part relate to decisions made by Hardee's in Missouri. The court refused to consider the franchisees' argument that the forum selection clause in the franchise agreement was barred by the Illinois Franchise Disclosure Act, because Hardee's chose expressly not to rely upon the clause in asserting that its choice of venue was proper under federal venue statute.

GRAY PLANT MOOTY

CHOICE OF LAW

DESPITE CHOICE OF LAW PROVISION, COURT REFUSES CALIFORNIA FRANCHISEE'S REQUEST TO APPLY WASHINGTON LAW TO DISPUTE

In *Red Lion Hotels Franchising, Inc. v. MAK LLC*, 2010 U.S. Dist. LEXIS 23633 (E.D. Wash. Mar. 15, 2010), the court held that the Washington Franchise Investment Protection Act ("FIPA") did not apply to a Washington-based franchisor in its dispute with a California franchisee, even though the franchise agreement contained a Washington choice of law provision. Franchisor Red Lion sued the franchisee for breaching the franchise agreement by failing to comply with a mandatory property improvement plan. The franchisee argued that the termination was improper and violated FIPA. Red Lion countered that FIPA was inapplicable because the franchisee was operating outside Washington. Instead, Red Lion asserted, the California Franchise Relations Act applied. The court applied Washington choice of law rules and held that FIPA was inapplicable because the relevant statutory provision demonstrated "a clear intent to limit the territorial scope of the Act to specific conduct that can be said to occur 'in this state.'"

VICARIOUS LIABILITY

FRANCHISOR NOT VICARIOUSLY LIABLE FOR DEATH CAUSED BY DISEASE OUTBREAK AT FRANCHISEE'S HOTEL

In *Braucher v. Swagat Group, LLC*, 2010 U.S. Dist. LEXIS 26294 (C.D. Ill. Mar. 19, 2010), the court granted summary judgment to Choice Hotels on a claim brought by a guest of one of its franchised hotels. The plaintiffs had visited a franchised hotel at which they contracted Legionnaires disease from the pool, which proved fatal to one of the named plaintiffs. The plaintiffs brought suit against both the franchisee and the franchisor, claiming that the franchisor was negligent and was liable under the doctrine of *res ipsa loquitur*, and that the franchisee acted as the franchisor's agent in operating the hotel.

The court granted Choice Hotels' motion for summary judgment, finding that Choice Hotels could not be held responsible for the acts of its franchisee and the franchisee was not the franchisor's agent. Although the court noted that Choice Hotels exercised sufficient control over its franchisee to protect its trademark rights, that did not give rise to the type of day-to-day control necessary for a franchisor to be found vicariously liable for the acts or omissions of its franchisee. Choice Hotels inspected the pool area only twice a year, at most, and retained the right to close the pool if the water was cloudy. But Choice Hotels did this to minimize the risk of drowning, not to prevent infections. Accordingly, the court granted summary judgment to Choice Hotels.

GRAY PLANT MOOTY

Minneapolis, MN Office

* **John W. Fitzgerald, cochair (612.632.3064)**
* Megan L. Anderson (612.632.3004)
  Wade T. Anderson (612.632.3005)
  Phillip W. Bohl (612.632.3019)
* Jennifer C. Debrow (612.632.3357)
* Elizabeth S. Dillon (612.632.3284)
* Collin B. Foulds (612.632.3388)
* Michael R. Gray (612.632.3078)
  Laura J. Hein (612.632.3097)
* Kelly W. Hoversten (612.632.3203)
  Franklin C. Jesse, Jr. (612.632.3205)
  Cheryl L. Johnson (612.632.3271)
* Jeremy L. Johnson (612.632.3035)
* Gaylen L. Knack (612.632.3217)
* Craig P. Miller (612.632.3258)
* **Kirk W. Reilly, cochair (612.632.3305)**
  Bruce W. Mooty (612.632.3333)
  John W. Mooty (612.632.3200)
* Kevin J. Moran (612.632.3269)
* Kate G. Nilan (612.632.3419)
* Max J. Schott II (612.632.3327)
  Daniel R. Shulman (612.632.3335)
  Erin B. Stein (612.632.3433)
* Jason J. Stover (612.632.3348)
  Michael P. Sullivan, Sr. (612.632.3351)
  Michael P. Sullivan, Jr. (612.632.3350)
* Henry Wang (612.632.3370)
  Lori L. Wiese-Parks (612.632.3375)
* Quentin R. Wittrock (612.632.3382)

Washington, DC Office

* **Robert Zisk, cochair (202.295.2202)**
* Arthur I. Cantor (202.295.2227)
* Jimmy Chatsuthiphan (202.295.2217)
* Ashley M. Ewald (202.294.2221)
* Jeffrey L. Karlin (202.295.2207)
* Peter J. Klarfeld (202.295.2226)
* Iris F. Rosario (202.295.2204)
* Stephen J. Vaughan (202.295.2208)
* Katherine L. Wallman (202.295.2223)
* David E. Worthen (202.295.2203)
* Eric L. Yaffe (202.295.2222)
* Carl Zwisler (202.295.2225)

**** Wrote or edited articles for this issue.***

For more information on our Franchise and Distribution practice and for recent back issues of this publication, visit the **Franchise and Distribution** practice group at www.gpmlaw.com/practices/franchise-and-distribution.aspx.

GRAY PLANT MOOTY

500 IDS Center
80 South Eighth Street
Minneapolis, MN 55402-3796
Phone: 612.632.3000
Fax: 612.632.4444

Suite 1111, The Watergate
2600 Virginia Avenue, N.W.
Washington, DC 20037-1905
Phone: 202.295.2200
Fax: 202.295.2250

franchise@gpmlaw.com