GRAY PLANT MOOTY

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:

FRANCHISOR ULTIMATELY PREVAILS IN MASSACHUSETTS FEDERAL COURT ON WHETHER FRANCHISEES ARE EMPLOYEES

The summary judgment in *Awuah v. Coverall North America* (summarized in Issue 130 of *The GPMemorandum*) did not result in a victory at trial for the plaintiffs. That much-discussed March ruling by a Massachusetts federal court judge was that Coverall, a janitorial services franchisor, could not classify its franchisees as independent contractors instead of employees. Less than two months later, however, on the eve of trial, the same judge dismissed the claims of the "franchisee/employees" for lack of evidence of damages suffered as a result of any misclassification. The case then went to trial on other claims, and the plaintiffs all lost. Two plaintiffs' claims were dismissed during the trial, and the jury on May 26, 2010, rendered a verdict against the other two plaintiffs after an 11-day trial.

ANTITRUST

SUPREME COURT RULING AGAINST NFL RAISES QUESTION OF APPLICABILITY TO NON-SPORTS FRANCHISORS

Late last month, the United States Supreme Court issued its decision in *American Needle, Inc. v. National Football League, et al.*, 2010 LEXIS 4166 (U.S. May 24, 2010), which was previewed in Issue 127 of *The GPMemorandum*. In a unanimous opinion authored by the retiring Justice Stevens, the court rejected the argument of the National Football League and its 32 teams that they are categorically immune from Sherman Act Section 1 liability because they operate as a single economic unit. The Supreme Court held that the teams function separately, with "independent centers of decisionmaking," and thus are theoretically capable of reaching illegal agreements in restraint of trade in violation of Section 1. The court reiterated that joint venturers are not *per se* immune from Section 1 liability and that such arrangements must be scrutinized under the rule of reason.

In light of this decision, the question now is whether business format franchisors and their franchisees could also be subject to Section 1 liability and, if so, as to what types of agreements. We will be analyzing this issue and writing more on it when time permits. The Supreme Court's decision is noteworthy in several additional respects. First and foremost, it is the first time in many years an antitrust plaintiff has prevailed at the high court. The unanimity of the decision is also notable. Further, the logic and reasoning of the decision could have profound effects. While franchisors and others ultimately may still defeat challenges to their joint activities, plaintiffs will be more encouraged to attack collaborative efforts, and courts will be more reluctant to dismiss such cases.

FRANCHISE ASSOCIATIONS AND CONTRACTS

COURT ALLOWS ASSOCIATION TO PROCEED ONLY ON GOOD FAITH AND FAIR DEALING PORTION OF CHALLENGE TO BURGER KING PRICE PLAN

A Florida federal court has dismissed the claim of the National Franchisee Association that Burger King Corporation lacks contractual power to set maximum prices for its franchisees, but has allowed the association to pursue its alternative claim that the exercise of that power to put the double cheeseburger on the chain's dollar menu violates the duty of good faith and fair dealing. *National Franchisee Association v. Burger King Corp.*, 2010 U.S. Dist. LEXIS 50721 (S.D. Fla. May 20, 2010). The NFA had sought a declaratory judgment that the franchisor does not have authority under its franchise agreements to impose maximum prices. The current ruling came on initial motions by BKC to dismiss the complaint on the merits, as well as for lack of associational standing.

The court's mixed decision went against the franchisor on the standing issue (at least for now) and as to the attempt to have the entire case dismissed on the merits at the outset. BKC's contractual power to set maximum prices, however, was upheld by the court. On that point, the court determined that the question had already been decided in BKC's favor by the Eleventh Circuit and that the contracts provide the franchisor pricing authority. The only remaining issue is whether BKC exercised its contractual power in good faith. Those claims are permitted under Florida law's implied covenant of good fair and fair dealing and by the good faith language in the franchise documents, the court noted. The franchisee association has standing to pursue this claim in the initial stages because it is unclear that individual franchisee participation will be needed given that the NFA is directing its challenge at the uniform, systemwide practices of the franchisor. We will continue to monitor this case.

TERMINATION

COURT GRANTS SUMMARY JUDGMENT ENFORCING TERMINATION OF FRANCHISE AGREEMENTS AND REJECTING COUNTERCLAIMS

A Georgia federal court issued its opinion last month in *Dunkin' Donuts Restaurants LLC v. Sandip, Inc.*, 2010 LEXIS 43484 (N.D. Ga. May 3, 2010), granting franchisor Dunkin' summary judgment. (Gray Plant Mooty represented Dunkin' in the case.) In the decision, the court held that defendants had breached their two franchise agreements by failing to remodel their shops, participate in mandatory programs, attend required training, and prepare immigration forms for new employees. While the court found that defendants had alleged that they attended all required training, they failed to contest any of the other breaches, warranting summary judgment and enforcement of the termination of the franchise agreements.

The court also granted Dunkin' summary judgment on defendants' counterclaims. The defendants had alleged that Dunkin' breached a settlement agreement between the parties, which required Dunkin' not to unreasonably reject a proposed buyer. The court held that Dunkin' acted reasonably in rejecting the proposed transfer because the transaction did not break even, *i.e.*, the proposed debt exceeded established sales. Dunkin' also acted reasonably in using regional data instead of store specific data to project future profits and liabilities. The defendants failed to show how the regional data would have changed the analysis. Further, the court granted summary judgment on the defendants' racial discrimination claims relating to the proposed transfer. The court held that an alleged discriminatory statement made, after the buyer was rejected, by a Dunkin' field level employee with no involvement in the rejection decision was not direct evidence of discrimination. Defendants provided no other direct evidence of discrimination other than the alleged statement. Finally, even if the defendants could establish a prima facie case of discrimination, the court found that Dunkin' had a legitimate, nondiscriminatory reason for rejecting the proposed transfer.

FRAUD

COURT DENIES SUMMARY JUDGMENT TO FRANCHISOR ON BASIS OF FRANCHISEE'S FRAUDULENT INDUCEMENT CLAIM

In *Luxottica Retail North America, Inc. v. Stonybrook Ventures, Inc.*, 2010 U.S. Dist. LEXIS 46265 (M.D. Fla. May 11, 2010), Luxottica was unsuccessful in seeking summary judgment on a collection action against a terminated franchisee. Luxottica, which previously owned Lens Crafters stores, had acquired the Pearle Vision franchise system shortly after the defendants entered into a franchise agreement to open a Pearle Vision store. In response to Luxottica's motion for summary judgment on its damages claims under the franchise agreement, the defendants argued that they had been fraudulently induced to enter the agreement by Pearle Vision, which had not disclosed the pending sale of the franchise system to Luxottica. The defendants alleged that they were encouraged to open their Pearle Vision store near a Lens Crafters store and that Pearle Vision had represented to them that the proximity of the two stores would not matter because Pearle Vision offered superior programs.

Luxottica argued that it was entitled to summary judgment because the franchise agreement permitted Pearle Vision, in its discretion, to assign the agreement to any third party. The court found, however, that the defendants' defense of fraudulent inducement was an intentional tort claim that was independent of the terms of the parties' contract. While the terms of the franchise agreement controlled Luxottica's breach of contract claim, they did not necessarily foreclose the fraud defense. Finding that fact issues surrounded the negotiation of the agreement, the court denied Luxottica's motion for summary judgment.

GOOD FAITH AND FAIR DEALING

CALIFORNIA FEDERAL COURT GRANTS MOTION TO DISMISS BREACH OF CONTRACT CLAIMS BUT ALLOWS GOOD FAITH AND FAIR DEALING CLAIM

In *Passport Health, Inc. v. Travel Med, Inc., et. al.,* 2010 U.S. Dist. LEXIS 46210 (E.D. Cal., May 11, 2010), a California federal court granted a franchisor's motion to dismiss the franchisee's claims for breach of the franchise agreement, but refused to dismiss its claims for the franchisor's breach of the covenant of good faith and fair dealing. The franchisee claimed that the franchisor breached the franchise agreement, in part, by failing to provide "training, marketing, management methods, procedures, and materials," by providing "flawed and defective methods, standards and procedures," and by providing a "flawed software program." After reviewing the relevant provisions of the franchise agreement, the court granted the franchisor's motion to dismiss because even if the allegations were true, the franchisor did not breach the express terms of the franchise agreement. The court, however, refused to dismiss the implied covenant claims, finding that even if the franchisor did not breach the express terms of the franchise agreement, it could breach the implied covenant of good faith and fair dealing.

FRANCHISEES' INJUNCTION MOTION UNDER IMPLIED COVENANT FAILS WHEN TERMINATION WAS BASED ON PLAIN LANGUAGE OF AGREEMENTS

In *Coriatt-Gaubil et al. v. Roche Bobois Int'l, S.A. et al.*, 2010 U.S. Dist. LEXIS 48880 (D. Mass. May 18, 2010), a Massachusetts federal court denied a motion of the plaintiff, who was a 50 percent shareholder of several corporate franchisees, for a preliminary injunction to enjoin the franchisor, who was the other shareholder via an affiliate, from terminating the parties' franchise agreements. The court found that the plaintiff and corporate franchisees had not established a likelihood of success on the merits on their claim for breach of the implied covenant of good faith and fair dealing. The plaintiff and corporate franchisees argued that the notice of termination they received was sent in bad faith in an attempt to coerce concessions from the plaintiff shareholder in an ongoing management dispute. The court found the plaintiff's position "untenable," noting that she was unlikely to succeed on the merits of her claims because the franchisor was simply enforcing the plain terms of the franchise agreements between the parties.

SYSTEM STANDARDS/CHANGE

REQUIRED UPGRADE NEAR END OF TERM NOT A CONSTRUCTIVE BREACH OF FRANCHISE AGREEMENT

In *LaQuinta Corp. v. Heartland Properties, LLC*, 2010 U.S. App. LEXIS 8757 (6th Cir. Apr. 28, 2010), the Sixth Circuit affirmed a grant of summary judgment in favor of the franchisor in connection with the refusal by a franchisee of the Baymont Inns franchise system to implement a new reservation system. (Plaintiff La Quinta is the corporate parent of Baymont). Under the franchise agreement, the defendant franchisee was required to participate in, and bear the costs of, whatever reservation system Baymont established in "its sole discretion." Two years before the franchise agreement was due to expire, Baymont implemented a new computerized reservation system, at an approximate cost of $35,000 to each franchisee. The franchisee refused to execute the agreements relating to the new system and did not complete installation, prompting Baymont to terminate the franchise agreement and sue for liquidated damages. The franchisee, in turn, argued that Baymont had constructively breached the franchise agreement by requiring an expensive system upgrade so close to the end of the agreement term.

Citing seminal system change cases *Trail Burger King* and *Economou v. Physicians Weight Loss Center of America,* among others, the Sixth Circuit reaffirmed a franchisor's broad right to implement changes in a franchise system. The court rejected the franchisee's contention that the system upgrade violated the franchisee's nonrenewal option—finding that the requirement to pay the unamortized cost of the upgrade (if the franchisee chose not to renew) was "fully contemplated and permitted by the unambiguous terms" of the franchise agreement. The court also reaffirmed the ability of a hotel franchisor to enforce liquidated damages, which in this case were calculated as an amount equal to the aggregate royalty fees that had accrued under the franchise agreement for the 36 months preceding termination.

FRANCHISE SALES/TRANSACTIONS

STATE APPELLATE COURT CONSTRUES WASHINGTON ACT

In an interesting decision in a case brought against a franchisor and its subfranchisor, the Washington Court of Appeals ruled last week that Washington's franchise disclosure law does not require a subfranchisor to register its offering documents if the franchisor itself has already registered those same documents. S*omething Sweet, LLC v. Nick-N-Willy's Franchise Co.*, 2010 Wash. App. LEXIS 1135 (Wash App. June 1, 2010). While the Washington Franchise Investment Protection Act does apply to disclosure documents registered by a subfranchisor, the court held that the registration can be done by the franchisor when it is the ultimate party to the franchise being offered. Summary judgment for the defendants was affirmed.

RICO

FRANCHISE SYSTEM CANNOT BE "ENTERPRISE" REQUIRED FOR RICO CLAIM

An Ohio federal court ruled June 4 that a franchisee's claims under federal racketeering law must be dismissed for failure to plead the existence of an illegal "enterprise." The case is *Arnold v. Petland, Inc.*, 2010 U.S. Dist. LEXIS (S.D. Ohio June 4, 2010). Federal RICO claims, to be viable, must include the presence of an enterprise separate and distinct from the defendant itself. The complaint in this case did not define a separate enterprise, but in opposition to the motion to dismiss, the plaintiff argued that the franchisees in the system may serve as the requisite enterprise. The court held that it would be impossible for the franchisees to be both the illegal enterprise and the victim of the unlawful scheme. Because the defendant franchisor was not a separate and distinct enterprise, and the franchisees could not comprise one either, the RICO claim failed as a matter of law and was dismissed.

NONCOMPETES

MINNESOTA FEDERAL COURT ENFORCES IN-TERM COVENANT UNDER TEXAS LAW

A Texas-based franchisor of building cleaning and maintenance services and supplies won a temporary restraining order to prevent its Minnesota master franchisee—and related persons and entities—from operating a competing business. *Bonus of America, Inc. v. Angel Falls Services, L.L.C., et al.*, No. 0:10-cv-02111-DSD-FLN (D. Minn. May 28, 2010). The defendants had also formed and been conducting business in Minnesota through another entity, which led the franchisor to file suit in federal court in Minnesota. (Gray Plant Mooty represents the franchisor in this action.)

Applying Texas law as specified in the parties' agreements, the court ruled that the covenants not to compete were enforceable and had been violated. To be enforceable under Texas law, the court held, the covenants must be reasonable and part of an otherwise valid contract. The master franchise agreements were deemed enforceable because they contained an exchange of promises related to use of trademarks and confidential information. The restrictive covenants were deemed reasonable because they prohibited competition "only for their duration plus two years, and limit the restrained territory to a 50-mile radius." The court enforced the covenants against the corporate franchisee and its individual guarantors and their newer, competing entity.

WASHINGTON FEDERAL COURT FINDS EXPIRATION SAME AS TERMINATION, BUT STILL REFUSES TO ENFORCE NONCOMPETE CLAUSE

In *Doyle v. Nutrilawn U.S., Inc.*, 2010 U.S. Dist. LEXIS 48613 (W.D. Wash. May 17, 2010), a Washington federal court concluded that language in a noncompete clause making it applicable "following the termination of this Agreement for any reason whatsoever" applied upon the agreement's expiration. The franchisee argued that the covenant only applied if the agreement was terminated, and that termination and expiration should be treated differently. After reviewing "the franchise agreement as a whole" and "giving its terms their ordinary meaning," the court concluded that the noncompete covenant would apply, but refused to enforce it because the franchisor failed to present sufficient evidence that the covenant was violated.

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TRADEMARK

CONTINUED USE OF DOMAIN NAMES AFTER TERMINATION FOUND TO CONSTITUTE TRADEMARK INFRINGEMENT

A federal bankruptcy court has held that continued use of a franchisor's trademark as part of a domain name after termination was trademark infringement. *In re Gharbi, 21 Real Estate LLC v. Gharbi*, 2010 Bankr. LEXIS 1247 (Bankr. W.D. Tex. April 19, 2010). The defendant, a former franchisee of the Century 21 real estate franchise system, continued to use domain names that included the mark CENTURY 21 on various Web sites after termination and featured the mark itself prominently on the home page of another Web site. The court granted summary judgment to the franchisor on the issue of trademark infringement under the Lanham Act, rejecting the defendant's claim that the use was not "in commerce" because the defendant was only selling his own property.

The court, however, denied summary judgment on the issue of whether use of the mark in the domain names was a violation of the Anti-Cybersquatting Protection Act (ACPA). The ACPA requires that the person have a "bad faith intent to profit from the mark" to be liable. The court reasoned that the evidence did not support a finding of bad faith, as slowness to act in removing the mark and shutting down the businesses' Web sites following termination of franchise agreements may not constitute bad faith.

POST-TERMINATION INJUNCTIONS

ARIZONA FEDERAL COURT HOLDS INJUNCTION MOTION NOT MOOT

In *Native New Yorker Franchising, Inc. v. Shabaz, Inc.*, 2010 U.S. Dist. LEXIS 50065 (D. Ariz. April 29, 2010), the franchisor of Native New Yorker restaurants filed a preliminary injunction motion against a former franchisee for its continued operation of the restaurant and refusal to transfer the restaurant's telephone number back to the franchisor. By the time the motion was heard, the former franchisee claimed that the motion was moot because it had ceased operating and was on the brink of bankruptcy. Injunctions, however, are only moot to the extent that it can be shown "that there is no reasonable expectation that the wrong will be repeated." Despite the former franchisee's claims, the court found in favor of the franchisor, noting that the fact that the franchisees "may have temporarily abated their misconduct d[id] not alter the analysis." The court granted the motion for preliminary injunction and ordered that the restaurant's telephone number be transferred back to the franchisor.

CHOICE OF FORUM

CALIFORNIA COURT OF APPEAL VOIDS FLORIDA FORUM SELECTION CLAUSE UNDER CALIFORNIA FRANCHISE RELATIONS ACT

Taking a broad view of the scope of the California Franchise Relations Act (CFRA), the California Court of Appeal in *T-Bird Nevada LLC, et. al. v. Outback Steakhouse, Inc., et al.,* 2010 Cal. App. Unpub. LEXIS 3610 (Cal. Ct. App. May 17, 2010), voided a Florida forum selection clause in a borrower agreement between Outback Steakhouse and a California developer. The parties had entered into an arrangement under which T-Bird signed off on a multi-million dollar loan to fund Outback's expansion into California. T-Bird's owner set up separate companies to act as franchisees for each location and the companies, not T-Bird, signed the franchise agreements. The parties then entered into a borrower agreement providing that Outback would guarantee the loan, but that any default of the loan obligations by T-Bird would also constitute a default under the franchise agreements. Outback later filed a collections action against T-Bird in Florida state court, and T-Bird then brought suit against Outback in California, contending that Outback, through false representations and promises, induced T-Bird's owner to enter into the agreement. Outback moved to dismiss the California action.

The court of appeal held that the forum selection clause in the borrower agreement did not apply to T-Bird's action because, under the CFRA, such clauses are void with respect to claims relating to a franchise agreement. The court rejected Outback's contention that the California case only involved the borrower agreement, finding that the majority of T-Bird's claims were "independent of the collections action and raised questions relating to the enforceability of the franchise agreements themselves." Furthermore, the appellate court found that even if the claims were viewed as arising solely out of the borrower agreement, the forum selection clause was still void under the CFRA. The court held that the term "franchise agreement" as used in the CFRA was not limited to a "single, formal document entitled 'franchise agreement' in which the elements of a franchise are addressed," but instead includes "additional contracts or agreements that bear directly on the relationship between franchisor and franchisee . . . ."

BANKRUPTCY

FRANCHISOR OBTAINS RELIEF FROM THE AUTOMATIC STAY TO ENFORCE POST-TERMINATION OBLIGATIONS OF FORMER FRANCHISEES

In *In re Tornado Pizza, LLC,* 2010 Bankr. LEXIS 1108 (Bankr. D. Kan. Apr. 9, 2010), and companion case *In re Team KC, Inc.,* 2010 Bankr. LEXIS 1107 (Bankr. D. Kan., Apr. 9, 2010), a Kansas federal bankruptcy court granted franchisor Domino's Pizza Franchising, LLC relief from the automatic stay to enforce the post-termination obligations of the former franchisee in bankruptcy. The bankruptcy court ruled that the franchise agreements, which were validly terminated pre-bankruptcy, were not executory contracts that could be assumed and assigned in the bankruptcy case. The bankruptcy court also held that the decision by Domino's to stay enforcement of the terminations for a period of time to allow the terminated franchisee an opportunity to sell its stores did not give rise to separate executory contracts that could be assumed in the bankruptcy case. Finally, the bankruptcy court held that where a contract would expire on its own terms by the mere passage of time, a bankruptcy filing prior to expiration would not prevent expiration and would not preserve the expired or expiring agreement. Accordingly, the court held that the former franchisees had no continuing rights to operate Domino's stores following the expiration of the period granted by Domino's to allow for the sale of the stores.

The terminated franchisee also argued that Domino's had waived its terminations of the franchise agreements by accepting royalty payments following the terminations. The bankruptcy court rejected that argument by pointing out that waiver under the applicable law (Missouri or Kansas law) required the intentional relinquishment of a known right. Here, the termination notices stated that during the period of time that the terminated franchisees were allowed to sell their stores, they must remain in compliance with the franchise agreements, including the payment of royalties. The acceptance of the royalties was consistent with the notices of termination, and therefore Domino's did not waive its right to enforce the termination.

ARBITRATION

NONCOMPETE ISSUES COULD BE EXCLUDED FROM ARBITRATION

In *Jewelry Repair Enterprises, Inc. v. Ajani*, 2010 LEXIS 61651 (Fla. Ct. App. May 5, 2010), the Florida Court of Appeals upheld a clause in a franchise agreement excepting noncompetition issues from binding arbitration. The case supports the proposition that contracts will be interpreted according to their plain meaning and that exceptions to binding arbitration provisions will be upheld. In this case, the franchisor terminated the franchisees and sued them for breach of contract after learning the franchisees were operating competing businesses. The franchisees moved to dismiss the complaint, invoking the right to arbitrate under the franchise agreement. The franchisees, however, did not quote the entire provision to the court and excluded the portion of the provision that excepted "claims related to noncompetition covenants" from binding arbitration.

The appeals court reversed the trial court's order to stay the action pending arbitration. The court held that the contract should be construed according to the plain language of the agreement, which clearly stated that claims relating to noncompetition covenants were excepted from arbitration.

IDENTITY THEFT

RED FLAGS RULE UPDATE—ANOTHER POSTPONEMENT

As we previously discussed in Issue Nos. 115 and 122 of *The GPMemorandum*, 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 was originally set to begin in 2008, but has now been delayed until December 31, 2010, although enforcement may begin earlier depending on the effective date of Congressional modification. http://www.ftc.gov/opa/2010/05/redflags.shtm.

THE GPMEMORANDUM – INTERNATIONAL

When international issues arise, *The GPMemorandum—International* highlights the news of interest to franchisors who engage in cross-border transactions. Our special report of one such recent development appears below.

AUSTRALIA AMENDS FRANCHISE CODE

On June 3, 2010, the Australian federal government released new amendments to the Franchising Code of Conduct. The changes will take effect July 1, 2010. Some significant changes that franchisors need to be aware of include the requirement to: (1) inform franchisees, at least six months prior to the end of the franchise agreement, of the franchisor's decision regarding the renewal of the franchise agreement; (2) disclose all payments that a franchisee may be required to make to third parties, where the expenditure is within the knowledge or control of, or is reasonably foreseeable by, the franchisor; (3) disclose whether the franchisor will require the franchisee to undertake any unforeseen significant capital expenditure that was not previously disclosed by the franchisor; (4) disclose the circumstances in which the franchisor has unilaterally varied a franchise agreement in the last three financial years and the circumstances in which the franchise agreement may be unilaterally varied in the future (there is no requirement to disclose unilateral variations that occurred before July 1, 2010); (5) disclose the details of the franchisee's rights at the end of the franchise agreement's term, including disclosing the franchisor's rights to acquire the franchisee's business; and (6) disclose whether the franchisor will amend the franchise agreement on or before transfer or novation of the franchise.

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