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:

POST-TERMINATION INJUNCTIONS: NONCOMPETE COVENANTS

DESPITE EARLIER LACK OF REGISTRATION, COURT ENFORCES IN TERM NONCOMPETE AGAINST MASTER FRANCHISOR AND AFFILIATED PARTIES

In a case handled by Gray Plant Mooty and first reported in Issue No. 131 of *The GPMemorandum* after a prior ruling, the court in *Bonus of America, Inc. v. Angel Falls Services, LLC,* 2010 U.S. Dist. LEXIS 67079 (D. Minn. July 6, 2010), has now entered a preliminary injunction against a master franchisor and two affiliated parties through which the master franchisor was conducting business, enjoining them from violating the in term noncompete provisions of the Master Franchisor Agreement (MFA) and from using the franchisor's name, trademarks, or proprietary materials. The master franchisor had entered into an initial MFA with the franchisor in June 2007, and entered into a subsequent MFA in August 2007 that superseded the first agreement. When the parties entered into the first MFA, the franchisor was not registered as a franchisor in Minnesota, but had registered by the time the parties entered into the second agreement.

After the franchisor discovered the competing business, it immediately sought to enjoin the defendants from operating. In response to the motion, the defendants argued that the MFA—including its noncompete provisions—was unenforceable because the franchisor had not been properly registered in Minnesota at the time the master franchisor was sold its franchise, as required

GRAY PLANT MOOTY

by the Minnesota Franchise Act. The court held that although a franchisee is allowed to seek rescission for certain violations of that Act, Minnesota courts have declined to rescind contracts based on technical violations. Here, the court concluded that the violations alleged by the master franchisor were technical in nature and allowing rescission would lead to an unjust outcome. After considering the harm to the franchisor's goodwill, the defendants' unclean hands, the balance of harms, the likelihood of success on the merits, and the public interest involved, the court granted the franchisor's request for injunctive relief against both the master franchisor (who had signed the MFA) and the other defendants (who had not), the latter on the ground that they were "in active concert and participation" with the master franchisor.

POST-TERMINATION INJUNCTIONS: TRADEMARKS

KRISPY KREME OBTAINS POST-TERMINATION INJUNCTION AGAINST FORMER FRANCHISEE UNDER HEIGHTENED STANDARD

In *Krispy Kreme Doughnut Corp. v. Satellite Donuts, L.L.C.*, 2010 U.S. Dist. LEXIS 73913 (S.D.N.Y. Jul. 22, 2010), a franchisor obtained a preliminary injunction against its former franchisee. Krispy Kreme had terminated the franchise agreement after Satellite failed to pay royalties and other amounts, but Satellite continued to operate as a Krispy Kreme store after termination. Krispy Kreme brought suit seeking a temporary restraining order and a preliminary injunction to stop Satellite from using its trademarks and proprietary materials.

In granting the franchisor's motion, the court found that Krispy Kreme demonstrated a "clear and substantial likelihood" of success on the merits, meeting the heightened standard in cases where the preliminary injunction is either "mandatory" or would "provide the movant with all of the relief sought and that relief cannot be undone even if the defendant prevails on a trial on the merits." The court found that Satellite was undisputedly in default under the franchise agreement—Satellite conceded that it owed Krispy Kreme more than $235,000. In addition, the court held that although Krispy Kreme titled its termination letter as a "cease and desist" letter rather than a "notice of termination," the letter constituted effective notice of termination under the franchise agreement. Thus, Krispy Kreme successfully demonstrated a clear and substantial likelihood of success on the merits of its breach of contract and Lanham Act claims.

TERMINATIONS

NEW JERSEY COURT AFFIRMS TERMINATION FOR NONPAYMENT AND HOLDS THAT FRANCHISEE'S CLAIM THAT FRANCHISOR BREACHED FRANCHISE AGREEMENT DID NOT ELIMINATE OBLIGATION TO PAY

In *Ramada Worldwide, Inc. v. Hotel of Grayling, Inc.*, 2010 U.S. Dist. LEXIS 65186 (D.N.J. June 30, 2010), Ramada terminated and sued its franchisee for failing to pay over $90,000 in royalties and defaulting on its guarantee. The franchisee counterclaimed, and alleged that because Ramada materially breached the agreement *before* the fees were due, by failing to provide it with proper signage, conduct training, and provide a working computer system, it was not liable for unpaid fees.

The court rejected that argument and awarded Ramada summary judgment on its claims. The court cited settled franchise law that "[u]nder no circumstances may the non-breaching party stop performance and continue to take advantage of the contract's benefits." The franchisor's alleged defaults did not absolve the franchisee from continuing to pay royalties. The court also awarded summary judgment to Ramada on the franchisee's claims, finding that the franchisee had put forth insufficient evidence of Ramada's alleged material breaches of the license agreement.

DAMAGES

TENNESSEE FEDERAL COURT ALLOWS FRANCHISOR TO MAINTAIN CLAIM FOR LOST FUTURE ROYALTIES

After a franchisee abandoned his franchise and allowed his son to open a competing business in the same location, the franchisor filed suit in *Moran Indus., Inc. v. Mr. Transmission of Chattanooga, Inc.*, 2010 U.S. Dist. LEXIS 71753 (E.D. Tenn. Jul. 15, 2010), claiming lost future royalties. The defendants filed a motion to dismiss, arguing that the license agreement provided that the royalty payment obligation lasted only five years. The court rejected that argument, noting that an addendum the parties signed seven years after the license agreement provided for a decreased royalty rate for certain work, which would be nonsensical if such payments ceased after five years. The court also rejected the defendants' argument that a franchisor who terminates a franchise agreement, even where the franchisee is in breach, is not entitled to lost future royalties because the franchisee's breach is not the proximate cause of the loss of those royalties. After a fairly extensive survey of the case law on this subject, including *Postal Instant Press, Inc. v. Sealy* and its progeny, the court ruled that the right to collect future royalties is very fact specific and could not be determined at this early stage in the litigation. Therefore, the motion to dismiss was denied.

RENEWAL

CALIFORNIA FEDERAL COURT DISMISSES CLAIM BY FRANCHISEES UNDER CFIL

A California federal court has granted a franchisor's motion to dismiss an amended complaint brought by many of its Union 76 brand gas station franchisees in connection with the franchisor's renewal of their franchise agreements. The case is *In re ConocoPhillips Co. Service Station Rent Contract Litig.*, 2010 U.S. Dist. LEXIS 61300 (N.D. Cal. Jun. 2, 2010). The plaintiff-franchisees sued, claiming that Conoco violated Section 31101 of California's Franchise Investment Law (CFIL). Section 31101 exempts the offer and sale of a franchise from the registration requirements of Chapter 2 of the CFIL if certain conditions are met, including the disclosure of prescribed information. Relying on this section, the franchisees alleged that Conoco had failed to disclose certain required information at the time of their renewals, including its intent to increase rent, its practice of charging credit and debit card processing fees, and its intent to assign each of their franchise agreements to a third party. The franchisees sued for declaratory relief under the CFIL and for relief under Section 17200 of California's Unfair Competition Law (UCL). Conoco moved to dismiss the amended complaint.

In dismissing the amended complaint, the court held that Section 31101 of the CFIL does not apply to the renewal of existing franchise agreements. The court cited Section 31001 of the CFIL, which explains that the CFIL was enacted to ensure that a *prospective* franchisee is cognizant of its duties and obligations before deciding to enter into a franchise relationship. The court also noted that the renewal of an existing franchise is excluded from the definitions of "offer" and "sale" under Section 31018, provided the renewal does not require a "material modification" of the franchise. Focusing on this section, the franchisees argued that the rent increase was a material modification to each of their franchise agreements and, therefore, a "sale" under the CFIL. The court found, however, that the franchisees failed to allege this claim in the amended complaint. The court further found that even if there was a material modification, no claim for damages existed for failure to provide disclosures under Section 31101 because the franchisees would be required to either object and rescind the franchise agreements or agree to the material modification. Finding the franchisees' other claims to be dependent on the validity of the CFIL claim, the court also dismissed the claim for declaratory relief and the UCL claim as not legally viable. However, the court granted the franchisees leave to amend their claims.

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TRADEMARK INFRINGEMENT

NINTH CIRCUIT VACATES DISTRICT COURT'S PRELIMINARY INJUNCTION ORDER REGARDING USE OF AN INTERNET DOMAIN NAME

The Ninth Circuit in *Toyota Motor Sales, USA, Inc. v. Farzad Tabari, et al.,* 2010 U.S. App. LEXIS 13903 (9th Cir. July 8, 2010), vacated and remanded an order granting a preliminary injunction in favor of Toyota enjoining the use of one of its trademarks in a domain name. Toyota, the exclusive distributor of Lexus vehicles in the United States, sued the defendant auto brokers based on the use of the term "Lexus" in their business Web site domain names. The district court found that the defendants' domain names, buy-a-lexus.com and buyorleaselexus.com, infringed the trademark *Lexus* and enjoined the defendants from using the mark *Lexus* in any domain name.

On appeal, the Ninth Circuit held that the defendants were using the term to describe their business of brokering *Lexus* automobiles, that such use of the trademark was a nominative fair use, and that fair use, by definition, was not infringement. In analyzing the nominative use defense, the court looked at "whether (1) the product was 'readily identifiable' without use of the mark; (2) defendant used more of the mark than necessary; or (3) defendant falsely suggested he was sponsored or endorsed by the trademark holder." The court found that the defendants had demonstrated that the use of the mark was necessary to describe their business because it was nearly impossible to convey a specialty in brokering the vehicles without mentioning "Lexus." Further, the injunction was plainly overbroad because it prohibited domain names that on their face dispelled any confusion that the defendants were sponsored or endorsed by Toyota. The appellate court vacated the injunction and remanded for reconsideration of the injunction's scope, stating that, at the very least, the injunction must be modified to allow some use of the mark in domain names. The court also noted that on remand Toyota would bear the burden of showing that the defendants' use of name was not nominative fair use, overruling precedent that required the defendant claiming the nominative fair use defense to show that confusion was not likely.

ARBITRATION

COURT ENFORCES ARBITRATION CLAUSE AGAINST PERSONAL GUARANTORS, BUT RESTRICTS VENUE

A recent case from a Michigan federal court represents a mixed bag for franchisors seeking to require arbitration of claims brought by franchisees. In *Binder v. Medicine Shoppe Int'l, Inc.*, 2010 U.S. Dist. LEXIS 72614 (E.D. Mich. July 20, 2010), a corporate franchisee signed a franchise agreement containing an arbitration clause. Its principals also signed personal guaranty agreements, under which they agreed to be personally bound by the franchise agreement. When a dispute arose between the parties, the franchisor commenced arbitration against both the corporate franchisee and the personal guarantors in St. Louis, MO, in accordance with the franchise agreement. The corporate franchisee asked the American Arbitration Association to transfer the arbitration to Michigan, but that request was denied. The corporate franchisee and individuals then sued in Michigan, with the individuals claiming they were not personally bound by the franchise agreement's arbitration clause. The franchisor filed a motion to compel arbitration, arguing in part that the individuals had waived their right to raise their claims by participating in the underlying arbitration proceeding. The court rejected that argument, finding that the individuals had participated in the arbitration in their capacity as corporate officers.

The court did find, however, that the individuals were bound to arbitrate their claims by virtue of the personal guarantees they signed, in which they assumed the corporation's obligations under the franchise agreement, including the obligation to arbitrate claims. While the court required the individuals to arbitrate their claims, it found that the franchisor had materially misrepresented the nature of the arbitration clause. The franchisor's UFOC stated that Michigan law prohibits franchise agreements from requiring arbitration outside of Michigan, even though that law is preempted by the Federal Arbitration Act. The corporate franchisee and individuals contended that they relied on that representation in signing the franchise agreement and that they would not have accepted the agreement had they known they might be required to arbitrate in a different state. The court found that the individuals had reasonably relied on the franchisor's representation that any arbitration proceeding would take place in Michigan, and ordered arbitration to proceed in that venue.

TWO CIRCUIT COURTS AFFIRM AWARDS, DESPITE ARGUMENTS THAT ARBITRATORS DISREGARDED THE LAW

The Third and Eighth Circuits recently affirmed arbitration awards in favor of franchisors, despite similar arguments by franchisees. Most recently, in *Paul Green School of Rock Music Franchising, LLC v. Smith*, 2010 U.S. App. LEXIS 16082 (3d Cir. August 2, 2010), the Third Circuit sidestepped the question of whether "manifest disregard of the law" remains a ground to vacate an arbitration award after the Supreme Court's decision in *Hall Street Associates, L.L.C. v. Mattel, Inc.* Describing a "circuit split" on that question, the Third Circuit simply ruled that the law was not manifestly disregarded, so it did not have to address whether manifest disregard would be a proper basis for vacating an award. The arbitrator's award in favor of the franchisor for more than $400,000 and other relief was upheld.

In the Eighth Circuit decision, *Medicine Shoppe Int'l, Inc. v. Turner Inv., Inc.*, 2010 U.S. App. LEXIS 14960 (8th Cir. July 21, 2010), the court affirmed an arbitration award that provided for future royalties and other damages in favor of franchisor Medicine Shoppe. At issue was whether the arbitrator had disregarded Missouri law, which requires that lost future royalties be proven with reasonable certainty. The franchisee closed the shop, leading the franchisor to file an arbitration claim. The franchisee on appeal contended that the franchisor had failed to prove lost future profits and that the arbitrator had disregarded the law in ruling in favor of the franchisor and awarding $472,164.42 in damages.

The Eighth Circuit, following the Supreme Court's decision in *Hall Street*, held that an arbitrator's award under the Federal Arbitration Act could be overturned only in four circumstances: if the award was procured by fraud, corruption, or undue means; where there was evident partiality or corruption by the arbitrator; where the arbitrator was guilty of misconduct in refusing to postpone the hearing or other misbehavior; or where the arbitrator exceeded his or her powers. Finding that the franchisee had not alleged that these acts had occurred on appeal and that the arbitrator had acted within the scope of his authority, the award was affirmed.

CHOICE OF LAW

NINTH CIRCUIT UPHOLDS RESTRICTION ON APPLICATION OF WASHINGTON FRANCHISE INVESTMENT LAW TO CONDUCT IN STATE

The Ninth Circuit recently confirmed that a state franchise law does not apply to claims involving out-of-state franchisees even if the franchise agreement has a choice of law provision applying that state's law. The franchisees in *Taylor v. 1-800-GOT-JUNK?, LLC*, 2010 U.S. App. LEXIS 14433 (9th Cir. July 14, 2010), operated a junk removal franchise in Oregon pursuant to a franchise agreement that contained a Washington choice of law provision. Neither the franchisees nor the franchisor were Washington residents. A previous dispute between the parties, in which the franchisees were not represented by counsel, had been settled and the settlement agreement included a broad mutual release. Nevertheless, the franchisees subsequently filed suit against the franchisor in federal court, raising claims under the Washington Franchise Investment Protection Act (FIPA), Wash. Rev. Code § 19.100-.940. The franchisor invoked the release to bar the claims. FIPA has an anti-waiver provision that voids any agreement that seeks to waive compliance with the statute unless the waiver was executed pursuant to a settlement in which the party was represented by counsel. The franchisees asserted that they had not released their FIPA claims because they had not been represented by counsel when they entered into the settlement agreement.

The district court granted summary judgment to the franchisor on the grounds that FIPA's anti-waiver provision had not been violated because the statute did not apply to a franchise sale that took place in Oregon. The Ninth Circuit affirmed, finding that "by its terms, FIPA applies only to conduct occurring in Washington." The court rejected the franchisees' argument that FIPA's territorial restriction was trumped by the franchise agreement's Washington choice of law provision. When a law "contains geographic limitations on its application," the court noted, it will not be applied "to parties falling outside those limitations, even if the parties stipulate that the law should apply."

CHOICE OF FORUM/VENUE

COURT UPHOLDS MEDIATION PROVISION UNDER CALIFORNIA LAW

In *Terry Delamater, et. al. v. Anytime Fitness, Inc.,* 2010 U.S. Dist. LEXIS 64126 (E.D. Cal., June 25, 2010), a California federal court granted the franchisor's motion to dismiss a franchisee's complaint for declaratory relief that sought to require the parties to mediate in California. The franchisor and the franchisee were parties to several franchise agreements, under which the parties were to engage in mediation at a site selected by the mediation organization before submitting their claims to arbitration or litigation. A dispute arose between the parties, and the franchisee demanded that they mediate. The mediation organization selected Atlanta, GA, as the venue.

Prior to the start of mediation, the franchisee filed a complaint for declaratory relief seeking to require that the mediation be held in California, claiming that the mediation clause violated the California Franchise Relations Act. The court disagreed, holding that the CFRA did not apply to nonbinding mediation. While the CFRA prohibits a franchise agreement from restricting venue to a forum outside California for any claim relating to a franchised business located in California, the court found that a mediation does not involve the assertion of "claims," but rather the parties work with a neutral in an effort to reach an agreement to a dispute. In addition, there was nothing in the CFRA or its legislative history that suggested that the statute should be applied to nonbinding mediation forum selection clauses.

JURISDICTION AND PROCEDURE

FIVE-DAY TRAINING AT FRANCHISOR'S HEADQUARTERS WAS KEY TO ESTABLISHING JURISDICTION OVER OUT-OF-STATE FRANCHISEE

In *Aussie Pet Mobile Inc. v. Benton*, 2010 U.S. Dist. LEXIS 65126 (C.D. Cal. June 28, 2010), a California federal court denied a franchisee's motion to dismiss, finding that the franchisee's attendance at mandatory training in the franchisor's home state of California was sufficient grounds for the California court to exercise personal jurisdiction over a principal of the franchisee, who was a resident of Ohio. Under federal law, a court can exercise jurisdiction over the resident of another state if (a) the defendant has purposefully directed activities within the forum state or is a resident of that state, (b) the suit at issue relates to those activities, and (c) exercising jurisdiction over the out-of-state party is "reasonable" and is consistent with "fair play and substantial justice." The franchisee in this matter had voluntarily traveled to the franchisor's home state to attend training related to the franchised business, satisfying the first prong of the test. Further, the franchisor's complaint alleged that the franchisee had closed its franchised business and started a similar, competing business, in violation of the franchise agreement, utilizing trade secrets learned during training. Finally, the court rejected the argument that litigating in California would cause undue expense, noting that the remaining franchisee-related defendants would have to litigate in California, and all defendants shared the same attorney. Under these circumstances, the court found that exercise of jurisdiction over the Ohio defendant was reasonable and consistent with the concepts of fair play and substantial justice.

Notably, the court granted the franchisee's motion to dismiss with respect to the non-compete covenant contained in the franchise agreement, holding that it was unreasonably broad and unenforceable under both Ohio and California law. The covenant prevented "anyone affiliated with Defendants' franchise from providing any similar services, anywhere." The court found that this broad provision was "greater than required" to protect the franchisor's legitimate business interest, and the covenant was held to be invalid.

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