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:

TERMINATIONS

COURT REFUSES TO DISMISS FRANCHISEE'S CLAIMS, INCLUDING CLAIM FOR BREACH OF FIDUCIARY DUTY

In *United Consumers Club, Inc. v. Prime Time Mktg. Mgmt., Inc.*, 2010 U.S. Dist. LEXIS 87236 (N.D. Ind. Aug. 23, 2010), a federal district court late last month denied a franchisor's motion to dismiss claims for, among other things, wrongful termination and breach of fiduciary duty. Prime Time, a franchisee of an organization known as DirectBuy, had sued the franchisor after its franchise was terminated. Prime Time sold memberships to its buying club, with DirectBuy receiving royalty fees. In denying the motion to dismiss, the court found that the majority of Prime Time's claims properly stated a claim for relief, and thus were not subject to dismissal at this early stage of the litigation.

The court found, first, that fact issues surrounded Prime Time's claim for wrongful termination of its franchise agreement. The court further permitted Prime Time to pursue its claims for conversion, tortious interference with contract, unjust enrichment, and breach of the implied covenant of good faith and fair dealing. Most significantly, however, the court also found, without much explanation, that Prime Time had properly stated a claim for breach of fiduciary duty. Prime Time alleged that a fiduciary relationship formed when DirectBuy exerted control and influence over Prime Time's customers. The

court noted that a franchise relationship does not typically create a fiduciary duty, but found that it was premature to determine whether such a relationship existed under the facts of this case. Accordingly, the court denied DirectBuy's motion to dismiss this claim as well. We will monitor any further decisions in this case, given the potential impact on franchising of the issue of whether a fiduciary duty exists.

MISSOURI COURT NARROWLY CONSTRUES GUARANTY IN FRANCHISE AGREEMENT

A recent Missouri federal court decision serves as a warning to franchisors to carefully draft guaranty provisions in franchise agreements to ensure they will be effective. In *Medicine Shoppe Int'l, Inc. v. Anick, Inc.*, 2010 U.S. Dist. LEXIS 78431 (E.D. Mo. Aug. 4, 2010), the court dismissed the franchisor's breach of guaranty claim against the franchisee's corporate representative who signed the license agreement. That agreement contained a "note," immediately below the franchisee's signature block, stating "IF THE LICENSEE IS A CORPORATION OR PARTNERSHIP, EACH OF THE STOCKHOLDERS OR PARTNERS MUST EXECUTE THE FOLLOWING UNDERTAKING. . . . Each of the undersigned agree . . . that they . . . shall be firmly bound by all of the terms, provisions, and conditions of the foregoing." The court found that the guaranty did "not expressly indicat[e] an obligation on the part of [the signatory] to guarantee [the franchisee's] performance of the License Agreement or to cure any of [the franchisee's] defaults under the License Agreement."

The court also dismissed claims against the franchisee's signatory for breach of the license agreement, reasoning that he was not a party to the agreement and the guaranty did not make him liable for the breaches.

NONCOMPETE COVENANTS

COLORADO FEDERAL COURT REFUSES PRELIMINARY INJUNCTION TO ENFORCE IN-TERM NONCOMPETE

In *Big O Tires, LLC v. Felix Bros. Inc.*, 2010 U.S. Dist. LEXIS 81559 (D. Colo. Jul. 12, 2010), a franchisee group owned and operated three Big O Tires franchises in California. The franchisee elected not to renew the franchise agreement for one of the units, and requested early termination of the remaining two units. That request was declined, and the franchisee continued to operate its remaining two franchises. The franchisee also continued to operate its first tire store, changing the name to "Budget Tires and Automotive."

The franchisor sought a preliminary injunction to prevent the franchisee from operating the competing business. The franchisor, however, did not attempt to enforce a post-termination noncompete contained in the expired franchise agreement (which, under the franchise agreement, would have required a "good cause" termination), but rather sought to enforce the *in-term* noncompete clauses in the remaining Big O franchise agreements. These clauses prohibited the franchisee from operating any competing tire or automotive business other than a Big O franchised unit.

Finding that the franchisor had failed to show irreparable harm, a Colorado federal court denied the franchisor's motion. Although the franchisor argued that the franchisee could use confidential information learned as a Big O franchisee in the operation of its competitive business and might refer customers to the competitive business, the court found that the franchisor failed to present any direct, admissible evidence that the franchisee was actually engaged in such activity. Having found against the franchisor on this element, the court declined to consider likelihood of success on the merits or the other injunction factors, and denied the motion.

TRADEMARKS

MINNESOTA COURT ENJOINS FOREIGN WEBSITE FROM TRADEMARK INFRINGEMENT

In *Doctor's Associates, Inc. v. Subway.SY LLC*, 2010 U.S. Dist. LEXIS 83223 (D. Minn. Jul. 30, 2010), the plaintiff franchisor, which owns numerous trademarks associated with the SUBWAY sandwich restaurant chain, obtained a permanent injunction against a defendant who operated an infringing Web site in Syria. The defendant formed Subway.SY LLC in 2008 and used images copied directly from plaintiff's Web site on its own Web site and Facebook page, which advertised the opening of a "Subway" restaurant shop in Syria. Although the defendant claimed that the Web site was not operated within the United States, the LLC was headquartered in Eden Prairie, Minnesota, and the defendant attempted to register the infringing trademark and assumed name with the Minnesota Secretary of State. The plaintiff sought summary judgment on claims for trademark infringement and unfair competition under the Lanham Act, violation of the Anti-Cybersquatting Consumer Protection Act under 15 U.S.C. § 1125(d)(1), and cancellation of the Minnesota trademark registration. The court awarded summary judgment on all of the plaintiff's claims.

Despite the summary judgment, the defendant continued to use the trademarks and sought to register the domain name Subway.sy with the Minnesota Secretary of State, prompting the plaintiff to file a motion for a permanent injunction. The court granted the motion, finding that the evidence overwhelmingly favored the issuance of injunctive relief. First, the continued use of infringing marks demonstrated irreparable harm to the

plaintiff. Second, the court held that the balance of hardships favored a permanent injunction because "[t]here is not cognizable harm to defendant from being enjoined from doing something that is against the law and for which [he] has already been found liable." Third, the court found that the public has an interest in the enforcement of valid trademarks and the right not to be confused by an infringing mark. Turning to damages, the court awarded statutory damages of $25,000 under the Lanham Act, finding that the defendant acted "willfully" by continuing to infringe on the plaintiff's marks after the court told him that he was violating the law. The court also awarded the plaintiff its entire request for attorneys' fees, holding that this was an "exceptional case" of egregious conduct of a defendant that warranted the award of attorneys' fees and costs. In addition, the court awarded statutory damages under the Anti-Cybersquatting Consumer Protection Act in the amount of $25,000.

ARBITRATION

FEDERAL COURT STAYS MATTER PENDING ARBITRATION

An Oregon federal court, in *JuiceMe, LLC v. Booster Juice Ltd. P'ship,* 2010 U.S. Dist. LEXIS 77375 (D. Ore. July 30, 2010), denied the defendant franchisors' motions to dismiss and stayed the case pending arbitration. The plaintiffs, who are U.S. and Canadian Booster Juice franchisees, had filed a demand for arbitration with the American Arbitration Association in January 2008 against Booster Juice Limited Partnership, the franchisor of the Booster Juice system in the U.S., and other related parties. The plaintiffs later added AW Holdings Corporation, the franchisor of the Booster Juice system in Canada, and other related parties. The demand for arbitration raised claims relating to the plaintiffs' franchise agreements and regional development agreements with the defendants. While each of the agreements contained valid arbitration clauses, none of them described who was responsible for paying arbitration costs. To address this issue, in August 2008, the plaintiffs, U.S. Defendants, and Canadian Defendants each orally agreed to pay one-third of the arbitration costs.

After discovery, the U.S. Defendants notified the AAA in November 2009 that they were unable to pay their share of arbitration costs, which at that time were approximately $58,000. Because the plaintiffs and Canadian Defendants were unwilling to pay the U.S. Defendants' share of arbitration costs, the AAA ultimately terminated the arbitration because of insufficient funding. Thereafter, the plaintiffs filed a complaint against the U.S. and Canadian Defendants in federal court, bringing claims similar to those in their demand for arbitration. The U.S. and Canadian Defendants filed motions to dismiss contending, among other things, that the court lacked jurisdiction because the plaintiffs' claims were subject to arbitration.

The court denied both motions to dismiss the federal case but attempted to return the matter to arbitration. In addressing the Canadian Defendants' motion, the court noted that they did not fail to pay their share of arbitration costs, did not agree to pay the U.S. Defendants' share of arbitration costs, and did not fail or refuse to arbitrate the matter. Thus, the court found that the claims against the Canadian Defendants remained subject to arbitration. As to the U.S. Defendants' motion to dismiss, the court concluded that the issue of whether their refusal to pay their portion of arbitration costs in accordance with the parties' oral agreement constituted default, neglect, or refusal to arbitrate under the agreements, is one for the arbitrators, and not for the court, to decide. Accordingly, the court stayed the claims pending a decision by the arbitrators.

STATE FRANCHISE LAWS

COURT RULES THAT THE MICHIGAN FRANCHISE INVESTMENT LAW DOES NOT APPLY, FINDING THAT NO FRANCHISE FEE WAS PAID

In *Bye v. Nationwide Mutual Ins.*, 2010 U.S. Dist. LEXIS 78930 (E.D. Mich., Aug. 5, 2010), a Michigan federal court last month granted Nationwide Mutual Insurance Company's motion for summary judgment, holding that the Michigan Franchise Investment Law did not apply to the relationship between Nationwide and its insurance agent because the agent did not pay a franchise fee. The plaintiff was a Nationwide insurance agent for many years. The agent eventually opened a competing business, and Nationwide terminated his agency. In response, the plaintiff filed suit alleging, among other claims, a violation of the MFIL.

Nationwide moved for summary judgment on the agent's claims contending, among other things, that the MFIL did not apply because the plaintiff did not pay Nationwide a franchise fee. Under the MFIL, a franchise fee is a "fee or charge that a franchisee or subfranchisor is required to pay or agrees to pay for the right to enter into a business under a franchise agreement including, but not limited to, payments for goods and services." The plaintiff claimed that he paid Nationwide a franchise fee because Nationwide makes a profit by taking a failed insurance agent's book of business and reselling it to a new agent at an increased price. The court disagreed, finding that even if Nationwide does earn a profit after an agent fails, that profit is not paid for a right to enter into an agreement. In addition, the court found that the plaintiff provided no evidence that he paid a franchise fee and further stated that any loans that the plaintiff took out from Nationwide were not a requirement to become a Nationwide insurance agent.

JURY WAIVER

COURT STRIKES FRANCHISEES' JURY TRIAL DEMAND BASED UPON WAIVER PROVISION IN PROMISSORY NOTES

In *Andre v. Sellstate Realty Sys. Network, Inc.*, 2010 U.S. Dist. LEXIS 84853 (M.D. Fla. July 30, 2010), the franchisor moved to strike the franchisees' jury trial demand based upon the following language in two promissory notes: "THE AREA REPRESENTATIVE, BY SIGNING OF THIS NOTE, AND THE FRANCHISOR, BY ACCEPTANCE OF THIS NOTE, MUTUALLY AND WILLINGLY WAIVE THE RIGHT TO A TRIAL BY JURY OF ALL CLAIMS BETWEEN THEM . . . ." The franchisees objected, arguing that the promissory notes were ancillary to their claims that the franchisor had made fraudulent representations and induced them to sign an area representative agreement and franchise agreement. They also argued that there was no jury waiver in the area representative agreement, the franchise agreement, or the Uniform Franchise Offering Circular, and, therefore, the franchisor's motion should be denied. The court sided with the franchisor and granted the motion to strike the jury demand. The court held that the promissory notes were not free-standing, independent documents, but were tied to the parties' area representative agreement. The promissory notes were specifically incorporated into the terms of the area representative agreement and UFOC.

PRACTICE OF FRANCHISE LAW

PENNSYLVANIA COURT REFUSES TO GRANT "SEVERE" SANCTIONS AGAINST FRANCHISEES DELIBERATELY DESTROYING EVIDENCE DURING LITIGATION

In *Maaco Franchising, Inc. v. Augustin*, 2010 U.S. Dist. LEXIS 83895 (E.D. Pa. Aug. 16, 2010), a Pennsylvania federal district court declined to impose sanctions on the franchisee defendants despite finding that they destroyed documents in bad faith during litigation with Maaco. This case involves the former franchisees' operation of a competing business after Maaco terminated their franchise agreements for nonpayment. Maaco served several requests for documents and then sought sanctions against the franchisees for destroying documents during litigation and making false and misleading statements in their verified pleadings. It then moved for a preliminary injunction. At the injunction hearing, the franchisees admitted that they had shredded documents. The litigation continued after the injunction was granted in part and denied in part. Maaco sought dismissal of the franchisees' counterclaims and affirmative defenses, exclusion of certain evidence at trial, and attorneys' fees and costs.

In denying Maaco's request for sanctions, the court described dismissal as a "severe" and "extreme" sanction. Even though the court found evidence that the franchisees failed to produce documents, were "less than truthful" in their pleadings, and acted in bad faith, the court held that Maaco failed to demonstrate how it had been prejudiced

at that point in the litigation. The court noted that Maaco could present evidence of the destroyed documents at trial, which might result in the jury receiving a "spoliation inference," i.e., an inference that "the destroyed evidence would have been unfavorable to the position of the offending party." The court further noted that the franchisees were having difficulty obtaining new counsel, and that an award of attorneys' fees and costs at this stage would worsen that problem and cause further delay in the litigation. The court rejected Maaco's arguments that the franchisee's counterclaims and affirmative defenses lacked merit. As to the lesser sanction of excluding evidence at trial because it was not timely produced, the court determined that a sanction was premature given that trial had yet to be scheduled. Despite finding evidence of bad faith, the court noted that the franchisees still had time to cure any prejudice to Maaco if they could produce the requested documents before trial.

CLASS ACTIONS

CALIFORNIA APPELLATE COURT UPHOLDS CLASS ACTION WAIVER PROVISION DESPITE UNCONSCIONABILITY ARGUMENTS

A California appeals court recently upheld a trial court's decision to strike all class allegations contained in a complaint brought by members of a walnut producing cooperative marketing association against a walnut processor. The court relied upon a class action waiver contained in the arbitration agreements between the parties, rejecting the argument that the waiver was unconscionable. The case is *Walnut Producers of California et al. v. Diamond Foods, Inc.*, No. C060346, 2010 Ca. App. LEXIS 1419 (Ca. Ct. App. 3d Div. Aug. 16, 2010). This nonfranchise decision is notable for franchisors because the analysis is relevant to the class action waivers frequently found in franchise agreements.

In California, the doctrine of unconscionability applies to all contracts, rather than being limited to those sales transactions governed by the UCC. The defendant argued that courts apply a different standard for determining unconscionability to consumer and employment contracts than they do to commercial contracts, but the court rejected this argument and found that the same standard applies. It found that unconscionability depends upon the factual circumstances involved. Here, the defendant was a successor by way of merger to the processing co-op. The majority of the plaintiff co-op's members had voted to approve the merger, and the waiver provision was clearly stated in the contract. This proved critical to the court's holding that the contract was not unconscionable.

The court also held that the plaintiffs had not pled sufficient facts to show that the class action waivers were unconscionable. California courts evaluate arbitration clauses in

adhesion contracts to determine whether they are procedurally and substantively unconscionable. The plaintiffs failed to overcome the motion to strike because, although they had argued the existence of a contract of adhesion, they had failed to allege that the defendant had superior bargaining strength or that the plaintiffs had no real alternatives to signing the contract available to them. Because the class action waiver was printed in the same sized text as the rest of the agreement, they could not sustain claims that the class action waiver was a surprise to them. Finally, the court found that the plaintiffs had failed to allege adequately that a class action was the only effective means of enforcing the plaintiffs' rights under the agreement, and was not, therefore, substantively unconscionable.

CALIFORNIA FEDERAL COURT APPROVES BURGER KING CLASS ACTION SETTLEMENT IN ADA CASE

In *Castaneda v. Burger King Corp.*, 2010 U.S. Dist. LEXIS 78299 (N.D. Cal. July 12, 2010), a California federal court approved a settlement of a disability class action lawsuit. The plaintiffs had contended that Burger King's restaurants were not accessible to customers who use wheelchairs and scooters in violation of the Americans with Disabilities Act and California's Unruh Act. Under the terms of settlement, Burger King agreed, among other things, to an injunction to eliminate accessibility barriers at certain of its restaurants and to pay $5 million in damages (an average of approximately $13,000 for each named and opt-in plaintiff) and $2.5 million in attorneys' fees and expenses. The settlement provides the court with ongoing jurisdiction until 2014 to monitor the terms of settlement and Burger King's compliance with the injunction.

BANKRUPTCY

REFERENCE FROM THE BANKRUPTCY COURT IS DENIED

In *Doctor's Associates, Inc. v. Jesal Desai*, 2010 Bankr. LEXIS 86454 (D.N.J. August 23, 2010), the franchisor ("DAI") sought to remove pending litigation from the bankruptcy court to federal district court. The procedural history of the case includes litigation in arbitration, state court, federal district court, and bankruptcy court. DAI's motion to withdraw the reference was brought after it was unsuccessful in asking the bankruptcy court to remand the pending litigation back to the district court. A motion to withdraw the reference is very similar to a motion to remand, except that the motion is heard by the district court and not the bankruptcy court. All bankruptcy matters, in theory, are within the jurisdiction of the district court.

In the case, the underlying facts involve four terminated franchises, the confirmation of an arbitration award, and potential Lanham Act violations. Withdrawing the reference from a bankruptcy court can either be mandatory or permissive. The district court

found that mandatory withdrawal was not warranted because the underlying issues did not involve substantive and material consideration of federal law outside of the Bankruptcy Code. Any involvement of the Federal Arbitration Act or the Lanham Act was deemed not to be sufficiently substantive or material to warrant mandatory withdrawal. Likewise, the district court found that permissive withdrawal was not warranted because several factors (uniformity in bankruptcy administration, reducing forum shopping and confusion, judicial economy, conserving estate assets, and expediting the bankruptcy process) weighed in favor of keeping the matter in the bankruptcy court. Therefore, the court denied DAI's motion.

FRAUD

COURT DISMISSES FRANCHISEES' FRAUD CLAIMS

In *Sherman v. PremierGarage Systems, LLC*, 2010 U.S. Dist. LEXIS 77392 (D. Ariz. July 30, 2010), a handful of PremierGarage franchisees sued the franchisor for, among other things, intentional and negligent misrepresentation and fraud, breach of contract and of the implied covenant of good faith and fair dealing, and violations of Florida's Franchise Misrepresentation Act. The franchisees claimed the franchisor, PremierGarage, made affirmative earnings claims before the execution of the franchise agreement and misrepresented the quality of the floor-coating materials used to operate a PremierGarage franchise. PremierGarage filed a motion to dismiss most of the claims except for breach of the implied covenant. As an initial matter, the court dismissed the claims brought by several Canadian franchisees, as their forum-selection clauses required them to litigate their claims in Canadian courts.

As for the remaining claims, the court granted the motion to dismiss, in part. It dismissed the fraud and intentional and negligent misrepresentation claims because they were barred under Arizona's economic loss doctrine. The court cited the recent *Flagstaff v. Design Alliance* decision stating that, in the context of construction-related contracts, "allowing tort claims poses a greater danger of undermining the policy concerns of contract law." It also dismissed the claim concerning violations of Florida's franchise law, finding that it was inapplicable under the choice of law provision in the parties' agreement, which provided for the interpretation of the agreement under Arizona law. PremierGarage's motion as to the breach of contract claim, however, was denied, as the court found that the franchisees had sufficiently pleaded provisions of the agreement that the franchisor had breached.

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