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:

ARBITRATION

NINTH CIRCUIT FINDS ARBITRATION CLAUSE UNENFORCEABLE UNDER CALIFORNIA LAW

In *Bridge Fund Capital Corp. v. Big Bad 1, LLC*, 2010 U.S. App. LEXIS 19309 (9th Cir. Sept. 16, 2010), the Ninth Circuit rejected a franchisor's appeal from a district court's holding that an arbitration clause contained in its franchise agreement was unenforceable under California law. The franchisor had first argued that the question of arbitrability was one to be decided by the arbitrator, not a court. The court disagreed, finding that the franchisee had raised a specific challenge to the arbitration clause itself, separate and apart from its challenge to the franchise agreement. Had the franchisee made the same challenge to the arbitration clause that it made to the franchise agreement as a whole, the issue of arbitrability would have been left to the arbitrator. Because the franchisee raised a separate and distinct challenge to the arbitration clause, however, the arbitrability question was properly decided by the district court.

The Ninth Circuit also upheld the district court's decision to disregard the choice of law provision contained in the franchise agreement in favor of California law. The court agreed that California's interest in the parties' dispute outweighed that of Texas, the law the parties selected to govern their contract.

Finally, the court of appeals agreed with the district court's finding that the arbitration clause was unconscionable under California law. The court agreed that the arbitration clause violated various provisions of the California Franchise Investment Law, and thus could not be enforced. In particular, the court rejected the arbitration clause's mandatory waivers of nonwaivable statutory rights, as well as the clause's forum selection provision.

MINNESOTA FEDERAL COURT ENFORCES ARBITRATION CLAUSE

In contrast to the California law ruling referenced above, a recent decision by the federal district court in Minnesota underscores the bulk of the judiciary's strong preference for enforcing arbitration agreements according to their terms. In *Green v. SuperShuttle Int'l, Inc.*, 2010 U.S. Dist. LEXIS 95235 (D. Minn. Sept. 13, 2010), the court granted a defendant franchisor's motion to dismiss the plaintiff franchisees' claims and to compel arbitration based on the plain language of the arbitration agreement in the parties' franchise agreements. The franchise agreements provided that American Arbitration Association rules applied, and the AAA rules expressly state that the arbitrator has the power to rule on his or her jurisdiction, so the court would not consider the plaintiffs' arguments that their claims fell outside the scope of the arbitration agreement. The court also held that the agreements' class action waiver was enforceable.

DUTY OF GOOD FAITH AND FAIR DEALING

COURT DENIES FRANCHISEES' MOTION FOR RECONSIDERATION AND AWARDS FRANCHISOR DAMAGES

In *Fleetwood, et al. v. Stanley Steemer Int'l, Inc.,* 2010 U.S. Dist. LEXIS 94402 (Sept. 10, 2010), the United States District Court for the Eastern District of Washington denied the plaintiff franchisees' motion for reconsideration of the court's denial of the franchisees' motion for summary judgment and partial grant of summary judgment in favor of the franchisor, Stanley Steemer. The franchisees claimed that Stanley Steemer breached its duty of good faith and fair dealing by giving them unsound business advice, counseling, and management assistance, and by failing to act in a timely manner when one of the individual franchisees sought to transfer his territory. In denying the franchisees' motion for summary judgment, the court found that Stanley Steemer did not breach its duty of good faith and fair dealing. On the franchisees' motion for reconsideration, the court found that none of the franchisees' arguments satisfied the requirements for granting reconsideration.

In a subsequent opinion issued only three days later, the same court in *Fleetwood v. Stanley Steemer Int'l, Inc.,* 2010 U.S. Dist. LEXIS 95115 (Sept. 13, 2010), awarded

Stanley Steemer reimbursement of its payment of a guaranty for vehicles leased by the franchisees and damages for the franchisees' violation of the covenant not to compete, including unpaid royalties and a percentage of future gross sales.

FRANCHISE SALES FRAUD

DISCLAIMER AND INTEGRATION CLAUSE DEFEAT CLAIMS OF FRAUD AND PERFORMANCE REPRESENTATION

In *JM Vidal Inc. v. Texdis USA, Inc.*, 2010 U.S. Dist. LEXIS 93564 (S.D.N.Y. Sept. 3, 2010), a franchisee sued under the Washington Franchise Investment Protection Act (WFIPA) after its "Mango" clothing store franchise did not meet performance expectations. It was undisputed that the franchisee had flown to Barcelona to meet with the franchisor regarding the possibility of purchasing a franchise before the franchisor had become registered in Washington or prepared an offering circular. In addition, the franchisee had prepared financial projections for the store, which it claimed the franchisor had "approved." The franchisee alleged that the franchisor violated the WFIPA by: (1) engaging in sales activity without registration, (2) making an unregistered earnings claim, (3) making fraudulent misrepresentations, and (4) violating the covenant of good faith and fair dealing.

On summary judgment, the court held that the registration claim was time barred, noting that Washington's two-year "catch-all" limitations period applies to the WFIPA and that more than two years had elapsed from the execution of the franchise agreement to the time of suit. The counts relating to fraud and unlawful earnings claims each required the franchisee to show that it justifiably relied on claims by the franchisor. In dismissing these claims, the court quoted heavily from the franchise agreement, which contained an extensive disclaimer of earnings representations and an integration clause. In addition, the record showed that the franchisee was an experienced retailer that aggressively pursued the franchisor (a European company) for a U.S. franchise. The franchisee had written to the franchisor that a Mango franchise in Seattle would be "very successful" and that obtaining a franchise quickly was an "emergency." Reliance by the franchisee on alleged earnings claims outside of the franchise agreement under these circumstances was not justified.

However, the franchisee's claim for breach of the good faith requirement of the WFIPA (as well as claims for breach of contract and breach of the implied covenant of good faith and fair dealing under New York law) survived summary judgment. The court found that the record included evidence from which a jury could determine that the franchisor made only "half-hearted" efforts to meet its advertising obligations under the franchise agreement.

POST-TERMINATION INJUNCTIONS : NONCOMPETE COVENANTS

FEDERAL MAGISTRATE RECOMMENDS PRELIMINARY INJUNCTION AGAINST FRANCHISEE FOR VIOLATING COVENANT NOT TO COMPETE

A federal magistrate judge recently recommended that an injunction be issued in favor of franchisor Smoothie King Franchises, Inc. enforcing a post-termination covenant not to compete against its former franchisee. *Smoothie King Franchises, Inc. v. UKE-MEX Enterprises, Inc., et al.*, 4:10-CV-01285 (S.D. Tex. Sept. 17, 2010). Gray Plant Mooty represents the franchisor in this matter. Smoothie King is the franchisor of a business offering nutritional drinks and products. Defendant UKE-MEX and its predecessor owned and operated one of Smoothie King's franchises in Texas until the parties entered a mutual termination agreement. UKE-MEX later opened a competing business at its former Smoothie King location.

In recommending that Smoothie King's motion for a preliminary injunction be granted, the magistrate judge held that the noncompete provision was reasonable because it prevented UKE-MEX from engaging in a "similar business" to the Smoothie King business and from competing with or soliciting the customers of Smoothie King within the market area of the UKE-MEX's former location for a period of two years. Further, the court held that the covenant was enforceable against the three individual defendants because they had agreed to comply with all of the post-termination obligations in the franchise agreement. Turning to irreparable injury, the court noted that Smoothie King had divulged confidential information to the defendants and that defendants' actions in competing with Smoothie King represented "the epitome of irreparable injury."

NEW HAMPSHIRE COURT UPHOLDS IN-TERM COVENANT, BUT FACT ISSUES PRECLUDE SUMMARY JUDGMENT ON DAMAGES AND INFRINGEMENT

In *Coldwell Banker Real Estate, LLC v. Brian Moses Realty, Inc.*, 2010 U.S. Dist. LEXIS 93827 (D.N.H. Sept. 8, 2010), a New Hampshire federal court last month granted franchisor Coldwell Banker's motion for summary judgment on its noncompete claim against a former franchisee, finding that the franchisee had clearly violated the in-term covenant not to compete in its franchise agreement by engaging in a competing Re/Max Properties real estate business. Although the court also granted Coldwell Banker's motion for summary judgment on all counterclaims, factual disputes regarding the amount of contractual damages and the likelihood of confusion from misuse of the trademarks precluded summary judgment in favor of Coldwell Banker on its nonpayment and trademark infringement claims.

At issue was the "merger agreement" that the franchisee signed with a competing Re/Max unit operating in the same market. Under the agreement, the franchisee combined its real estate agents and business with Re/Max's, and transferred to Re/Max all of its customers, listings, and pending sales. Brian Moses, the sole owner of the franchise, also agreed to provide certain training, recruiting, limited management, and referral services to Re/Max, but not to continue to list or sell properties. In granting summary judgment to Coldwell Banker on its noncompete claim, the court determined that Moses' ongoing role with Re/Max was irrelevant given that the merger of the franchisee's real estate business with Re/Max was "explicitly designed" to increase Re/Max's market share in the relevant geographic area. Finding ample evidence of diverted business—a violation of the noncompete clause in the franchise agreement—the court noted that Re/Max received commissions, marketing fees, and service costs under the agreement from any pending or future sales originating from the Coldwell Banker franchise. Interestingly, the franchise agreement did not contain a post-term covenant not to compete; thus, the court made clear that the franchisee only violated the covenant not to compete from the date it abandoned its franchise and joined Re/Max until the date that Coldwell Banker eventually terminated the franchise agreement. The court held that it could grant judgment as to liability on Coldwell Banker's breach of contract claim for abandonment without having to determine the exact amount of damages.

In granting summary judgment to Coldwell Banker on the franchisee's counterclaims, the court rejected several arguments commonly raised by franchisees. As to the franchisee's claim that it was fraudulently induced to sign the franchise agreement based on a misrepresentation as to the agreement's expiration date, the court found that the franchisee could not reasonably rely on alleged prior statements if the franchise agreement itself was clear and unambiguous. The integration clause, the court held, further demonstrated that "the contract speaks for itself." The court then rejected the franchisee's negligent misrepresentation claim, finding it not only barred by the statute of limitations but also meritless because Coldwell Banker owed no duty to the franchisee, even if it knew the franchise "was a bad investment." The franchisee's unjust enrichment claim failed as a matter of law because the alleged obligation of Coldwell Banker to refer business to the franchisee was absent from the plain language of the franchise agreement. Finally, the court found that an unfair trade practices claim for "unfair, immoral, unethical or oppressive conduct" under New Hampshire law could not survive because it had already denied the franchisee's other counterclaims, which were similar in nature.

JURISDICTION AND PROCEDURE

MARYLAND COURT RULES THAT USE OF THE INTERNET DID NOT CONFER PERSONAL JURISDICTION OVER BREAKAWAY FRANCHISEE'S MANAGER'S OPERATION OF AN IDENTICAL BUSINESS IN SOUTH CAROLINA

A residential home cleaning franchisor brought suit in federal court in Maryland against several South Carolina franchisees as well as one franchisee's office manager in *The Cleaning Authority, Inc. v. Neubert, et al.*, 2010 U.S. Dist. LEXIS 92526 (D. Md. Sept. 7, 2010). The Cleaning Authority (TCA) alleged several of its franchisees attempted to terminate their franchise agreements in order to continue operating an identical cleaning business with identical customers through an employee or other third parties unknown to TCA. The office manager moved to dismiss on the grounds that the Maryland court had no personal jurisdiction over her in South Carolina. TCA argued that the court had jurisdiction because the manager used the internet to access its customized, proprietary business management software (headquartered in Maryland) for the franchisee's business information and continued operation of the cleaning business.

The court's analysis of jurisdiction hinged on whether the use of TCA's software was direct electronic activity into Maryland, with the intent to engage in business in Maryland, that resulted in a cognizable potential cause of action in the state. The court held that because the manager's access was limited to information posted to the internet *from* Maryland, and did not involve the transmission of information by the manager *into* Maryland, TCA failed to establish personal jurisdiction. Moreover, any effect of the manager's actions was felt in South Carolina, not Maryland. Therefore, and because neither party sought to transfer the case to South Carolina, the court dismissed the claims against the manager without prejudice.

TERMINATION

CALIFORNIA APPEALS COURT AFFIRMS SUMMARY JUDGMENT FOR FRANCHISOR IN NONPAYMENT CASE

A California appellate court upheld a trial court's grant of summary judgment dismissing a former franchisee's action for wrongful termination against franchisor International House of Pancakes. In doing so, the appellate court found that IHOP was within its rights to terminate the franchisee for failure to pay fees and produce records. The case is *Safaei v. IHOP Corp.*, No. E046996, 2010 Cal. App. Unpub. LEXIS 7700 (Cal. Ct. App. 4th Dist. Sept. 28, 2010).

IHOP terminated the franchise agreement after having sent 10 separate notices to cure for failure to pay fees between 1996 and 2003. In May 2003, IHOP filed a complaint against the franchisee for failure to pay fees, and the parties entered into a stipulated judgment that was stayed as long as the franchisee timely paid a set amount of the total owed per week and otherwise kept current and in compliance with his franchise agreement and lease. In 2005, after further problems, the franchisee stopped all checks to IHOP and refused to pay fees, so IHOP terminated the franchise agreement. The franchisee sued for breach of contract, breach of the covenant of good faith and fair dealing, unjust enrichment, and unfair business practices, among other claims. The trial court granted IHOP's motion for summary judgment on all of the franchisee's claims, and the appellate court affirmed. It noted that IHOP was within its rights to terminate the franchise agreement for nonpayment and that the franchisee was not permitted to stop performing its contractual obligations while continuing to enjoy the benefits of the contract. The court also found that IHOP had not violated the covenant of good faith and fair dealing.

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