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: **November 11, 2010—No. 136**

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

EMPLOYMENT

MASSACHUSETTS COURT LIMITS PLAINTIFF'S DAMAGES IN FRANCHISEE MISCLASSIFICATION CASE

Earlier this year, *The GPMemorandum* reported on a ruling that sent shock waves through the franchise community when a Massachusetts federal district court judge compared a franchise to a modified Ponzi scheme and ruled in a putative class action case that Coverall, a janitorial services franchisor, had misclassified its franchisees as independent contractors when they were actually employees. *Awuah v. Coverall North America*, 2010 U.S. Dist. LEXIS (D. Mass. March 23, 2010). Following its earlier adverse ruling, the Massachusetts court has provided Coverall with some victories in the case. The court tried the claims of a few of the named plaintiffs as an example and then denied class certification, without prejudice to the possible later certification of a class raising the misclassification claim. Most recently, the court ruled on the damages claims of one of the named plaintiffs, Anthony Graffeo, granting Coverall partial summary judgment on all but two of Graffeo's damages theories, but granting partial summary judgment to Graffeo on the remaining theories. See *Awuah,* 2010 U.S. Dist. LEXIS 101876 (D. Mass. Sept. 28, 2010).

Graffeo sought damages under a Massachusetts independent contractor statute that provides that a misclassified worker is entitled to "damages incurred." Graffeo made the overarching argument that Coverall had violated public policy

by creating a system in which employees are charged to work, and he sought "damages incurred" consisting of fees paid to or withheld by Coverall, including franchise fees. Coverall countered that Graffeo could not prove any damages, because he had received at least minimum wage, had not worked overtime or submitted a workers' compensation claim, and had agreed to all of the fees in his franchise agreement.

Noting that it was sympathetic to Graffeo's public policy argument, the court nevertheless rejected it. The court ruled that Graffeo was effectively arguing that, at least in the cleaning industry, a franchise system must be unlawful when, in fact, there was no indication that the Massachusetts legislature disfavored franchises and, to the contrary, state statutes condone such systems. The court then went on to accept most of Coverall's arguments, holding that the court was not aware of any law that prevented Coverall from entering into an agreement with Graffeo to shift certain costs to Graffeo, so long as Coverall paid the statutorily required amounts that are an employer's obligation. The court did rule, however, that Coverall was not entirely free to shift the cost of insurance to Graffeo, because state law required Coverall to provide workers' compensation coverage. Recognizing issues of statutory law determinative to the case's outcome, the court further ruled that, with the parties' agreement, it would certify the dispositive issues to the Massachusetts Supreme Court for that court's review.

CLASS ACTIONS

FEDERAL COURT DENIES CERTIFICATION OF CONSUMER OBESITY CLAIMS

On October 27, the United States District Court for the Southern District of New York rejected class action certification in the obesity case filed against McDonald's Corporation in 2002. *Pelman v. McDonald's Corp.*, 2010 U.S. Dist. LEXIS 114247 (S.D.N.Y. Oct. 27, 2010). This is the case in which the plaintiff claimed that "deceptive marketing schemes" had caused consumer obesity. In a lengthy opinion, the court ruled that "extensive individualized inquiries" in the case preclude class action treatment. Those individual questions include causation and injury. As to the possibility that there could be many persons with identical injuries (and at least some common questions of law and fact), the court found insufficient evidence of other persons with the same conditions as the named plaintiffs, thus the numerosity element also was not met at this point. Class certification was denied in its entirety.

GRAY PLANT MOOTY

ANTITRUST

OHIO FEDERAL COURT DENIES WENDY'S SECOND MOTION TO DISMISS FRANCHISEES' "LOCK-IN" TYING CLAIM

In September 2009, *The GPMemorandum* reported that an Ohio federal court had denied the motion of Wendy's International Inc. to dismiss a claim by several of its franchisees that Wendy's had violated Section 1 of the Sherman Act by requiring the franchisees to purchase food supplies only from sellers in which Wendy's had a financial interest. *Burda v. Wendy's Int'l, Inc.*, 659 F. Supp. 2d 928 (S.D. Ohio 2009). The court held that the franchisee-plaintiffs had sufficiently alleged that Wendy's had market power in the tying product market under the "lock-in" theory discussed in *Eastman Kodak Co. v. Image Technical Serv., Inc.*, 504 U.S. 451 (1992).

The court recently again denied Wendy's motion to dismiss the tying claim in *Burda v. Wendy's International Inc.,* No. 2:08-cv-00246 (S.D. Ohio Oct. 25, 2010). This motion grew out of the withdrawal of the plaintiffs' counsel of record. Thereupon, one of the plaintiffs, Robert Burda, who is also a lawyer, indicated that he would step in and represent himself and the other plaintiffs. Burda, however, neglected to file a notice of appearance within the time allowed by the court, and Wendy's moved to dismiss the amended complaint on that basis. The court denied the motion, noting that dismissal would be improper because "Burda's violation of the Court's Order was more a technical than a substantive violation, and because Defendants are not prejudiced by Burda's failure to file the Appearance of Counsel in a timely fashion[.]"

CONTRACTS

FRANCHISOR NOT OBLIGATED TO ENFORCE TERRITORY RESTRICTIONS AGAINST OTHER FRANCHISEES

Must a pizza franchisor force its franchisees to stay within their delivery territories? "No", said the United States District Court for the Eastern District of Michigan last month. *Cottage Inn Carryout & Delivery, Inc. v. True Freedom Investments LLC*, 2010 U.S. Dist. LEXIS 113170 (E.D. Mich. Oct. 20, 2010). The question was raised by a franchisee who claimed the franchisor was allowing others to infringe on its "protected" trading area. The franchisor argued that the parties' agreement did not require it to police its franchisees to make sure that they were staying inside their territories. Relying in part on the integration clause and a careful reading of the protected trade area language, the court found no obligation to enforce, audit, or monitor franchisee compliance.

GRAY PLANT MOOTY

MISSOURI FEDERAL COURT UPHOLDS CONTRACTUAL AGREEMENT TO WAIVE JURY

A franchisee since the 1970s who had owned 21 Hardee's stores lost on its attempt to evade the jury trial waiver in its franchise renewal agreement. *Hardee's Food Sys., Inc. v. Hallbeck*, 2010 U.S. Dist. LEXIS 114192 (E.D. Mo. Oct. 27, 2010). Jury trial waivers "are valid under federal law," the court held. In this recent decision, the court also found significant that the jury waiver appeared twice in the agreement, including once in bold type. Under these facts, the court found the waiver was made knowingly and voluntarily. The case will go forward sans jury.

POST-TERMINATION INJUNCTIONS: TRADEMARKS

INJUNCTION AGAINST "USE" OF MARKS DID NOT REQUIRE FRANCHISEE TO TAKE THEM DOWN

In an unusual split decision, a federal district court in Georgia ruled last week that a former franchisee was not in contempt of an injunction order against use of the franchisor's trademarks. *AFC Enterprises, Inc. v. The Restaurant Group LLC*, 2010 U.S. Dist. LEXIS 117240 (N.D. Ga. Nov. 3, 2010). The franchisee had simply closed the store in face of an order not to "operate" it and not to "use" the POPEYES® marks of the franchisor. The signs apparently stayed up, and the franchisor moved for contempt. The court held, however, that its order not to "use" the marks meant only that the franchisee could not promote its business with them. Since the store was closed, the franchisee was not using the marks for any commercial gain. Since there had been no specific order to "remove" the marks, the franchisee was not in contempt.

In all other respects, the injunction ruling of the court was upheld over the former franchisee's jurisdictional challenge and request for a stay on appeal.

PROCEDURE

FRANCHISEE SURVEYS DEEMED POTENTIALLY RELEVANT IN GOOD FAITH CLAIM

In a troubling discovery ruling in ongoing litigation between Burger King Corporation and a franchisee association, a magistrate judge in the Southern District of Florida has found that BKC must produce sensitive information to the plaintiff. *National Franchisee Ass'n v. Burger King Corp.*, 2010 U.S. Dist Lexis 105953 (S.D. Fla. June 20, 2010). First, "Show of Support" documents related to the addition of the double cheeseburger to Burger King's Value Menu must be turned over. Show of Support documents are voting forms that franchisees submit to indicate whether they agree with a proposed

menu item change. In this case, the franchisee association claims that the addition of the double cheeseburger to the Value Menu (requiring a maximum price of $1 for the product) constitutes a breach of contract and breach of the covenant of good faith and fair dealing because it costs franchisees more than $1 to produce the burger. Despite a ruling by the court that the franchise agreement does not prevent BKC from setting maximum prices, the magistrate ruled that the franchisees' opinions on the menu change is relevant to a determination of whether BKC acted in good faith in making the change.

The magistrate also declined to issue a protective order sought by BKC to prevent discovery of information from Coca Cola relating to sales volumes of Coke products at BKC restaurants. The court found that this sensitive information could be relevant to the franchisee association's claim that BKC added menu items to the Value Menu with total disregard to the effect on the overall profitability of the franchisees.

NONCOMPETE COVENANTS

ALABAMA FEDERAL COURT UPHOLDS COVENANT NOT TO COMPETE

In *Sylvan Learning, Inc. v. Gulf Coast Educ., Inc.*, 2010 U.S. Dist. LEXIS 107160 (M.D. Ala. Oct. 6, 2010), the franchisor of Sylvan Learning Centers brought a preliminary injunction motion against a recently terminated franchisee for continuing to operate a learning center in violation of the license agreement's noncompete provision. At issue was whether Sylvan had a substantial likelihood of success in enforcing its two-year, 20-mile noncompete provision, and whether the court should apply Alabama or Maryland law. As an initial matter, the Alabama federal court applied Maryland law, since the parties agreed to it in the license agreement and the application of Maryland law did not contradict Alabama's public policy.

The court found the two-year, 20-mile radius restriction to be reasonable, and that success on the merits was likely. In particular, the court found that the Sylvan brand would likely be harmed if the franchisee was able to compete against Sylvan in contravention of the terms of the noncompete, because the franchisee had 18 years of access to Sylvan's confidential operations manuals and the goodwill of the Sylvan brand. The court also opined that the noncompete still allowed the franchisee to operate a learning center outside of the 20-mile radius or work as an instructor in another learning center.

CHOICE OF LAW

CALIFORNIA COURT ENFORCES WASHINGTON CHOICE OF LAW PROVISION

In *1-800-GOT JUNK? LLC v. Superior Court*, 2010 Cal. App. LEXIS 1805 (Cal. App. 2d Dist. Oct. 21, 2010), a California court of appeals decided that a franchisee could enforce a Washington choice of law clause in a California case notwithstanding the anti-waiver provision in the California Franchise Relations Act (CFRA), which voids a contractual stipulation that purports to waive any provision of the CFRA. A California-based franchisee had sued 1-800-Got-Junk, a Delaware company headquartered in Vancouver, Canada, for wrongful termination and argued that the franchise agreement's choice of law provision, specifying the application of Washington State law, applied. 1-800-Got-Junk argued that the choice of law provision was unenforceable because there was no reasonable basis for the application of Washington law. The trial court held that Washington law applied. 1-800-Got-Junk filed a petition for writ directing the trial court to vacate its order and to enter a new order that California law applied.

In denying the petition, the California appellate court ruled that there was a reasonable basis for the inclusion of the Washington choice of law provision in the franchise agreement, finding that a multi-state franchisor had an interest in having its franchise agreements governed by a uniform body of law. Further, it held that given Washington's proximity to 1-800-Got-Junk's headquarters in Vancouver, there was a reasonable basis for the parties' choice of law. The court also found that California public policy did not preclude application of Washington law because, in this instance, Washington law is more protective of franchisees than is California law. Washington law restricted the franchisor to four situations in which it could summarily terminate a franchise without providing notice and an opportunity to cure, while California law provided for immediate termination without the opportunity to cure in the same four situations as well as numerous others. Thus, enforcing the parties' choice of law provision did not require a franchisee to waive compliance with any CFRA provision.

ARBITRATION

COURT GRANTS FRANCHISOR'S MOTION TO COMPEL ARBITRATION AND ENFORCES FORUM SELECTION CLAUSE

In *Edible Arrangements Int'l, Inc. v. JHRV Enter., Inc.*, 2010 U.S. Dist. LEXIS 105614 (D. Conn. Oct. 1, 2010), a Connecticut federal court enforced franchise agreements that provided for arbitration in Connecticut of all disputes arising from the franchise relationship. The franchisee had operated 18 stores in California. The franchisor and

franchisee had entered into a settlement agreement to resolve one series of disputes, and the settlement agreement provided that any dispute arising out of that agreement would be resolved in California state court.

Approximately one year later, the franchisee sued the franchisor in California state court alleging various violations of the franchise agreements. The franchisor then terminated the franchise agreements and commenced an arbitration proceeding. It then filed an action in federal court in Connecticut to compel the franchisees to arbitrate the claims they had filed in California state court. The franchisee moved to dismiss for improper venue, arguing that the parties' settlement agreement contained a California forum selection clause. The court denied that motion, finding that the franchisor's claims arose under the franchise agreements rather than the unrelated settlement agreement.

The court also granted the franchisor's motion to compel arbitration. The court found that the franchisee's state court claims fell within the terms of the arbitration clause in the franchise agreements. The court also rejected the franchisee's argument that a forum selection clause requiring arbitration in Connecticut was unenforceable under the California Franchise Relations Act. The court found that law to be preempted by the Federal Arbitration Act, as previously explained by the Ninth Circuit. The court ordered the franchisee to proceed with arbitration in Connecticut.

INSURANCE

APPELLATE COURT ENFORCES FRANCHISEE'S OBLIGATION TO DEFEND

A franchisor is not obligated to contact its franchisee's insurance company directly in order to invoke the franchisee's obligation to defend and indemnify the franchisor, the Michigan Court of Appeals ruled late last month. *Basset v. Burger King Corp.*, 2010 Mich. App. LEXIS 2091 (Mich. App. Oct. 28, 2010). This decision arose out of a personal injury case in which only the franchisor was sued originally. It notified the franchisee of the lawsuit and demanded defense and indemnity under the franchise agreement. When the franchisee failed to assume defense of the case, BKC was forced to incur over $20,000 in defense costs. The trial court granted summary disposition in BKC's favor on its claim against the franchisee to recoup those expenses.

On appeal, the issue was whether the franchisor was required to "mitigate its damages" by going directly to the franchisee's insurance company to demand a defense. Nothing in the franchise agreement required the franchisor to do so, the court of appeals held.

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)
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 (202.295.2221)
Maisa J. Frank (202.295.2209)
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