The GPMemorandum

TO: OUR FRANCHISE CLIENTS AND FRIENDS

FROM: GRAY PLANT MOOTY'S FRANCHISE AND DISTRIBUTION PRACTICE GROUP

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DATE: January 13, 2011—No. 138

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

STATE TAXATION

IOWA SUPREME COURT UPHOLDS DISTRICT COURT'S DECISION THAT IOWA MAY ASSESS INCOME TAXES ON OUT-OF-STATE FRANCHISORS

On December 30, 2010, the Iowa Supreme Court affirmed the Iowa Department of Revenue's imposition of income taxes on royalties an out-of-state franchisor, KFC Corporation, received from its Iowa franchisees. *KFC Corporation v. Iowa Department of Revenue*, No. 09-1032 (Iowa S. Ct. Dec. 30, 2010). As background, in *Quill v. North Dakota*, 504 U.S. 298 (1992), the U.S. Supreme Court had reaffirmed an interpretation of the Commerce Clause that prevents states from imposing *sales or use* taxes on any business without a "physical presence" in the state. The U.S. Supreme Court, however, has been far less clear regarding nexus between a state and a foreign business when looking to impose *income* taxes on profits from the state. As support for its conclusion, the Iowa Supreme Court noted that the U.S. Supreme Court "has emphasized a flexible approach based on economic reality and the nature of the activity giving rise to the income that the state seeks to tax."

The Iowa Supreme Court, after a very lengthy analysis of the U.S. Supreme Court's state income taxation cases, found that the "intangibles owned by KFC, but utilized in a fast-food business by its franchisees that are firmly anchored within the state, would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence,'" and thus allow Iowa to impose income taxes on the royalties collected. Alternatively, the Iowa justices expressed the belief that the U.S. Supreme Court would not extend the sales and use tax "physical presence" requirement to income taxes, and would instead use a more flexible, economic analysis. In the end, the Iowa Supreme Court found that "by licensing franchises within Iowa, KFC has received the benefit of an orderly society within the state and, as a result, is subject to the payment of income taxes that otherwise meet the requirements of the dormant Commerce Clause."

As noted repeatedly in the Court's decision, the lack of clarity by the U.S. Supreme Court in applying the "physical presence" test has led to a myriad of state laws and regulations to collect taxes from foreign businesses. Beginning in 2009, several members of Congress, supported by the International Franchise Association (IFA) and many in the franchise community, proposed legislation that would require a "physical presence" in any state before the state can impose sales, use, or income taxes on the business. The legislation has been stalled for the last several years, but may garner more support in the coming months as the 112th Congress gets underway.

Impact on Franchisors with Franchisees in Iowa. KFC has 90 days to appeal the Iowa Supreme Court's decision to the U.S. Supreme Court, which has not yet taken up the issue of states assessing state income taxes on foreign corporations without a "physical presence" in the state. Iowa's decision is only the latest example, however, of states looking to tax out-of-state businesses. We understand that slightly more than half the states take the position that licensing of intangibles or granting of franchises in the state constitutes sufficient nexus with the state to allow for income taxation, whether or not there is a physical presence there.

It is likely that the Iowa Department of Revenue will begin organizing more extensive collection proceedings against other out-of-state franchisors with Iowa franchisees. Iowa does have a Voluntary Disclosure Program under which its Department of Revenue may be willing to work with franchisors to settle back taxes and negotiate lesser penalties. The Voluntary Disclosure Program, however, is only available to franchisors who contact the state before receiving a notice from the Department. For more information on this program, visit http://www.iowa.gov/tax/business/voluntary_disclosure.html.

We recommend that franchisors get in touch with their tax advisors and discuss the implications of this recent decision and whether or not to make the first contact with Iowa's Department of Revenue.

GRAY PLANT MOOTY

CLASS ACTIONS / DUTY OF GOOD FAITH AND FAIR DEALING

FLORIDA FEDERAL COURT GRANTS BURGER KING'S MOTION TO DISMISS FRANCHISEE CLASS ACTION SUIT

A federal district court judge in *National Franchisee Association v. Burger King Corp.*, 2010 U.S. Dist. LEXIS 123065 (S.D. Fla. Nov. 19, 2010), has dismissed for failure to state a claim a class action suit brought by Burger King franchisees challenging the franchisor's ability to set maximum prices on products. The franchisees claimed that Burger King's decision to set a $1.00 maximum price for certain items to be included on the $1.00 Value Menu breached its express and implied duties of good faith and fair dealing, was not permitted under the franchise agreements, and violated state law. In particular, they alleged that the company had no contractual right to set maximum prices unilaterally, and that, even if such a right existed, the $1.00 maximum price for a double cheeseburger violated Burger King's "duty to exercise its pricing judgment in good faith" and was below the cost of the double cheeseburger. In an earlier decision, the court found that the franchise agreement conferred on Burger King the right to require franchisees, without their consent, to offer designated items as part of the Value Menu. Soon thereafter, Burger King ceased requiring franchisees to sell the double cheeseburger for $1.00 and raised the maximum price to $1.29. It also introduced a new menu item, the "Buck Double," which was the same as the double cheeseburger, minus one slice of cheese. Burger King required its franchisees to sell the Buck Double for $1.00. The franchisees supplemented their complaint and alleged that a $1.00 price was below the cost of the Buck Double.

In dismissing the claims, the court noted, first, that it had already found that the franchise agreement allows Burger King the discretion to set maximum prices for products sold by franchisees. The court focused on Burger King's motive – namely, whether the prices were set "to achieve a purpose contrary to that for which the contract had been made." In this regard, the court found wanting the franchisees' contention that Burger King acted in bad faith. To the contrary, the court found "nothing inherently suspect about such a pricing strategy for a firm selling multiple products." The court further noted various reasons why Burger King may have chosen its pricing strategy, including building goodwill and customer loyalty, holding or shifting customer traffic away from competitors, or generating increased sales on other higher margin products. The court noted that the test is not the wisdom of the strategy, but whether it was "so irrational and capricious that no reasonable person would have made such a decision." The other key factor, the court held, was the magnitude of the injury. The court found that the franchisees improperly focused on losses from a single product sold below cost, rather than on whether those losses had a substantial effect on their overall business. The court concluded, therefore, that they failed to allege the kinds of motive and serious injury required for a finding of bad faith.

GRAY PLANT MOOTY

ARBITRATION

CALIFORNIA APPEALS COURT REINSTATES STAY OF LITIGATION IN FAVOR OF ARBITRATION IN COLORADO

Last week, a state appellate court in California issued what appears to be an important ruling upholding a franchisor's right to arbitrate in another state against a California franchisee. *MKJA, Inc. v. 123 Fit Franchising, LLC*, 2011 Ca. App. LEXIS 6 (Cal. App. 4th Dist., Div. 1 Jan. 4, 2011). This appeal was from a California state court's order that had lifted a stay of the franchisee's California litigation. The trial court had found that the franchisee could not afford to arbitrate in Colorado, thus the stay previously issued under California Code Civ. Pro. §1281.4 had been lifted.

In what it described as a case of first impression, the appellate court interpreted the California statute and concluded that a party's inability to afford to arbitrate is not a ground on which a trial court can lift a stay. The court of appeals added that the statute is designed to uphold the right to arbitrate and to preserve the legal status quo while an arbitration is pending. Any challenges based on unconscionability or otherwise will need to be presented to the arbitrator, the court held, as will the merits of the franchisee's claims (*i.e.*, fraudulent inducement and lack of support) arising from their franchise purchase and relationship.

POST-TERMINATION INJUNCTIONS: NON-COMPETE COVENANTS

PENNSYLVANIA DISTRICT COURT ENJOINS FORMER FRANCHISEE FROM COMPETING WITH FRANCHISOR

In *Marblelife, Inc. v. Stone Resources, Inc.*, 2010 U.S. Dist. LEXIS 136041 (E.D. Pa. Dec. 23, 2010), the defendant franchisee chose to let its franchise agreement expire. The franchisee then began operating a competing business in violation of a covenant against competition contained in the franchise agreement, using the franchisor's confidential business information, trade secrets, trademarks, and exclusive advertising arrangement. The franchisor moved for injunctive relief to prevent trademark infringement and to enforce the two-year post-termination non-compete agreement.

In granting the franchisor's motion, a federal court in Pennsylvania found that the franchisor had a strong likelihood of success on the merits based on the franchisee's failure to comply with the non-compete provisions of the franchise agreement. The court found that the franchisor's goodwill was likely to be irreparably harmed by the former franchisee's continued operation in his former territory, and enjoined the franchisee from operating any competitive business within the 10 county area or any other county where a MARBLELIFE business operates.

With respect to the trademark infringement claims, the court found a significant risk of confusion and enjoined the former franchisee from any further infringement.

EMPLOYMENT

FRANCHISOR HELD NOT LIABLE FOR ITS FRANCHISEE'S ALLEGED WAGE AND HOUR VIOLATIONS

A federal district court in Mississippi recently issued a reminder that franchisors should not establish or control their franchisees' employment policies, practices, or decisions and should not participate in hiring or managing their franchisees' employees. In *Reese v. Coastal Restoration and Cleaning Services, Inc. d/b/a SERVPRO of Pearl River/Hancock & SW Harrison Counties et al.*, 2010 U.S. Dist. LEXIS 132858 (S.D. Miss. Dec. 15, 2010), the plaintiff was hired and employed by Coastal Restoration and Cleaning Services, Inc. (Coastal), a SERVPRO franchisee. Reese initially worked as a non-exempt hourly technician, but was later promoted to a salaried position that was classified as exempt from the federal Fair Labor Standards Act's minimum wage and overtime pay requirements. After his promotion, Reese continued to perform technician work and sued both Coastal and SERVPRO, claiming that he was still non-exempt, that he had not been properly paid for overtime work, and that he had been subjected to a retaliatory pay cut for asserting his right to overtime pay. The federal district court dismissed Reese's claims against SERVPRO, holding that SERVPRO was not Reese's "employer" and, therefore, could not be liable to him under the FLSA.

The court applied a four-factor "economic reality" test to determine whether SERVPRO satisfied the FLSA's expansive definition of an employer. Under the FLSA, an employer includes "any person acting directly or indirectly in the interest of an employer in relation to the employee," including individuals with "managerial responsibilities" and who exercise "substantial control of the terms and conditions of work." The four factors that the court analyzed under the "economic reality" test included whether SERVPRO had the power to (1) hire and fire the plaintiff, (2) supervise or control his work schedule or conditions of employment, and (3) determine his rate and method of payment; and (4) whether SERVPRO maintained employment records. The court found that none of these four factors was satisfied. While Reese argued that various provisions of SERVPRO's franchise agreement with Coastal, including a requirement that Coastal periodically conduct background checks on employees, established that SERVPRO was his employer, the court found that this language simply related to SERVPRO's right to set and enforce franchise system quality service standards. The court also found that Reese had presented no evidence that SERVPRO had hired Reese, that it supervised or controlled his schedule or work conditions, that it set his rate or pay, or that it maintained employment records for Reese.

FRANCHISE SALES

COURT DENIES FRANCHISOR'S MOTION FOR SUMMARY JUDGMENT ON FLORIDA DECEPTIVE AND UNFAIR TRADE PRACTICES ACT CLAIM

In *Hetrick v. Ideal Image Development Corp.*, 2010 U.S. Dist. LEXIS 135065 (M.D. Fla. Dec. 21, 2010), a Florida judge recently denied franchisor Ideal Image's motion for summary judgment on the franchisee's claim that certain representations made during the sale of the franchise violated the Florida Deceptive and Unfair Trade Practices Act. The Hetricks claimed that during meetings discussing their purchase of a franchise, an Ideal Image representative made representations (not included in Item 19 of its UFOC) regarding the profitability of certain existing franchises, which induced them to purchase a franchise. Their franchise was unsuccessful, and the Hetricks eventually lost their investment. Ideal Image argued that the franchisees had no evidence that their loss was caused by the representative's statements, so a claim under the Act, which requires a deceptive act or unfair practice, causation, and actual damage, could not stand.

The court decided to allow the franchisees to continue pursing their claim despite Ideal Image's evidence that the Hetricks received a UFOC which warned that the listed initial investment was an estimate and a business advisor should be consulted. Ideal Image also presented evidence that the Hetricks signed a franchise agreement which acknowledged that the franchisees had not "received or relied upon any warranty or guarantee, express or implied, as to the potential volume, profits, or success of the business venture…" In denying the summary judgment motion, the court noted the statements made in affidavits by the Hetricks that they would not have invested in the franchise but for the statements made by Ideal Image's representative, and decided that a jury should determine whether the Hetricks suffered injury as a result of the statements.

The court, however, also denied the Hetricks' motion for summary judgment as to the element of the Act that requires a deceptive act or unfair practice. The Hetricks argued that the Act, which incorporates the Federal Trade Commission Rule, makes it an unfair or deceptive trade practice to disseminate any financial performance representations. Since they had established that Ideal Image made representations, they asked the court to find they had satisfied this element. But the court decided that a mere technical violation would not suffice to show liability; rather, the Hetricks would also have to prove the representation was likely to deceive a consumer in similar circumstances.

TERMINATION

FEDERAL COURT FINDS FRANCHISOR HAD GOOD CAUSE TO TERMINATE UNDER NEW JERSEY FRANCHISE PRACTICES ACT

In *Dunkin' Donuts Franchised Restaurants LLC, et al. v. Strategic Venture Group, Inc., et al.,* 2010 LEXIS 119417 (D. N.J. Nov. 10, 2010), a case handled by Gray Plant Mooty attorneys, the U.S. District Court for the District of New Jersey entered a declaratory judgment finding that Dunkin' Donuts had good cause under the New Jersey Franchise Practices Act to terminate the defendants' franchise agreements for failing to "obey all laws" in connection with the operation of the franchises.

Dunkin' terminated the defendants' franchise agreements based on their failure to comply with payroll tax laws, in violation of the "obey all laws" clause of the franchise agreements. The court ruled that the "obey all laws" clause authorized Dunkin' to terminate without the ability to cure if it had "proof" that the franchisees had violated the law. At trial, Dunkin' proved that the defendants failed to properly classify as wages payments made on behalf of their employees for things such as rent, travel, car payments, day care expenses, and tuition. Based on the evidence, the court held that the defendants violated the tax laws and failed to pay taxes owed, including payroll taxes, by improperly classifying the expenses. The court also determined that the acts were not inadvertent or isolated mistakes but were part of a calculated effort to disguise the true nature of the payments. Accordingly, the defendants' noncompliance with tax laws was a material and terminable breach of the franchise agreements' obey all laws clauses. Furthermore, the violations constituted "good cause" for termination under the New Jersey Franchise Practices Act, which defines "good cause" as the failure to substantially comply with the terms of the franchise agreements.

FRAUD

ADDING TERRITORY TO EXISTING AGREEMENT WITHOUT ADDITIONAL DISCLOSURE IS BASIS FOR FRAUD CLAIM

The United States District Court in Colorado recently denied dismissal of a franchisee's fraud claim in connection with the franchisor's failure to provide an updated Franchise Disclosure Document when the franchisee was granted additional territory. In *McKinnis v. Fitness Together Franchise Corp.,* 2010 U.S. Dist. Lexis 133976 (D. Colo. Dec. 6, 2010), the plaintiff—a Fitness Together master franchisee—claimed that the franchisor committed fraud by selling the plaintiff an additional master franchise territory and requiring that the sale be accomplished by amending an existing master franchise agreement between the parties, rather than by executing a new master franchise agreement. The franchisor did not provide FDD disclosure to the plaintiff prior to the sale of the new territory—apparently because it did not have an up-to-date document prepared. The franchisor argued that the fraud claim was barred by a provision of the agreement requiring that all claims be brought within one year of accrual. The court rejected this argument, noting that a fraud claim (if successful) enables the franchisee to rescind the agreement, thereby negating the one-year limitations period. This case is an important reminder to franchisors to provide updated FDD disclosures to existing franchisees that are adding a new territory, rather than attempting to bootstrap onto a prior agreement.

Also noteworthy was the court's rejection and dismissal of the plaintiff's claims for breach of contract and breach of the covenant of good faith and fair dealing, both of which arose out the franchisor's repurchase of a territory from a different master franchisee. The plaintiff claimed that it had a right of first refusal to purchase the subject territory; however, the court found that the plain language of the master franchise agreement applied the plaintiff's purchase option only to sales *by* the franchisor—not sales from a different franchisee *to* the franchisor.

DAMAGES TO FRANCHISOR

TENNESSEE FEDERAL COURT RULES THAT FRANCHISOR IS ENTITLED TO MORE THAN $700,000 IN LIQUIDATED DAMAGES

In *Captain D's, LLC v. Arif Enterprises, Inc.*, 2010 U.S. Dist. LEXIS 129242 (M.D. Tenn. Dec. 6, 2010), Captain D's moved for summary judgment on its claim for past due fees and liquidated damages. Arif Enterprises breached its franchise agreements by failing to comply with the franchisor's quality standards. Captain D's then terminated those agreements and sought to recover both past due fees and liquidated damages to compensate it for fees that would have been payable for the agreements' remaining terms. The court granted Captain D's motion for summary judgment and awarded it more than $700,000 in liquidated damages.

The court rejected the franchisee's argument that Captain D's caused its own damages by terminating the franchise agreements, and further rejected the defendant's claim that the liquidated damages clause at issue constituted an unenforceable penalty. Citing franchise cases from across the country in which liquidated damages have been awarded, the court found the provision at issue to be reasonable—and thus enforceable. The defendants' bare argument, unsupported by evidence, that the liquidated damages amounted to a penalty was insufficient to defeat the motion for summary judgment.

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