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:

FRAUD

FRANCHISOR'S FAILURE TO DISCLOSE AMOUNTS RECEIVED FROM AFFILIATE DID NOT CONSTITUTE FRAUD

A federal court in Maryland granted a franchisor's motion to dismiss franchisees' counterclaims in an interesting case challenging the adequacy of the franchisor's disclosure regarding payments from its affiliate. *The Cleaning Authority, Inc. v Neubert*, 2011 U.S. Dist. LEXIS 13949 (D. Md. Feb. 11, 2011). Franchisor TCA had filed separate actions against each of the defendants for termination of their franchise agreements. The franchisees countersued, alleging that they were fraudulently induced to enter into the franchise agreements because the Uniform Franchise Offering Circular at the time of sale allegedly failed to disclose payments TCA received from an affiliate that supplied the defendants with direct mail advertisement services. One franchisee also alleged that the pre-sale UFOC did not comply with the FTC Franchise Rule.

The court reviewed the UFOC and sided with TCA. It found that by disclosing that all franchisees must purchase the mailers from the affiliate (including providing the costs of such mailers), the "obvious implication of that disclosure was that TCA's affiliate, S&T, would derive revenue from those purchases. No further disclosure was necessary." The court also stated that what the affiliate did with the money it received from franchisees' purchases of mailers was not material, "[w]hat was material was how much franchisees would have to pay for advertising services, ..." and the defendants were fully informed of that.

SYSTEM STANDARDS

MASSACHUSETTS FEDERAL COURT NARROWLY INTERPRETS THE MEANING OF AN OPERATIONAL DEFAULT

Last month a Massachusetts federal court narrowly interpreted a settlement agreement and determined that KFC was required to provide a notice and opportunity to cure for each separate operational deficiency under that agreement. *KFC Corp. v. Springfield Food Sys.*, 2011 U.S. Dist. LEXIS 14218 (D. Mass. Feb. 14, 2011). At issue was the language in the settlement agreement that said that after KFC provided written notice of default to the franchisees, they "shall have ten (10) days from the date of the notice to cure the default. PROVIDED, HOWEVER, that KFC shall not be obligated to give more than one (1) such notice during any 120 day period during the Reinstatement Period." Shortly after the settlement agreement was signed, KFC inspected the franchisee's premises on two separate occasions and defaulted them for failing to maintain adequate food and hot water temperatures. At the third reinspection of the premises for standards compliance, KFC found a separate default concerning improper handwashing procedures, and it declared the franchisees in breach of the settlement agreement. KFC also moved to reinstate the litigation.

In its motion to lift the litigation stay, KFC argued that it was only required to provide the franchisees with an opportunity to cure a first operational default within a 120-day period. The court disagreed, holding that the settlement agreement required KFC to provide a notice to cure for improper handwashing procedures because that violated a different operational standard than inadequate food and hot water temperatures. In essence, the franchisees were entitled to a notice to cure each time they committed a new operational deficiency, which meant that KFC could terminate the agreement for an operational default without giving a notice to cure only if the franchisees committed the exact same operational deficiency (*e.g.*, improper handwashing procedures) a second time within a 120-day period. Thus, the court concluded that the franchisees had not breached the settlement agreement and denied KFC's motion.

ARBITRATION

COURT CONFIRMS ARBITRATOR'S CLARIFICATION OF PRIOR ARBITRATION AWARD

A Minnesota federal court recently confirmed an arbitrator's award despite a clarification to which the losing former franchisee objected. In *Wakeman v. Aqua2 Acquisition, Inc.*, 2011 U.S. Dist. LEXIS 14672 (Feb. 14, 2011), in which Gray Plant Mooty represented the franchisor of the AutoQual system, the franchisor had sought to prevent the former franchisee from operating a competing business in violation of his franchise agreement's post-termination restrictive covenant. AutoQual commenced an arbitration proceeding to enforce that restrictive covenant, and it prevailed. After the arbitrator issued his award, however, Wakeman advised AutoQual that he intended to continue operating his competing business by transferring nominal ownership of that business to his sister. He contended that the arbitrator's award (which referenced only Wakeman and not his family members or agents) did not prohibit such a transfer.

AutoQual presented the issue to the arbitrator and asked the arbitrator to clarify the award to prohibit expressly Wakeman's threatened conduct. The arbitrator agreed and clarified the original award to extend not just to Wakeman, but also to a defined group of people working in concert with him, as the franchise agreement itself provided. Wakeman asked the federal court to vacate, contending that the arbitrator was prohibited from clarifying his original decision if that clarification substantively expanded the original award rather than just correcting it. The court disagreed and granted AutoQual's cross-motion to confirm the clarified award. The court found that the clarification did not reexamine the merits of the controversy, but instead remedied a latent ambiguity in the original award. It found the clarified award consistent with the arbitrator's stated intent in the memorandum accompanying his first award.

TRADEMARKS AND TRADE ISSUES

EIGHTH CIRCUIT UPHOLDS AWARD OF DAMAGES IN LANHAM ACT CASE DESPITE LACK OF ACTUAL CONFUSION

In *Masters v. UHS of Del., Inc.*, No. 09-3543 (8th Cir. Jan. 6, 2011), the Eighth Circuit affirmed a jury verdict finding that UHS, the owner of psychiatric hospitals, willfully infringed on the plaintiff's service mark and breached a licensing agreement with the plaintiff. Although this was not a franchise case, the scenario could easily arise in franchising. Under the parties' license agreement, the plaintiff licensed its service mark to UHS for a certain use. But UHS expanded its use of the mark beyond the scope of the license by using it to promote other programs. The licensor sued UHS for breaching the license agreement and for service mark infringement under the Lanham Act. At trial, the jury returned a $2.4 million verdict in the plaintiff's favor, finding that UHS had willfully infringed on the service mark and breached the licensing agreement.

The important point for franchisors is that on appeal, defendant UHS claimed, among other things, that the plaintiff failed to prove actual confusion. In a ruling that could help franchisors in similar cases, the Eighth Circuit rejected this argument and noted that neither the relevant statutes nor previous case law expressly required proof of actual confusion to support a jury's damages award. The court declined, however, to state that actual confusion was not a prerequisite to recovering damages for *unintentional* infringement. The court found that UHS' willful, unauthorized use of the marks entitled the plaintiff to UHS' profits.

CLASS ACTIONS

CALIFORNIA DISTRICT COURT DISMISSES ATTEMPTED FRANCHISEE CLASS ACTION AGAINST IHOP

A California federal court recently dismissed a putative franchisee class action against IHOP for violation of California's Unfair Competition Law in *Hameed v. IHOP Franchising, LLC et al.,* No. 2:10-cv-02276 (E.D. Cal. Feb. 10, 2011). Hameed, an IHOP franchisee in Sacramento, sued IHOP on behalf of a class of IHOP franchisees, alleging that IHOP violated California's Unfair Competition Law by, among other things, denying him monetary aid pursuant to IHOP's Development Impact Assistance Program (DIAP). The DIAP provides money to an existing franchisee who is impacted when a new IHOP franchise restaurant opens within a specified proximity. Hameed alleged that he was denied assistance due to discriminatory practices, while another nearby franchisee was granted assistance.

The court granted IHOP's motion to dismiss, holding that under *Twombly*, Hameed had failed to plead sufficient facts regarding the DIAP program, the timing of his application for assistance, details of the application and denial process, why he is entitled to funding, and how he is similarly situated to "favored" franchisees who did receive DIAP assistance. The court also dismissed Hameed's unfair competition claims relating to an equipment lease agreement.

NONCOMPETE COVENANTS

NEW YORK FEDERAL COURT GRANTS PRELIMINARY INJUNCTION ENFORCING COVENANT NOT TO COMPETE

In *Singas Famous Pizza Brands Corp. v. New York Advertising LLC*, 2011 U.S. Dist. LEXIS 14524 (S.D.N.Y. Feb. 14, 2011), the court granted franchisor Singas a preliminary injunction to prevent its franchisee from running two competing businesses in violation of an in-term and post-term covenant not to compete. This case arose when the franchisee's husband started a business called Queens New York Famous Pizza, in which the franchisee participated. In holding that the standards for an injunction were met, the court cited the fact that the Queens restaurant provided nearly identical products and used a nearly identical menu to that of a Singas franchise. Its operations also were similar, including the use of machetes to cut the pizzas and specially designed Singas' pans. Furthermore, the franchisee and her husband promoted their businesses in joint advertisements, and the franchisee assisted in the operations of the Queens restaurant.

The court found that the noncompete covenant was reasonable as it only covered an area within a ten-mile radius of the terminated franchise for a period of two years.

FRANCHISEE ASSOCIATIONS

COURT GRANTS DECLARATORY JUDGMENT TO FRANCHISEES IN DISPUTE REGARDING RIGHT TO DETERMINE NATIONAL ADVERTISING STRATEGY

A Delaware state court has resolved an ongoing dispute regarding the control of advertising strategy in the KFC franchise system. In *KFC Nat'l Council & Advertising Cooperative, Inc. v. KFC Corporation*, No. 5191-VCS (Del. Ch. Jan. 31, 2011), the dispute was between KFC and its franchisees over the authority of the KFC National Council and Advertising Cooperative (NCAC) to determine the national advertising strategy for the KFC brand. KFC argued that it had sole authority to develop advertising plans, and the NCAC (whose governing body consists of 13 franchisee representatives and four KFC representatives, with each having equal voting rights) was limited to either accepting or rejecting the plans presented by KFC. To the contrary, the franchisees argued that the NCAC could accept, reject, or modify advertising plans presented, and sought a declaratory judgment confirming their interpretation of the NCAC's authority. The court sided with the franchisees, noting that over the years, the NCAC had modified advertising proposals several times over KFC's objections.

PROCEDURE

MICHIGAN DISTRICT COURT UPHOLDS JURY WAIVER BY FRANCHISEE

Once again, a jury trial waiver has been upheld by a federal court, this time in Michigan. In *ERA Franchise Systems LLC v. Bowers Realty and Associates, Inc.*, 2011 U.S. Dist. LEXIS 14474 (E.D. Mich. Feb. 14, 2011), the court enforced the language of the parties' franchise agreement. The franchisor had sued the franchisee for breach of the agreement, and Bowers' answer included a demand for a jury. ERA moved to strike the demand, arguing that the franchise agreement's express waiver provision controlled.

To strike a jury waiver provision in the Sixth Circuit, the contesting party has the burden of proving that it entered into the agreement "unknowingly and involuntarily." Bowers argued that the franchise agreement was nonnegotiable, it was not represented by counsel when entering into it, and separate compensation was not paid for the jury waiver. The court held that these allegations did not rise to the level of proving that the franchisee entered into the franchise agreement unknowingly or involuntarily. The court found instead that the franchise agreement was a negotiable contract signed after consideration by both parties and the jury waiver was, therefore, enforceable.

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