The GPMemorandum

TO: **OUR FRANCHISE AND DISTRIBUTION 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:

DAMAGES TO FRANCHISOR

FOURTH CIRCUIT HOLDS FRANCHISORS CAN RECOVER FUTURE DAMAGES FOR BREACH OF FRANCHISE AGREEMENT

In *Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC*, 2011 U.S. App. LEXIS 7809 (4th Cir. Apr. 14, 2011), the U.S. Court of Appeals for the Fourth Circuit reversed the judgment of the federal district court in the Western District of North Carolina, which had held that future damages could not be recovered by the franchisor. Meineke, a franchisor of automotive car care centers, terminated RLB Holdings' franchise agreements based upon its abandonment of its shops. Meineke brought suit against RLB in North Carolina state court, alleging that RLB breached the franchise agreements and caused Meineke to lose future royalties and advertising fees. The case was removed to federal court, which granted RLB's motion for summary judgment, finding that Meineke was not entitled to lost future damages for prospective royalties and advertising fund contributions for the period after the termination of the franchise agreements. Meineke appealed that decision.

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In reversing the district court's ruling, the Fourth Circuit considered whether Meineke was entitled to future damages under the franchise agreements as well as under North Carolina law. The court found that while the franchise agreements did not specifically provide for the recovery of future damages in the event of a breach of contract, such damages were "reasonably supposed to have been" within the contemplation of the parties, so an express written agreement was not required.

The Fourth Circuit went on to explain that the recovery of future damages was not an unduly conjectural, remote, or speculative claim under North Carolina law, even if RLB claimed it was unprofitable. The court found that the franchisee's payment obligations were based on its sales and not on its profits. By basing its claim for future damages on the franchisee's historical performance, Meineke properly used what the Fourth Circuit found to be the widely accepted methodology of using past profits as a basis for calculating future lost profits.

COURT REJECTS FRANCHISEE'S ECONOMIC DURESS DEFENSE TO FRANCHISE AGREEMENT OBLIGATIONS

A federal court in Illinois has granted summary judgment to franchisor Hardee's on its claim for money damages against a franchisee, rejecting the defense that the franchisee's failure to pay should be excused by bad economic conditions. *Hardee's Food Systems, Inc. v. Shree Krishna Foods, L.L.C.*, 2011 U.S. Dist. LEXIS 40542 (C.D. Ill. Apr. 14, 2011). The case arose after the franchisee defaulted under its franchise agreements by failing to pay amounts due, and Hardee's terminated the agreements. The parties subsequently entered into a temporary license agreement under which the franchisee acknowledged a $749,808.04 debt to Hardee's and released all claims under the franchise agreements. The franchisee failed to meet its obligations under the temporary license agreement.

The court granted Hardee's all amounts owed up to the date the temporary license agreement was signed. The court rejected the franchisee's claim that it was coerced into signing the temporary license agreement by financial duress. The court held that in order to show economic duress sufficient to relieve it of its obligations, the franchisee would have to show that it was prevented from exercising its free will by a wrongful act of Hardee's. The court held that while the franchisee's hopes for success may have been dashed by the economic downturn in 2008, that was not a defense to its contract obligations. The court also rejected the franchisee's claim that Hardee's prior breach of the franchise agreements excused the franchisee's breach, as that defense was waived under the temporary license agreement.

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ANTITRUST

TWO OF SUPPLIER'S ANTITRUST TYING CLAIMS SURVIVE FRANCHISOR'S MOTION TO DISMISS

The United States District Court for the Western District of Kentucky recently granted in part but denied in part a motion brought by tire retreading franchisor, Bridgestone Bandag, LLC, to dismiss a four-count complaint brought by Shamrock Marketing, Inc., alleging that Bandag implemented an unlawful tying arrangement in violation of Sections 1 and 2 of the Sherman Act. *Shamrock Marketing, Inc. v. Bridgestone Bandag, LLC*, 2011 U.S. Dist. LEXIS 25109 (W.D. Ky. Mar. 11, 2011). Shamrock is a family-owned Kentucky corporation that supplies "curing envelopes" and other accessories to tire retreading shops, including Bandag franchisees. It alleged that Bandag's "Q-Fund," which provides incentives to its franchisees to purchase curing envelopes and other accessories from Bandag, unlawfully ties the sale of precured tread rubber to the sale of Bandag curing envelopes and other Bandag accessories.

Noting that the motion "raises some difficult questions at the intersection of franchise agreements and antitrust enforcement," the court denied Bandag's motion to dismiss Counts II and III of Shamrock's complaint, holding that Shamrock had standing and sufficiently pled an antitrust injury by alleging that the Q-Fund eliminated competition throughout the market for curing envelopes and accessories. The court granted Bandag's motion to dismiss Counts I and IV, however, holding that *Kodak*-style lock-in claims were not appropriate in the franchise context and Shamrock's alleged single-brand relevant tying market therefore failed to state a claim.

BANKRUPTCY

BANKRUPTCY COURT DENIES FRANCHISOR'S MOTION FOR RELIEF FROM THE AUTOMATIC STAY TO ENFORCE DISTRICT COURT'S ORDER GRANTING PRELIMINARY INJUNCTION

In *In re Stone Resources, Inc.*, 2011 Bankr. LEXIS 1166 (E.D. Pa. Mar. 28, 2011), the franchisor, MarbleLife, moved for relief from the automatic stay against the debtor, its former franchisee, seeking to enforce an earlier preliminary injunction order granted in its favor by the U.S. District Court for the Eastern District of Pennsylvania. The preliminary injunction order prohibited the debtor from continued operation in violation of a covenant not to compete contained in the expired franchise agreement between the parties. MarbleLife's primary argument to establish "cause" for relief from the automatic stay was based upon the lack of adequate protection of its interest in property. MarbleLife did not present any witnesses at the evidentiary hearing in the bankruptcy court, instead relying on the district court's preliminary injunction order and legal argument from its counsel.

The bankruptcy court denied MarbleLife's lift stay motion because it was not persuaded that MarbleLife had established any basis for such relief. The court was critical of MarbleLife's attempt to establish the lack of adequate protection to its property interest based primarily on the district court's finding of irreparable harm in its preliminary injunction order. The court questioned whether MarbleLife could even establish that it had a protectable property interest based solely on the finding of irreparable harm. The court held that even if MarbleLife could establish that it had a protectable property interest, there was simply no evidence in the record to demonstrate its diminishing value. The court then applied a balancing test to determine whether continued litigation in a forum outside of the bankruptcy court was justified under the facts. The court reasoned that because the franchise agreement between the parties had expired, MarbleLife's only other protectable interest was its right to enforce the covenant not to compete. The court held that such an interest alone was not enough to warrant that the automatic stay be lifted to allow the enforcement of the preliminary injunction in the district court.

VICARIOUS LIABILITY

COURT DISMISSES DISCRIMINATION AND VICARIOUS LIABILITY CLAIMS AGAINST FRANCHISOR WHERE NO PLAUSIBLE FACTS EXISTED TO DEMONSTRATE EMPLOYMENT RELATIONSHIP WITH FRANCHISEE

In *Bricker v. R & A Pizza, Inc.*, 2011 U.S. Dist. LEXIS 39017 (S.D. Ohio Apr. 8, 2011), an Ohio federal district court granted a motion by franchisor Domino's Pizza to dismiss the claims of its franchisee's former employee. The court held that the former employee's complaint failed to state plausible claims against the franchisor under Title VII and for sexual harassment, retaliation, and negligence under state law. Each of those claims requires that there be an employer/employee or agency relationship between the worker and the franchisor, and the court found no allegations to support the existence of such a relationship.

Although the court held that a franchisor generally is not the employer of a franchisee's employee, the franchisor's potential status as an employer is determined in the Sixth Circuit through a four-part test: (a) interrelation of operations; (b) common management; (c) centralized control of labor relations; and (d) common ownership or financial control. The only allegation made by this plaintiff to satisfy any of the four factors was that the franchisor and franchisee were engaged in a joint venture, and thus, "acted as a joint employer." The court found that this was nothing more than a legal conclusion. Applying the heightened pleading standard under the *Twombly* and

Iqbal Supreme Court opinions, the court found no factual allegations to "cross the line from possibility to plausibility" that Domino's had joint involvement in aspects of the franchisee's relationship with its employees. Therefore, the court found nothing to suggest that Domino's had "constructively employed" the plaintiff. The court also rejected the conclusory allegation that the franchisee served as the agent of Domino's. The court emphasized the necessity for "factual enhancement" of these conclusory statements since it was undisputed that the defendants were in a franchisor/franchisee relationship. For essentially the same reasons, the court dismissed the negligence claims, finding that the plaintiff had failed to establish that the franchisor and franchisee were principal and agent or could be aggregated together and treated as a joint employer for vicarious liability purposes.

ARBITRATION

FRANCHISOR DID NOT WAIVE ARBITRATION BY MOVING TO DISMISS FOR IMPROPER VENUE

The Seventh Circuit Court of Appeals recently upheld the dismissal of a franchise-related lawsuit in light of the existence of a binding arbitration provision. In *Faulkenberg v. CB Tax Franchise Systems, LP,* 2011 U.S. App. LEXIS 6391 (7th Cir. Mar. 29, 2011), a disgruntled franchisee brought suit against its tax preparation franchisor after closing its five franchised outlets. The franchisee-plaintiff alleged, among other things, that the franchisor violated the Illinois Franchise Disclosure Act by failing to register its offering circular in the state prior to the sale. The parties disputed whether the Illinois Act applied to their relationship. The franchise agreements at issue contained arbitration clauses which stated that all claims relating to "the franchise" would be subject to arbitration in Houston, Texas. Consequently, the franchisor removed plaintiff's action from Illinois state court to the applicable federal district court, and then moved to dismiss the action for improper venue.

The franchisee, for its part, argued that the Illinois Franchise Disclosure Act voids any forum selection clause requiring a forum outside of Illinois. The court made quick work of this assertion, noting that the Act explicitly states that "a franchise agreement may provide for *arbitration* in a forum outside of" Illinois. The franchisee also argued that the franchisor had waived its right to enforce the arbitration clause when it appeared in Illinois court to challenge the franchisee-plaintiff's choice of venue. The court also rejected this claim, noting that several Seventh Circuit cases had previously held that "a motion to dismiss based on a contractual arbitration clause is appropriately 'conceptualized as an objection to venue, and hence properly raised'" as a motion to dismiss. Finally, the court rejected the plaintiff-franchisee's argument that the agreement to arbitrate was obtained by fraud, noting that the franchisee admitted receiving a copy of the agreement and there was no legitimate dispute as to whether the franchisee had signed the agreement. The franchisee also acknowledged receiving (and signing a receipt for) the franchisor's offering circular, which summarized the arbitration provision. The court affirmed dismissal of the plaintiff's case, leaving the franchisee to pursue arbitration.

SETTLEMENT AGREEMENT

FEDERAL COURT DISMISSES FRANCHISEE'S CLAIM FOR BREACH OF SETTLEMENT AGREEMENT

In *Prosperity Systems, Inc. v. Ali*, 2011 U.S. Dist. LEXIS 43884 (D. Md. Apr. 22, 2011), a Maryland federal court granted a franchisor's motion to dismiss a franchisee's counterclaim alleging that the franchisor breached a settlement agreement entered between the franchisor, franchisee, and other unrelated entities. That agreement granted Ali a PIZZA BOLI'S franchise and required franchisor PSI to insert language in the franchise agreement stating that it would treat Ali the same as all other franchisees. The agreement also required its signatories to use their best efforts to sell a competing restaurant called American Pizza. After PSI terminated Ali's franchise rights and sued for trademark infringement, Ali counterclaimed that PSI breached the settlement agreement by: (a) discriminating against him; (b) failing to sell American Pizza; and (c) conspiring with the other signatories to infringe on his exclusive territory.

The court dismissed Ali's claim for breach of the settlement agreement for three reasons. First, the agreement did not itself impose on PSI an obligation not to discriminate against Ali as a franchisee, but simply required PSI to include language in the franchise agreement stating that it would treat Ali the same as it treated its other franchisees, which PSI did. Second, with respect to Ali's claim that PSI failed to sell American Pizza, the court held that PSI had no ownership interest in the restaurant and lacked authority to sell it. Finally, the court held that even if PSI conspired with the other signatories to infringe on Ali's exclusive territory, the settlement agreement did not guarantee Ali an exclusive trade territory. Rather, the agreement simply required PSI to include a trade area provision in the franchise agreement. Thus, the court held that although Ali may have a claim for breach of the franchise agreement, Ali did not state a claim for breach of the settlement agreement.

JURISDICTION AND PROCEDURE

COURT DENIES CONFIRMATION OF ARBITRATION AWARD FOR LACK OF JURISDICTION

A federal court in New York held that it lacked federal diversity jurisdiction over an action to confirm a $60,000 arbitration award. *In re Doctor's Associates, Inc. v. Navindra Gharbaran*, 2011 U.S. Dist. LEXIS 33693 (S.D.N.Y. Mar. 30, 2011). The franchisor, Doctor's Associates, Inc., had obtained an award against a former franchisee that included damages of $60,000 and an injunction prohibiting the former franchisee from continuing to operate her restaurant as a Subway franchise. The federal court denied the petition to confirm the award because the amount in controversy did not exceed the federal jurisdictional minimum of $75,000. The court rejected the franchisor's request to consider the value of the declaratory and injunctive relief, as the court found that the $60,000 award had addressed all damages suffered.

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