The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

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

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DATE: June 10, 2011—No. 143

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

FRANCHISOR EXECUTIVE REJOINS GRAY PLANT MOOTY

Angela L. Rud, who has spent the last nine years on the business side of franchising, most recently as executive vice president of human resources and senior employment law counsel for International Dairy Queen, Inc., has rejoined Gray Plant Mooty. Rud practiced employment law at Gray Plant Mooty from 1996 to 2002, during which time she served many franchisor clients, then gained extensive business experience and knowledge in the retail, restaurant, and franchise industries while working in her senior management role at IDQ.

ARBITRATION

COURT DENIES FRANCHISEE'S MOTION TO ENJOIN ARBITRATION

In *Wild v. H&R Block, Inc.*, 2011 U.S. Dist. LEXIS 55140 (D. Colo. May 12, 2011), a franchisee unsuccessfully sought a temporary restraining order to enjoin a pending arbitration between it and franchisor H&R Block. The franchise agreement between the parties provided that if a final award in arbitration was not rendered within 180 days of the notice of arbitration, either party could terminate the arbitration and pursue the matter in court, and the decision deadline in this case became March 9, 2011. The arbitration hearing was set for March 1-3, 2011, but because the hearing was set during the height of tax season, the franchisee asked H&R Block if the hearing date could be moved to May. H&R Block agreed, and the hearing date was re-set to May 23, 2011.

After the March 9, 2011, deadline had passed, the franchisee sought to terminate the arbitration, arguing that the parties did not extend the decision deadline (only the hearing date) and that therefore the franchisee had the right under the agreement to terminate the arbitration. The franchisee also argued that the arbitration panel did not have authority to resolve the issue of whether the dispute remained arbitrable, arguing that the court should apply the American Arbitration Association (AAA) rules in effect when the franchise agreement was signed in 1981. The court denied the franchisee's application for a temporary restraining order. First, it found that the franchisee did not have a substantial likelihood of success on the merits (due to the fact that the franchisee had requested extension of the hearing date in the first place). And on the issue of the panel's authority to decide its own jurisdiction, the court determined that by choosing the AAA rules as governing, the franchise agreement included all changes and updates to the rules, and that Rule R-7 of the AAA Commercial Arbitration Rules, as amended, clearly gave the arbitrators the ability to decide the matter.

NEW JERSEY APPEALS COURT REQUIRES DISCOVERY BEFORE DISMISSAL PURSUANT TO ARBITRATION CLAUSE

Plaintiffs hoping to avoid having to comply with contractual arbitration clauses were given a glimmer of hope in *Brooks v. Fetch! Pet Care, Inc.*, 2011 N.J. Super. LEXIS 1236 (N.J. Super. Ct. App. Div. May 13, 2011). In this case, the New Jersey Superior Court reversed the trial court's dismissal of the plaintiffs' complaint and remanded the case for further discovery. The trial court held that the constitutional Supremacy Clause and Federal Arbitration Act ("FAA") required enforcement of the mandatory arbitration provision in the parties' franchise agreement, which required arbitration in California. In so holding, the trial court rejected the plaintiffs' contention that their general claims of fraud warranted New Jersey being the venue for resolution of their disputes pursuant to the New Jersey Franchise Practices Act.

The New Jersey Superior Court reversed, finding that dismissal was premature. The plaintiffs raised arguments that could provide valid defenses to enforcement of an arbitration clause under the FAA. Based on certifications filed by the plaintiffs in opposition to the motion, as well as their allegations of fraud in relation to the franchise agreement negotiations, the appellate court remanded the case for additional discovery to develop the record on whether the contract was one of adhesion, whether the arbitration clause was unconscionable, or whether plaintiffs made a conscious business decision that the agreement's overall benefits outweighed the detriments of its inclusion of an out-of-state arbitration provision.

POST-TERMINATION INJUNCTIONS : NON-COMPETE COVENANTS

FEDERAL COURT DENIES FORMER FRANCHISEE'S MOTION TO STAY INJUNCTION PENDING APPEAL

In *Wakeman v. Aqua2 Acquisition, Inc.*, 2011 U.S. Dist. LEXIS 47498 (D. Minn. May 3, 2011), in which Gray Plant Mooty represented the franchisor of the AutoQual system, a Minnesota federal court last month denied the franchisee plaintiff's request to stay the court's judgment and injunction pending appeal. As reported in Issue 140 of *The GPMemorandum*, the court in February had confirmed an arbitrator's award despite a clarification to which Wakeman, a former AutoQual franchisee, objected. Specifically, the court enjoined Wakeman and a defined group of people working in concert with him from offering or selling any interior re-conditioning services. Wakeman filed a notice of appeal to the United States Court of Appeals for the Eighth Circuit and filed a motion with the district court to stay the injunction pending resolution of the appeal.

In denying Wakeman's motion, the district court found that Wakeman failed to show that he was likely to succeed on the merits of the appeal because he was merely reiterating arguments already heard by the court. The court further found that Wakeman failed to show that he would suffer irreparable harm without the stay because he knew that upon termination of his franchise agreement he would be required to cease operation of the AutoQual business. The court also found that AutoQual would suffer irreparable harm from Wakeman's continued operation of the AutoQual business and the public interest would be best served by enforcing a valid restrictive covenant.

TRADEMARKS

SEVENTH CIRCUIT AFFIRMS DECISION THAT PLAINTIFFS ABANDONED TRADEMARK BY NOT EXERCISING REASONABLE CONTROL

In *Eva's Bridal Ltd v. Halanick Enterprises, Inc.,* 2011 U.S. App. LEXIS 9539 (7th Cir. May 10, 2011), the United States Court of Appeals for the Seventh Circuit affirmed a district court's decision that the plaintiffs abandoned their trademark because they had granted a naked license under which the plaintiffs had no "reasonable control over the nature and quality of the goods, services, or business on which the [mark] is used" by the defendants. The plaintiffs had granted various family members licenses to use their trademark *Eva's Bridal* to operate bridal salons in the Chicago suburbs, and the defendants had purchased one of these operations, including the license agreement. After expiration of the license agreement, the defendant stopped paying royalties but continued to use the mark. The licensor sued under the Lanham Act, alleging that the defendant no longer had a license to use the mark. The district court dismissed the suit on the grounds that the plaintiffs had abandoned their rights to the *Eva's Bridal* mark by engaging in "naked licensing": licensing the mark without any right to supervise the business, exercise quality control, or dictate how the trademark was used.

On appeal, the plaintiffs argued that there was no need to exercise reasonable control because the defendants operated a "high quality" business. The Seventh Circuit disagreed, finding that a trademark licensor does not need to ensure *high quality* goods or services—it needs to exercise reasonable control to ensure *consistent* quality under a trademark license. Analyzing trademark licenses in franchising, the Seventh Circuit noted that popular fast food franchisors do not ensure that the products offered are of the highest quality; rather, franchisors ensure that the products offered under the trademark are of consistent quality so that consumers will receive the same experience at each location. The appellate court did not analyze how much control was necessary because the plaintiffs exercised no control, but noted that the level of control must be "sufficient under the circumstances to insure that the licensee's goods or services would meet the expectations created by the presence of the trademark."

PERSONAL LIABILITY

COURT REFUSES TO IMPOSE LIABILITY ON FRANCHISOR'S OFFICER

In *@Wireless Enterprises, Inc. v. AI Consulting, LLC*, 2011 U.S. Dist. LEXIS 51973 (W.D.N.Y. May 16, 2011), a New York federal district court granted summary judgment in favor of the franchisor and its corporate officer dismissing the former franchisee's counterclaims for breach of contract, breach of the covenant of good faith and fair dealing, actual fraud, constructive fraud, and tortious interference, among others. The franchisor had terminated the franchise agreement for a retail cell phone store and sued the franchisee for monies owed. The franchisee countersued based on a series of alleged statements made by the franchisor's president during the term of the agreement.

One important issue was whether the franchisee could pierce the corporate veil to maintain claims against the franchisor's president in his personal capacity as the franchisor's alter ego. In addition to other adverse evidence, the court noted the franchisee's acknowledgment in the franchise agreement that, "in all of their dealings with you, our officers, directors, employees and agents act only in a representative, and not in an individual, capacity." The court viewed the franchisee's assertion that he thought he was dealing with the president in his personal capacity to be a "subjective belief," which was insufficient to create a triable issue of fact. Without any evidence that the president abused the corporate form or was a party to the contract in his individual capacity, the court determined that the franchisee's contract claims against the president could not withstand summary judgment. The court noted, however, that officers acting on behalf of a corporation can be held individually liable for tortious conduct, but the court then went on to dismiss all of the tort claims, as well.

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DAMAGES TO FRANCHISOR

COURT AWARDS LIQUIDATED DAMAGES ON FRANCHISOR'S BREACH OF CONTRACT CLAIM

A federal court in North Carolina has awarded franchisor Choice Hotels International, Inc. liquidated damages after granting its motion for reconsideration. *Choice Hotels Int'l, Inc. v. Smith Hotel Props., LLC*, 2011 U.S. Dist. LEXIS 48928 (E.D.N.C. May 6, 2011). In an earlier opinion, the court found in favor of the franchisor on its motion for summary judgment with regard to its claims for trademark infringement, unfair competition, and unfair and deceptive trade practices against a franchisee that was terminated for nonpayment. The court also found in favor of Choice Hotels with regard to liability on its breach of contract claim, but denied the request for liquidated damages provided for in the franchise agreement. In denying liquidated damages, the court found that the franchise agreement provision did not meet the elements required for liquidated damages under Maryland law, the governing law chosen by the parties.

The provision stated that damages would be calculated based on the franchisee's revenue, but would be no less than $40 multiplied by the number of rooms, multiplied in turn by the greater of the number of months left in the agreement or thirty-six. The court found that the provision did not provide in "clear and unambiguous" terms for a certain sum, as required under Maryland law, because the potential amount of damages was unbounded and the formula did not even allow for a "ball-park" determination. The court also found that the liquidated damages did not reasonably anticipate the potential value lost by the franchisor because the formula was based on the franchisee's revenues. Thus, the court originally held the liquidated damages provision was an unenforceable penalty.

On reconsideration, the court noted that the "sum certain" element does not require a specific dollar amount, but merely requires a means of calculating damages at the time of the breach. The court then found that the provision was not an unenforceable penalty; rather, it was a reasonable attempt to put Choice Hotels in the position it would have been absent the breach, and was not grossly excessive. Lastly, the court noted that the provision complied with the Maryland requirement that liquidated damages provisions must not be alterable. The court ultimately granted Choice Hotels $158,400 in liquidated damages.

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CONTRACTS

COURT REFUSES TO ALLOW GRAMMAR EXPERT TO TESTIFY IN DISPUTE OVER DEFINITION OF NET SALES

A federal district court in Georgia recently rejected a franchisor's attempt to introduce expert testimony regarding the proper grammatical interpretation of the sentence in its franchise agreement defining "Net Sales." In *Coyote Portable Storage, LLC v. PODS Enterprises, Inc.,* 2011 U.S. Dist. LEXIS 51899 (N.D. Ga. May 16, 2011), several franchisees sued for breach of contract, claiming that their franchisor had improperly calculated royalties, and had thus overcharged them. The franchise agreements at issue calculated royalties as a percentage of "Net Sales," defined (in relevant part) as all revenues received by the franchised business, but excluding "revenue from the sale of Containers as part of a long distance program organized and managed [by the franchisor]." The plaintiffs claimed that they had been improperly charged royalties on monies received from sales of containers as part of the franchisor's cross country move program. The franchisor initially asserted that the definition of "Net Sales" in the franchise agreement was patently ambiguous, and "the result of a scrivener's error and mistake." Later, however, the franchisor retreated from this position and sought to introduce the testimony of an "expert grammarian" to assist the court in resolving the meaning of the "Net Sales" definition, by addressing the "grammatical nuances" of the sentence at issue.

The court, noting the well-settled principle that interpretation of an unambiguous contract is for the court alone to decide, found that the proffered expert's opinion regarding the grammatical effect of the sentence did not create an ambiguity in the contract and that the contract was not ambiguous on its face. Accordingly, the expert's testimony was deemed improper and excluded from trial.

FRANCHISE SALES

COURT DISMISSES CLAIM FOR VIOLATION OF NEW YORK FRANCHISE ACT ON STATUTE OF LIMITATIONS GROUNDS

In *Vysovsky v. Glazman*, 2011 U.S. Dist. LEXIS 51909 (S.D.N.Y. May 11, 2011), eight franchisees sued franchisor U.S. Pack Courier Services and various individuals for violations of the New York Franchise Act. The franchisees claimed that they paid franchise fees for unregistered franchises, a violation of the statute, and that they were entitled to damages, including the reimbursement of their franchise fees. After a jury found for the franchisees, the franchisor moved for judgment as a matter of law on the grounds that (among other things) the claims were barred by the three year limitations period set forth in the New York Franchise Act. The franchisor argued that because six of the plaintiffs became franchisees before 1998, and their action was not filed until 2001, their claims were subject to the limitations period. In opposing the motion, the six franchisees contended that because the franchisor was acquired by another company in 1999, the limitations period began to run as of that time. The court rejected this argument—and ruled in favor of the franchisor—on the ground that because the franchisees were seeking reimbursement of their royalty fees, the court should look to when the franchisees first started paying fees as a measure for applying the limitations period.

CLASS ACTIONS

COURT PERMITS CLASS ACTION TO PROCEED AGAINST FRANCHISOR

In *Vallabhapurapu v. Burger King Corp.*, 2011 U.S. Dist. LEXIS 48804 (N.D. Cal. May 6, 2011), a California federal district court denied a motion to dismiss brought based on standing and the failure to join necessary parties. The case is part of a series of attempted class action lawsuits against Burger King as a franchisor of 96 restaurants leased to franchisees in the state of California. The complaint alleges that the restaurants are inaccessible to customers in wheelchairs, in violation of the Americans with Disabilities Act, the California Civil Rights Act, and the California Disabled Persons Act. The complaint further alleges common characteristics among the franchised restaurants, and that Burger King, as franchisor, exercises control over the development, design, remodel, alteration, maintenance, and operation of the restaurants.

The court reiterated its decisions on the same motion in an identical earlier lawsuit between the parties that was settled and dismissed, *Castaneda v. Burger King Corp.* Burger King's argument that the named plaintiffs lacked standing to file on behalf of restaurants that they had never visited was quickly dismissed as a maneuver to defeat class certification. Burger King also argued that the plaintiffs should be required to join the franchisees of the restaurants at issue as additional defendants in the litigation because the franchise agreements required the franchisees to operate and maintain the facilities in question, and the franchisees were required to indemnify Burger King for any accessibility violations that occurred. Although the plaintiffs did not disagree that the franchise agreement contained these requirements, the court nevertheless reiterated its finding from *Castaneda* that the franchisees were not necessary parties. The court held that Burger King, pursuant to its rights under the franchise agreements, exercised sufficient and substantial control over the premises and the franchisees. Consequently, the court allowed the case to proceed without requiring the plaintiffs to add the franchisees as defendants.

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BANKRUPTCY

DISCHARGE INJUNCTION DOES NOT PROHIBIT ENFORCEMENT OF VALID NON-COMPETITION CLAUSE

In *In re Quattrin,* 2011 Bankr. LEXIS 1941 (Bankr. N.D. Cal. May 26, 2011), the debtor was a franchisee in the Total Car Franchising Corporation ("Total Car") system at the time he filed for bankruptcy. During the bankruptcy case, the franchise agreement was terminated. The debtor subsequently received his bankruptcy discharge, which gave rise to the discharge injunction against the collection of discharged debts. Total Car thereafter sought to enforce its post-termination remedies under the franchise agreement, including enforcement of the two year non-competition clause.

The debtor alleged that Total Car's efforts to enforce the non-competition clause violated the discharge injunction, and sought declaratory relief that his obligations, including the non-competition clause under the franchise agreement, were discharged. The court noted that some bankruptcy courts had held that non-competition obligations could be discharged in bankruptcy. In the absence of any binding precedent in the Ninth Circuit, however, the court adopted the analysis of two circuit court decisions holding that non-competition obligations cannot be discharged in bankruptcy. Those decisions reasoned that a right to injunctive relief does not fall under the Bankruptcy Code's broad definition of a "claim" or a "debt" and, therefore, that a right to injunctive relief against a debtor is not discharged in bankruptcy. Ultimately, the court held that, to the extent enforceable under state law, the non-competition clause in the Total Car franchise agreement was not discharged by the debtor's bankruptcy discharge, and that Total Car had not violated the discharge injunction.

SYSTEM STANDARDS

FRANCHISEE MAY PURSUE CHALLENGE TO FRANCHISOR POLICY TO CONTROL MENU AND PRICING

A federal court in Illinois has let stand a franchisee's complaint about the new menu and pricing policy of its franchisor. *Stuller, Inc. v. Steak N Shake Enterprises, Inc.*, 2011 U.S. Dist. LEXIS 57704 (C.D. Ill. May 31, 2011). Rejecting parts of a federal magistrate judge's recommendation, the district court denied the franchisor's motion to dismiss two counts of the complaint. In those two counts, the franchisee is challenging the Steak N Shake franchisor's new policy that requires franchisees to follow set menu and pricing on some items, and to participate in system promotions. The franchisee alleges that the franchisor formerly allowed franchisees freedom in these areas, but that now default notices have been sent for noncompliance.

In allowing the case to proceed past the initial pleading stage, the court found that the plaintiff franchisee had claimed sufficient "damages" even though no termination has occurred. The issue of whether a non-terminated plaintiff truly has been damaged is best resolved at a later stage, the court held, as long as the franchisee at least has pleaded that it has been damaged. Similarly, the court ruled that the franchisee can for now pursue a claim that the franchisor's new policy differs from what had been disclosed to the franchisee in the UFOC, which allegedly stated that franchisees were free to set prices and were not obligated to participate in promotions. The court found "premature" the franchisor's defense that the statute of limitations had expired on any claim based on the UFOC.

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