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: July 20, 2011—No. 144

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

SYSTEM STANDARDS

COURT GRANTS FRANCHISEE'S MOTION TO ENJOIN FRANCHISOR FROM ENFORCING POLICY TO CONTROL MENU AND PRICING

A federal district court in Illinois granted a franchisee's motion for a preliminary injunction preventing a quick service restaurant franchisor from requiring the franchisee to comply with pricing and promotional policies. *Stuller, Inc. v. Steak N Shake Enterprises, Inc.*, 2011 U.S. Dist. LEXIS 66455 (C.D. Ill. June 22, 2011). As reported in the June 10, 2011, edition of *The GPMemorandum*, the franchisee is challenging Steak N Shake's new policy that requires franchisees to follow set menu and pricing on some items, and to participate in system promotions. The franchisee sought to prevent enforcement or termination for failure to comply. Although a magistrate judge recommended denial of the preliminary injunction, the district court now granted the motion.

The district court found the franchisee had shown it was likely to succeed on the merits, in part because the language of the franchise agreements was ambiguous as to whether the franchisor could require franchisees to follow set menu pricing. Further, the court found that the franchisee demonstrated it would suffer irreparable harm if the preliminary injunction was not granted, even though the magistrate had found the franchisee could avoid any harm by complying with the franchisor's policies.

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EMPLOYMENT

APPELLATE COURT IN GEORGIA REVERSES RULING THAT FRANCHISEE WAS FRANCHISOR'S EMPLOYEE

A Georgia appellate court recently ruled that there was no employer-employee relationship between a Massachusetts unit franchisee and a commercial cleaning franchisor—reversing the trial court's grant of summary judgment to the unit franchisee. In *Jan-Pro Franchising Int'l, Inc. v. Depianti*, 2011 Ga. App. LEXIS 543 (Ga. Ct. App. June 23, 2011), the franchisor, Jan-Pro, brought a declaratory judgment action seeking to clarify the employment status of a Massachusetts franchisee. The trial court granted the franchisee's motion for summary judgment, determining that he was an employee under the Massachusetts Independent Contractor Statute. Jan-Pro appealed, claiming that the statute did not apply and that the franchisee was not its employee. The appellate court reversed, first noting that Jan-Pro licensed its business model to regional franchisees, who then marketed the business model and customer accounts to unit franchisees, such as the defendant. Next, the appellate court analyzed the Massachusetts statute, noting that there is a presumption than an individual is providing services to an employer. The court determined that all three factors of the applicable test showed that the unit franchisee was not an employee.

In going through the three-part test, the court found that as to the first element, the unit franchisee was free from Jan-Pro's control and direction. The contract was entered into between the unit franchisee and the regional franchisee. Jan-Pro, although a third-party beneficiary of that contract, did not participate in any of the unit franchisee's activities. As to the second element, the court noted that services provided by the unit franchisee were not the same as those provided by Jan-Pro. Jan-Pro established a trademarked cleaning service, which it licenses to regional franchisees. The unit franchisee is in the business of offering cleaning services directly to customers. On the third element, the court determined that Jan-Pro does not control the unit franchisee's business and is not a party to its contract with the regional franchisee.

MASSACHUSETTS COURT AWARDS ATTORNEYS' FEES AND COSTS TO PREVAILING FRANCHISEES ON CLAIMS THEY WERE MISCLASSIFIED

In *Awuah v. Coverall North America, Inc.*, 2011 U.S. Dist. LEXIS 63381 (D. Mass. June 15, 2011), a case followed closely by the franchise industry, two franchisees who prevailed on their claims in arbitration that they had been misclassified as independent contractors under Massachusetts law were awarded reasonable attorneys' fees and costs. Following the conclusion of the arbitration hearing, the two franchisees sought an award of all attorneys' fees and costs from the court related to summary judgment in the underlying litigation on the misclassification issue, their challenge to the arbitration clause, and the arbitration itself. The court limited the award to those reasonable fees and costs incurred in the arbitration itself and held that it was inappropriate to award fees and costs on the other issues because they had not yet been fully decided.

CLASS ACTIONS

DISTRICT COURT DECERTIFIES CLASS OF FORMER 7-ELEVEN FRANCHISEES

A federal district court in the Southern District of California recently decertified a class of former 7-Eleven franchisees seeking to recover federal excise tax refunds issued to 7-Eleven. *Grayson v. 7-Eleven, Inc.*, 2011 U.S. Dist. LEXIS 62211 (S.D. Cal. June 10, 2011). The parties had stipulated to the certification of a class of former 7-Eleven franchisees who sold prepaid long distance telephone cards that were subject to a three percent federal excise tax, who terminated their franchise agreements, and to whom 7-Eleven refused to pay any portion of its excise tax refund. After the parties filed summary judgment motions, the court asked why it should not decertify the nationwide class when the parties both contended that the claims could be decided solely under California law.

The court noted its appreciation for the "parties' desire to resolve their Rule 56 motions on a class-wide basis to promote efficiency and judicial economy," but ultimately ordered decertification. The court held that the class did not meet the cohesion or requirement requirements under the applicable rule. The court stated that because a class cannot be cohesive if the states' laws governing the class are notably different, it was not convinced that California law could be applied to the nationwide class members' claims. The court further held that a nationwide class action that involves claims requiring the application of multiple state laws implicates Rule 23(b)(3)'s predominance requirement, yet plaintiffs failed to offer "any analysis of state law variations regarding their claims to establish this case could be managed in a practical manner." The court further rejected the parties' request to certify a sub-class.

POST-TERMINATION INJUNCTIONS: NONCOMPETE AND TRADEMARKS

MICHIGAN COURT GRANTS FRANCHISOR'S MOTION FOR PRELIMINARY INJUNCTION ON NONCOMPETE AND LANHAM ACT CLAIMS

In *Victory Lane Quick Oil Change, Inc. v. Darwich*, 2011 U.S. Dist. LEXIS 70062 (E.D. Mich. June 29, 2011), a federal court in Michigan granted a franchisor's motion for a preliminary injunction against its former franchisee for breaching the noncompete provision in the parties' franchise agreement and violating the Lanham Act. Although the franchisee's principal argued that he sold his oil change business to his brother, who was now operating it as Saline Quick Lube, the court noted that the franchisee remained the tenant of record on the lease for the premises. As a result, the franchisee was arguably "connected with," or ha[d] an "interest in," or was "assist[ing] any person or Entity engaged in a Competitive Business" in violation of the franchise agreement. Accordingly, Victory Lane was likely to prevail on the merits of its contract claim.

As to the Lanham Act claim, the court noted that, like Victory Lane, Saline Quick Lube used a logo with a black and white checkered pattern surrounding the name of the company. Although the company names were different, the general look and overall impression was similar. Moreover, because Saline Quick Lube operated in the same location as the former Victory Lane franchise, confusion was even more likely. Considering all the preliminary injunction factors, the court held that Victory Lane was likely to prevail on its Lanham Act claim as well.

ALABAMA FEDERAL COURT REFUSES TO GRANT COMPLETE INJUNCTION

In *Sylvan Learning, Inc. v. Learning Solutions, Inc.*, 2011 U.S. Dist. LEXIS 64492 (S.D. Ala. June 17, 2011), a federal court in Alabama granted in part and denied in part a preliminary injunction against a licensee for continuing to operate business locations following the licensor's termination of the license agreements. The defendant operated three Sylvan Learning centers under separate license agreements, two in Mississippi and one in Alabama. Richard Blow, a signatory to all the license agreements and partial owner of the defendant entity, was convicted of felony bank fraud. The Alabama license agreement had specific language that any felony conviction by *any signatory* to the agreement was an incurable breach. The Mississippi agreements had less specific language allowing termination of the agreement for "conviction of a Licensee of a felony or misdemeanor relevant to the operation of the Center." Based on the felony convictions, Sylvan terminated the license agreements due to incurable breaches.

In addressing the first factor for preliminary injunctive relief, the judge determined that there was a likelihood of success on the merits in terms of the Alabama agreement, but that Sylvan had not presented valid grounds to terminate the Mississippi agreements because Blow, as a signatory (who had a 50 percent interest in the licensee entity) was not the actual licensee. The court emphasized that the signatory was an individual, not a "licensee" under the agreement, so that there had been no felony conviction of a "licensee" as a basis for terminating the Mississippi agreements. Another clause addressing an "incurable tarnishment" of Sylvan's reputation was determined to be ambiguous and also not applicable to an individual's convictions. The court then extensively addressed, for the Alabama agreement only, the preliminary injunction factor of irreparable injury, and whether there is a presumption of irreparable harm once a plaintiff establishes the likelihood of success on the merits of a trademark infringement claim. As a precaution because of contrary cases, the court also did a specific analysis of the irreparable injury threat, determining that because Sylvan had lost control of its reputation and ability to control the nature and quality of services provided by the infringing defendants, Sylvan did stand to suffer irreparable harm by unauthorized use of the marks.

VICARIOUS LIABILITY

COURT DENIES FRANCHISOR'S MOTION FOR SUMMARY JUDGMENT ON VICARIOUS LIABILITY CLAIM

In *Hayes v. Jani-King of Jackson*, 2011 U.S. Dist. LEXIS 66736 (S.D. Miss. June 22, 2011), a Mississippi federal district court denied a franchisor's motion for summary judgment on a vicarious liability claim, concluding that under Mississippi law there was a question of fact regarding whether a janitorial cleaning service franchisor exercised sufficient control over its franchisee to be held liable for the franchisee's negligent acts. The case arose out of an injury to the plaintiff who, after entering a restroom recently cleaned by the franchisee, slipped on the wet, recently mopped floor and was hurt. The plaintiff sued the franchisee and the franchisor, seeking damages for negligence because the restroom allegedly had no warning about the wet surface.

In denying summary judgment to the franchisor, the court focused exclusively on the language of the franchise agreement, marching through an analysis of every relevant provision to determine whether the franchisee was the franchisor's independent contractor or whether they essentially were employer and employee. At the outset, the court emphasized that this line of demarcation is, at least under Mississippi law, "a twilight zone filled with shades of gray." The court noted that a provision in the agreement explicitly identifying the franchisee as an "independent contractor" was relevant to the parties' intent, but not enough to resolve the issue. The court focused on the fact that the franchisor approved and standardized the franchisee's workspace, established requirements relating to its policies, practices, and procedures, and provided a comprehensive operational training program. As further evidence of an employer/employee relationship, the court noted the franchisor's right to inspect the franchisee's books and records as well as the actual cleaning work it performed for customers. The numerous bases for termination enumerated in the agreement, the court held, made the franchise agreement appear more like an at-will employment contract. Despite these findings the court counted an equal number of factors in the franchisor's favor, noting the franchisee had sole responsibility for its labor, equipment, and supplies, for setting prices and discounts, and for furnishing means and appliances for the work. The court said its decision was a "close call" but seemed troubled by the fact that, if the franchisee did not perform its tasks "in a good and workmanlike manner," the franchisor had the right to assume a customer contract and service that customer itself. That provision and others like it in the franchise agreement led the court to conclude that the agreement in many ways controlled the franchisee's "physical conduct." In viewing the "conflicting evidence" in the light most favorable to the plaintiff, the court found a material question of fact about whether an employer/employee relationship existed.

PERSONAL LIABILITY OF INDIVIDUALS

ILLINOIS FEDERAL COURT DISMISSES CLAIMS AGAINST INDIVIDUAL INVESTOR IN A FRANCHISOR

In *Free Green Can, LLC v. Green Recycling Enterprises, LLC,* 2011 U.S. Dist. LEXIS 65132 (N.D. Ill. June 20, 2011), the federal district court for the Northern District of Illinois dismissed claims against an individual investor in the franchisor, refusing to pierce the corporate veil and find an individual personally liable as an alter ego. In 2009, Free Green Can (FGC), an Illinois-based franchisor of a recycling concept, entered into a franchise agreement with Green Recycling Enterprises (GRE), a Nebraska-based limited liability company. The parties' relationship was troubled from the start, and in 2010 FGC filed suit against GRE for breach of the franchise agreement. GRE filed counterclaims against FGC and against Michael Menas, a recent individual investor in FGC. GRE alleged that Menas had become the alter ego of FGC and brought counterclaims. Menas moved to dismiss all claims against him, arguing that the misconduct alleged in the counterclaims was attributed to FGC and not to him.

In granting Menas' motion, the court found that GRE failed to establish a unity of interest between Menas and FGC, which the court stated is required to pierce the corporate veil and hold Menas individually liable. Further, the court found that GRE failed to allege any facts to support its claim that Menas engaged in conduct that violated the Nebraska Seller-Assisted Marketing Plan Act, the Nebraska Consumer Protection Act, or the Nebraska Deceptive Trade Practices Act, or that Menas breached a warranty. The court found that GRE was trying to hold Menas accountable for acts that were undertaken prior to his involvement with FGC.

ARBITRATION

FOURTH CIRCUIT UPHOLDS ARBITRATION AWARD; REFERENCE TO AAA RULES CONFERS INTENTION OF BINDING ARBITRATION

Does an arbitration clause have to use the word "binding" to be binding? That was the question raised in *Akaoma v. Supershuttle Int'l Corp.*, 2011 U.S. App. LEXIS 12763 (4th Cir. June 22, 2011). The parties arbitrated a dispute under a franchise agreement, and the defendant franchisor succeeded on all but one claim. The federal district court granted the franchisor's motion to confirm the arbitration award. On appeal to the

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Fourth Circuit, the franchisee challenged the district court's holding that the arbitration was binding, on the grounds that the arbitration clause in the franchise agreement did not include the word "binding." The Fourth Circuit affirmed the ruling, noting that federal law favors arbitration and interprets arbitration provisions under normal contract principles. The court held that where the arbitration provision references the rules of the American Arbitration Association, the parties intended that the arbitrator's decision would be binding.

PANEL UPHOLDS FRANCHISOR'S POWER TO ENFORCE POLICIES

In *Wild v. H&R Block Tax Services LLC*, AAA Case No. 77 114 266 10 (June 15, 2011), a panel of arbitrators upheld the termination of an H&R Block franchisee who had refused to convert to H&R Block's proprietary tax return preparation software when Block made that software mandatory for all system offices. (Gray Plant Mooty represented the franchisor in this case.) Although the franchisee had been allowed to use other tax return preparation software for many years, the panel held that Block should not be penalized for its patience as it sought to convince its franchisees to voluntarily convert. Ultimately, the panel found that a franchisor has the right to adapt its polices, practices, and franchise operating requirements to changes in the marketplace.

The panel recognized that the franchisee's failure to comply with Block's updated policies required Block to take action to protect its franchise system. The panel focused on the franchisee's inability to offer the full spectrum of services available in other H&R Block offices nationally as evidence of how Block's valuable trademarks were being damaged by the franchisee's actions. It also found unsupported the franchisee's claim that Block's new mandatory software would somehow jeopardize the privacy of her client's tax information. Finally, the panel enforced the franchisee's post-termination noncompetition agreement, finding that the franchisee had failed to provide evidence establishing that the provision was overbroad or unreasonable in any way.

COURT FINDS ARBITRATION PROVISION IN FRANCHISE AGREEMENT COVERS CLAIMS ARISING OUT OF RELATED AGREEMENT

A Michigan federal court recently decided that an arbitration provision contained in a franchise agreement governed claims arising out of a subsequent, related agreement. The parties in *Braverman Props., LLC v. Boston Pizza Rests*, 2011 U.S. Dist. LEXIS 68536 (W.D. Mich. June 27, 2011), had a franchise agreement that included an arbitration provision requiring arbitration of "any and all controversies, claims and disputes between [the parties] arising out of or related to this Agreement." The franchise agreement also gave the franchisor, Boston Pizza Restaurants, a right of first refusal if the franchisee sold the real estate or other assets of the business. When the franchisee entered into a purchase agreement with a third party, Boston Pizza notified the franchisee of its intent to exercise its right of first refusal. Boston Pizza later attempted to terminate the purchase agreement, leading the franchisee to bring four claims based on the attempted termination.

Boston Pizza moved to dismiss the claims for lack of subject matter jurisdiction, arguing that the arbitration provision contained in the franchise agreement applied to the claims that arose out of the attempted termination of the purchase agreement. The franchisee maintained that the arbitration provision did not apply since its claims were not based on provisions in the franchise agreement. The court agreed with Boston Pizza, noting that the scope of a broadly worded arbitration clause is determined by asking whether the claim could be maintained without reference to the agreement containing the arbitration provision. In this case, the court reasoned that each claim (common law fraud, breach of contract, tortious interference, and violation of the Michigan Franchise Investment Law) stemmed from the right of first refusal. Because each claim related to a right granted by the franchise agreement, the broadly worded arbitration provision applied, and the court lacked subject matter jurisdiction.

FRANCHISE SALES/FRAUD

NO CLAIM FOR REFUSAL TO PROVIDE SAME STORE SALES UNDER OLD RULE

The federal district court for the Northern District of Illinois recently rejected a franchisee's counterclaims, relating to the franchisor's omission of same store sales information for the franchised unit purchased by the franchisee. In *7-Eleven, Inc. v. Spear,* 2011 U.S. Dist. LEXIS 67415 (N.D. Ill. June 23, 2011), a convenience store franchisee was terminated for consistent failure to maintain a minimum net worth for the franchised store, as required by the franchise agreement. The franchisor obtained summary judgment on its action to enforce termination, leaving only the franchisee's counterclaims, which alleged that the franchisor's presale disclosure activity violated the Illinois Franchise Disclosure Act (IFDA) and the Illinois Consumer Fraud and Deceptive Business Practices Act (ICFA). The franchisee argued that the franchisor should have disclosed the allegedly poor prior financial performance of the unit that was purchased by the franchisee. The court rejected the counterclaim, holding that because the prior FTC Franchise Rule and the UFOC Guidelines (in effect at the time disclosure was made) did not affirmatively require the franchisor to provide same store earnings information, the franchisor had no duty to do so.

The franchisee also argued that, regardless of whether the IFDA or the UFOC Guidelines required it, the franchisor had an independent duty to disclose the poor prior performance of the store to correct a misimpression left by the earnings claim that the store at issue would perform as well as the average. The court flatly rejected this

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argument, noting that to rely on such a misimpression, the franchisee would have had to ignore the express instructions of the earnings claim, including the admonition that franchisees should not use the earnings claim to predict the financial performance of their store. Further, the franchisor's Item 19 disclosure specifically stated that the information represented an average of store earnings for stores which had been open and operating for at least 12 months and excluded the results from stores open for less time, such as the store at issue. The franchisee could not reasonably have been misled about what information the franchisor's earnings claim was communicating. **(Note: the disclosure in this case was made prior to the effective date of the revised FTC Franchise Rule, which now requires disclosure of certain information regarding the past ownership of a previously franchised unit now under the franchisor's control.)**

COURT ALLOWS CLAIMS BASED ON FRAUDULENT COST PROJECTIONS

In *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, 2011 U.S. Dist. LEXIS 73539 (D. Md. July 7, 2011), the federal district court in Maryland this month declined to dismiss several claims brought by a Maryland-based franchisee under the New York Franchise Sales Act (NYFSA) and the Maryland Franchise Registration and Disclosure Law (MFDL). The franchisee alleged that Maoz, a New York-based franchisor of quick-service vegetarian restaurants, had made misrepresentations in its UFOC that induced the franchisee to enter into the franchise agreement. Specifically, the franchisee alleged that it had to spend more than twice the high end of Maoz's cost projections in the UFOC to establish its franchise in Washington, DC.

In analyzing Maoz's motion to dismiss, the Maryland court first looked at whether the NYFSA applied to the Washington, DC franchise. Although a "close" question, the court found that important aspects of the franchise transaction took place in New York. The parties held initial discussions in New York about the potential sale of the franchise, and the franchise agreement and UFOC were both mailed from New York to the franchisee. Finding that Maoz's offer to sell the franchise originated in New York, the court refused to dismiss the NYFSA claims. In analyzing the franchisee's fraud and MFDL claims together, the court determined that "the time, date, place, and contents of the allegedly fraudulent cost projections" were "consistently specific" enough to satisfy the heightened pleading burden under Rule 9(b). Satisfied that the pleading requirements for fraud had been met, the court turned to whether the franchisee had a cognizable fraud claim. The court viewed the fraud claims to be strong, noting that the cost projection in the UFOC could have been underestimated by 85% or more. The court also found that certain language in the UFOC specifically encouraged the franchisee to rely on Maoz's estimates, but whether the cost estimates were statements of fact or statements of opinion required a "context-sensitive inquiry." The court concluded that all the claims were sufficiently pled.

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