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. If you wish to discuss any of these cases further, please call any of the attorneys listed on the back page of this memorandum.

DAMAGES

COURT DENIES FRANCHISEES' MOTION FOR SUMMARY JUDGMENT, FINDING THAT FRANCHISOR COULD RECOVER LOST FUTURE PROFITS

The United States District Court for the Eastern District of Missouri recently issued an important decision for franchisors seeking to recover damages caused by a franchisee's abandonment of the franchise. In *Hardee's Food Systems, Inc. v. Hallbeck*, 2011 U.S. Dist. LEXIS 107038 (E.D. Mo. Sept. 21, 2011), Hardee's sued the Hallbecks when they abandoned their franchised restaurant before the expiration of their franchise agreement. (Gray Plant Mooty represents the franchisor in this case.) Hardee's sought to recover damages caused by that abandonment, including the royalties and advertising fees that the Hallbecks would have paid for the remaining term of the agreement. The Hallbecks moved for summary judgment, contending that Hardee's could not recover prospective fees because it had terminated the franchise agreement following their abandonment and the agreement did not expressly provide for the recovery of post-termination fees.

The court denied the franchisees' motion, finding that Missouri law recognizes the right to recover lost future profits upon a breach of contract. Citing the Fourth Circuit's recent decision in *Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC*, the court found that Missouri courts likely would take the same approach and that a franchisor can, in an appropriate case, recover lost future profits from a franchisee that abandons the franchise before expiration. The court held that the claim by Hardee's need not cite an express contractual provision allowing recovery of future fees, and that Hardee's had presented sufficient evidence to raise a fact question as to the amount of its damages.

Notably, the court also rejected the franchisees' contention that lost future profits could not be awarded under the rationale of the California decision in *Postal Instant Press v. Sealy*. The *Sealy* court held that a franchisor could not recover lost future profits because the franchisor had made the decision to terminate the franchisee's agreement. The Missouri court found that decision inapplicable to the case before it because the Hallbecks had abandoned their restaurant. The court also distinguished its own prior decision in *Medicine Shoppe Int'l, Inc. v. TLC Pharmacy*, which had denied a claim for lost future royalties in similar circumstances.

STATE FRANCHISE LAWS

NEW JERSEY COURT UPHOLDS COMPLIANT FRANCHISEES' RIGHTS TO RENEW

The New Jersey Franchise Practices Act (NJFPA) makes it unlawful for a franchisor to terminate or fail to renew a franchise agreement without good cause. In *BP Prod. N. Am., Inc. v. Hillside Service, Inc.*, 2011 U.S. Dist. LEXIS 10473 (D.N.J. Sept. 14, 2011), a federal district court in New Jersey noted that the NJFPA was not limited to "those situations in which the franchisor seeks to arbitrarily and capriciously terminate the franchise agreement. . . ." It held that the NJFPA also requires the franchisor to renew franchise agreements with New Jersey franchisees regardless of whether the agreements contain an express right of renewal. In granting summary judgment for the franchisee, the court found that the franchisor could only terminate or non-renew an existing agreement where it could show the franchisee's noncompliance with the franchise agreement, despite the franchisor's valid desire to cease franchising in that location.

CONTRACTS

COURT DENIES FRANCHISEE'S MOTION TO DISMISS CLAIM ALLEGING BREACH OF CONTRACT BASED ON UNDERREPORTING OF SALES

In *AAMCO Transmissions, Inc. v. Trovato*, 2011 U.S. Dist. LEXIS 111943 (S.D. Cal. Sept. 28, 2011), a California federal court denied a motion to dismiss AAMCO's claim for breach of contract based on a franchisee's failure to accurately report sales and failure to allow AAMCO to inspect its books and records. The dispute arose when AAMCO learned that the franchisee had completed a $2,400 transaction for a customer, which it did not report to AAMCO. During a resulting audit, AAMCO's inspectors found two books with receipts for transactions that were not reported. When the franchisee refused to allow the inspectors to copy the books, AAMCO sued based on underreporting of sales, fraud, and a declaratory judgment that it could terminate.

The franchises moved to dismiss the underreporting count of the complaint, arguing that it did not allege that the receipt books found by AAMCO's inspectors were the type of books and records contemplated by the inspection and audit provisions of the franchise agreement. It also argued that since the complaint stated that the customer repair cost $2,400, but alleged over $75,000 in damages, AAMCO must have omitted some components of the claim. The court denied the motion to dismiss, finding that AAMCO properly alleged contractual breaches and resulting damages.

NORTH DAKOTA FEDERAL COURT DENIES FRANCHISOR SUMMARY JUDGMENT

In *JMF, Inc., et al. v. Medicine Shoppe International, Inc.*, 2011 U.S. Dist. LEXIS 106100 (D.N.D. Sept. 19, 2011), the federal district court for North Dakota denied, in part, a franchisor's motion for summary judgment, finding that issues of fact existed regarding whether the franchisor had offered new franchises in North Dakota sufficient to trigger a "most favored nations" (MFN) clause contained in the plaintiffs' franchise agreements. Defendant Medicine Shoppe International, Inc. (MSI), the franchisor of nationwide prescription pharmacies, in 2009 announced an overhaul of its franchise program. At the time of the overhaul, the plaintiffs were operating under franchise agreements with most favored nations clauses, which provided that the franchisees could adopt any new or updated terms the franchisor later offered. When MSI later registered a new Medicine Shoppe disclosure document with the North Dakota Securities Commissioner, the plaintiffs asked to convert to the new, more favorable terms it contained. MSI refused. In the ten states where franchisees owned franchise agreements with MFN clauses, MSI declined to offer new Medicine Shoppe franchises. Instead, MSI offered Medicap franchises, a wholly owned subsidiary of MSI, in North Dakota.

In denying MSI's motion for summary judgment, the court found that genuine issues of fact existed with regard to whether MSI "offered" new franchises in North Dakota sufficient to trigger the MFN clause. The court found that registering the FDD in North Dakota and offering Medicap franchises raised fact issues inappropriate for summary judgment. The court did, however, grant summary judgment in MSI's favor on plaintiffs' claims of breach of contract pertaining to advertising, bookkeeping and accounting services, and continuing training and guidance because MSI had retained discretion over the type and amount of such services to offer franchisees.

FRAUD

FRANCHISEE'S FRAUD CLAIM DISMISSED IN LIGHT OF CLEAR DISCLOSURE AND UFOC RECEIPT

In *Moua, et al. v. Jani-King of Minnesota, Inc.,* 2011 U.S. Dist. LEXIS 104026 (D. Minn. Sep. 12, 2011), the United States District Court for the District of Minnesota granted summary judgment in favor of a cleaning service franchisor on a franchisee's claim of fraud. The case was originally brought as a class action (*see* Issue 130 of *The GPMemorandum*) and the bulk of the plaintiffs' claims, including a claim for violation of the Minnesota Franchise Act, later were dismissed (*see* Issue 147).

In the most recent decision, the court addressed a single remaining plaintiff's claim that Jani-King had committed fraud by failing to disclose the terms of its offering. Jani-King had offered each of its franchisees the right to service a certain minimum volume of customer accounts. A customer account is applied toward this quota as long as Jani-King offers it to the franchisee, regardless of whether the franchisee accepts the account. The franchisee alleged that this method of calculating the quota was not disclosed, claiming that it had not actually received Jani-King's UFOC. The court found, however, that no genuine issue of material fact existed as to whether Jani-King had committed fraud. The evidence (including signed receipts) established that the franchisee had received Jani-King's UFOC. Moreover, the UFOC disclosed in clear, plain language that all *offered* accounts would count toward Jani-King's quota of customer accounts that must be offered to the franchisee. Accordingly, the court granted summary judgment in Jani-King's favor on this claim, as well.

COURT DENIES SUMMARY JUDGMENT TO FRANCHISOR ON FRAUD CLAIM

In *Cousin Subs Systems Inc. v. Better Subs Development Inc. et al.*, 2011 U.S. Dist. LEXIS 112903 (E.D. Wis. Sept. 30, 2011), Cousins Subs brought multiple claims against a former franchisee/area developer for breach of contract and failure to pay a promissory note after its two restaurants failed and area development stalled. The franchisee, in turn, brought counterclaims for alleged representations made by a sales consultant (though the court noted the consultant's relationship with Cousins Subs was not entirely clear). The franchisee based its damages claim on what it likely would have earned in its proposed markets. The franchisee had signed two different franchise agreements and an area development agreement.

Cousins Subs moved for summary judgment, arguing that both franchise agreements and the area development agreement contained clear language stating that no representations had been made by Cousins Subs that were not contained in the agreements or the (pre-2007) franchise disclosure documents. Although the court found that a basic fraud claim could not survive this clear no-reliance language, the no-reliance language may not shield the franchisor from a claim of intentional fraud. The court found it an issue of fact whether the Cousins Subs' sales consultant actually made intentionally fraudulent representations regarding the gross revenue of nearby franchisees and the projections for this franchisee's business to induce the franchisee to sign. As for the timing of the fraud claims, Cousins Subs argued that the franchisee should have discovered (or at least disclosed) the fraud at the time the agreements were signed. The court found that "[i]n the absence of a convincing argument and supportive facts from [Cousins Subs] as to when the [franchisee] should have discovered the alleged fraud, the court finds that the fraud was discovered when the [first franchised] restaurant closed," and therefore did not grant summary judgment.

FRANCHISE ASSOCIATIONS

ON RECONSIDERATION, COURT DECLINES TO DISMISS FRANCHISEE ASSOCIATION CASE CHALLENGING FRANCHISOR'S RULES AND PRACTICES

A Connecticut federal court has declined to dismiss a complaint filed by a franchisee association against Edible Arrangements alleging breach of contract, breach of a duty of good faith and fair dealing, and violation of the Connecticut Unfair Trade Practices Act after the franchisor filed a motion for reconsideration. *EA Independent Franchisee Association v. Edible Arrangements, International, Inc.*, Case 3:10-cv-01489-WWE (D. Conn. Sept. 21, 2011). The original ruling was the topic of a special edition of *The GPMemorandum* in August 2011 (Issue 145). Edible Arrangements brought a motion to dismiss the complaint, alleging that the franchisee association lacked standing to bring claims on behalf of its members and that the association's complaint was a blatant attempt to circumvent the individual arbitration clauses in each member's franchise agreement. The court denied the motion to dismiss.

On reconsideration, Edible Arrangements argued that the court overlooked "extensive authority" holding that an association cannot pursue claims on behalf of its members when the members have agreed to mandatory arbitration of those claims. In rejecting this argument, the court held that none of the authority cited was controlling and that most of the decisions involved motions to compel arbitration, not motions to dismiss for lack of standing. The court reiterated that it relied on a Third Circuit opinion, *Penn. Psychiatric Society v. Green Spring Health Services, Inc.*, 280 F.3d 278 (3d Cir. 2002), in which an association survived a motion to dismiss for lack of standing even though an arbitration provision was also at issue. In citing *Penn. Psychiatric*, the court held that dismissal is premature when an association represents that it will be able to meet its burden of proof with minimal participation of its members, even if it appears that it has a questionable chance of success. The court did note, however, that its decision did not preclude Edible Arrangements from seeking to compel individual arbitration.

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