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 summaries of recent decisions and laws of interest to franchisors.

POST-TERMINATION INJUNCTIONS: NON-COMPETE COVENANTS

NON-COMPETE PROVISION EXTENDING TO ALL BUSINESS PRODUCTS AND SERVICES FOUND OVERLY BROAD

A Minnesota federal district court has enjoined a former franchisee's use of its franchisor's trademarks and certain proprietary products, but has refused to prevent the defendant from operating a competing business. In *Novus Franchising, Inc. v. Dawson*, 2012 U.S. Dist. LEXIS 103025 (D. Minn. July 25, 2012), Novus, the franchisor, terminated Dawson's franchise rights and alleged that Dawson breached that agreement's post-termination obligations by operating a competitive automotive glass replacement and repair business under the name of CarMike, and by using the Novus trade name, trademarks, and products in connection with the new business.

The court granted a preliminary injunction to stop Dawson from using Novus' trademarks and products. The court declined, however, to enforce the non-compete provision which applied to "all business products and services that compete with Novus businesses," because such a provision was deemed broader than necessary to protect Novus' legitimate business interests. Novus did not show the court that it would suffer irreparable harm if Dawson were to operate his business without using Novus' products or services, nor did Novus show that the balance of harms or the public interest favored enforcement.

FEDERAL COURT DECLINES TO ENTER PRELIMINARY INJUNCTION TO ENFORCE COVENANT AGAINST COMPETITION

The United States District Court for the District of New Jersey also recently refused to grant injunctive relief to enforce a covenant against competition contained in a franchise agreement. In *Lawn Doctor, Inc. v. Rizzo*, 2012 U.S. Dist. LEXIS 89678 (D.N.J. June 27, 2012), the franchisor sought a preliminary injunction requiring the defendant franchisees to comply with their post-termination obligations. The parties agreed to all the relief sought by Lawn Doctor, except enforcement of the covenant that required the franchisees to refrain from operating a competing business in their territory or any other franchisee's territory for a period of eighteen months after termination.

The court considered whether Lawn Doctor was likely to succeed on the merits of its claim by analyzing whether the covenant was likely to be enforced under New Jersey law. Citing a case involving a restrictive covenant in an employment agreement, the court held that a covenant could be enforced if it protects the legitimate interests of the employer, imposes no undue hardship on the employee, and is not injurious to the public. A covenant also must be reasonably tailored in time, geographic limits, and scope of activities restricted. The court determined that Lawn Doctor had a legitimate interest in protecting its trade secrets, confidential information, customer information, and goodwill. However, it found the geographic scope of the covenant to be unreasonable and not tailored to protect Lawn Doctor's legitimate interests because it would prevent the franchisees from operating a competing lawn care business in 38 states. The court also declined to blue pencil the covenant to reduce its geographic scope because the parties did not present any evidence on that issue.

CONTRACTS

COURT GRANTS FRANCHISEE SUMMARY JUDGMENT IN DISPUTE OVER FRANCHISOR'S ATTEMPT TO ENFORCE PRICING AND PROMOTIONS POLICY

Last month, the United States District Court for the Central District of Illinois granted summary judgment to a franchisee of five Steak N Shake restaurants in a contract dispute over the franchisor's policy requiring all franchisees to "follow set menu and pricing (with the exception of breakfast items), and to offer all company promotions published." *Stuller, Inc. v. Steak N Shake Enterprises, Inc.*, 2012 U.S. Dist. LEXIS 97414 (C.D. Ill. July 12, 2012). According to the plaintiff, the policy was "contrary to long-standing custom, practice, policy, agreement, and representation, that franchisees could set their own prices for menu items and choose whether to follow promotions." When the franchisor threatened to terminate the plaintiff's franchise agreement for failure to comply, the plaintiff filed suit seeking a declaratory judgment that it was not required to comply, for damages for breach of contract, and, in the alternative, for damages based on the alleged violation of the Illinois Franchise Disclosure Act.

In ruling on the parties' cross-motions for summary judgment, the district court noted that the case turned primarily on the language of the franchise agreements. The court found the agreements ambiguous but, after turning to extrinsic evidence, determined that as a matter of law the franchisor could not modify the system to require the plaintiff to follow the franchisor's pricing and promotion decisions. Accordingly, the court granted summary judgment in favor of the franchisee on its request for a declaratory judgment. The court further held that fact questions regarding damages precluded summary judgment on the plaintiff's breach of contract claim.

DISMISSAL GRANTED IN PART AND DENIED IN PART ON FRANCHISE SYSTEM DISTRIBUTOR'S CLAIMS RELATING TO E. COLI OUTBREAK IN 2006

McLane Foodservice, Inc., a regional distributor of raw produce to Taco Bell restaurants, was named as a defendant in several customer lawsuits arising out of a 2006 E. coli outbreak that was allegedly traced to lettuce served at the restaurants. McLane subsequently filed suit against Ready Pac Produce, Inc., who processed produce for Taco Bell, and Tanimura & Antle, Inc., the entity that procured the raw produce processed by Ready Pac. McLane sought to recover inventories, profits, and goodwill that it lost as a result of the outbreak. McLane also asserted claims for indemnification and contribution for money it spent defending and settling the E. coli lawsuits. In *McLane Foodservice, Inc. v. Ready Pac Produce, Inc.*, 2012 U.S. Dist. LEXIS 89087 (D.N.J. June 27, 2012), the court granted portions of Tanimura's motion to dismiss certain counts alleged by McLane.

The court granted Tanimura's motion to dismiss McLane's claim for breach of a supplier agreement for the franchise system. The court held that, even if McLane could claim third-party beneficiary status under the contract, Tanimura could not be held liable because it was not a party to that agreement. With respect to a Safe Produce Guarantee signed by the supplier, the court found that the complaint did not state any facts that could lead to the possible conclusion that the parties intended McLane to have contractual rights thereunder. McLane's quasi contract and unjust enrichment claims also failed, because the complaint did not contain necessary allegations that McLane reasonably expected compensation for defending and settling the legal actions, or that Tanimura accepted those benefits. In addition, the court denied the motion to dismiss McLane's claims for negligence and breach of the implied warranty of merchantability.

This case demonstrates the complexity of liability issues when a food safety incident occurs within a franchise system.

GRAY PLANT MOOTY

TRADEMARKS AND TRADE ISSUES

FLORIDA FEDERAL COURT DISMISSES TRADEMARK CLAIMS DUE TO PLAINTIFF'S INCORRECT CITATIONS

In *Phelan Holdings, Inc. v. Wendy's International, Inc.*, 2012 U.S. Dist. LEXIS 101643 (M.D. Fla. July 3, 2012), the United States District Court for the Middle District of Florida dismissed three trademark-related claims because the plaintiff failed to cite properly to statutory causes of action. The dispute arose in connection with the alleged misuse of plaintiff's service mark "you can't fake fresh." (The plaintiff operates seafood restaurants under the mark "Pincher's Crab Shack.") The court granted leave for the plaintiff to amend its complaint, but specifically noted that the plaintiff could have avoided the issue with "[m]ore careful proofreading."

In response to the plaintiff's federal trademark infringement and trademark counterfeiting claims, the court noted that the Lanham Act provides causes of action under sections 1114 and 1125. Although its complaint made fleeting reference to these sections, the plaintiff cited provisions that set forth remedies only. The complaint likewise made its state law trademark infringement claim by erroneously citing to Florida's trademark *dilution* statute, rather than the infringement provisions. Because the plaintiff did not base its trademark claims upon the proper statutory causes of action, the court granted the motion to dismiss, but did give the plaintiff leave to amend.

ARBITRATION

SILENCE ON CLASS ARBITRATION DOES NOT NECESSARILY BAR ALL CLASS ACTIONS IN ARBITRATION FORUM, FIRST CIRCUIT HOLDS

An association representing its 35 regional franchisee members brought an arbitration proceeding against franchisor Fantastic Sams for breach of contract and other claims on behalf of its members. In *Fantastic Sams Franchise Corp. v. FSRO Association Ltd.*, 683 F.3d 18 (1st Cir. June 27, 2012), FSRO sought declaratory and injunctive relief, but not damages. Fantastic Sams filed a motion in federal court to stay the arbitration and to compel the Association's members to arbitrate their claims individually. The court granted that motion in part, finding that 25 of the members' franchise agreements expressly prohibited class arbitration. Because the remaining ten agreements did not expressly prohibit class arbitrations, FSRO was allowed to proceed with its claims on their behalf in arbitration. Under applicable AAA rules, the arbitrators were to decide whether FSRO could maintain the claims of the ten members.

On appeal to the First Circuit, the franchisor relied on the Supreme Court's decision in *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*. In that 2010 case the court held that "class arbitration may not be imposed on a party to an arbitration agreement 'unless there is a contractual basis for concluding that the party agreed to' submit to class arbitration." The Supreme Court did not indicate what a "contractual basis" for class arbitration is, and it did not rule out the possibility that parties may implicitly authorize class arbitration. The existence of an agreement concerning class arbitration is a question for arbitrators to decide under AAA rules. In *Fantastic Sams*, the franchisor maintained that, under the Supreme Court's decision, only when an arbitration clause expressly allows class arbitration could franchisees arbitrate as a class. The First Circuit rejected that interpretation and agreed with the district court that the decision of whether the parties had agreed to class arbitration was to be made by the appointed arbitrators.

LIMITATION OF ACTION

LIMITATIONS PERIOD UNDER CALIFORNIA FRANCHISE INVESTMENT LAW RUNS FROM TIME OF DISCLOSURE

The California Court of Appeals recently affirmed dismissal of a franchisee's claims for violation of the California Franchise Investment Law (CFIL) and breach of contract, both of which were based on a franchisor's alleged oral promise to grant an additional franchise territory in the future. In *Celsi v. H&R Block Tax Services, LLC,* 2012 Cal. App. Unpub. LEXIS 5275 (July 17, 2012), an H&R Block franchisee entered into a franchise agreement that gave it the right to operate a business in a specific franchise territory. At the same time, the franchisee also executed an addendum giving it the exclusive right to operate an H&R Block business in a second territory in the future, on the same terms and conditions as the first agreement. The franchisee asserted, however, that H&R Block had also orally promised it the right to develop a third business in a third territory, although no written addendum was ever executed. When the franchisee later sought to enter into a franchise agreement for the third territory, H&R Block declined and granted the territory to a different franchisee.

Although neither party had briefed the issue, the court of appeals upheld dismissal of the franchisee's CFIL claims based on expiration of the statute of limitations. The CFIL's limitations period runs for two years from the date a violation occurs or one year from its discovery, whichever expires *first.* Here, the franchisee claimed that H&R Block violated the CFIL by making an untrue oral statement of fact (specifically, that it would grant the franchisee a third franchise territory) when it sold the original franchise. The franchisee's suit was brought 13 years after the time of the franchise sale and thus well outside the CFIL's "hard" two-year limitations period. The court was not persuaded by the franchisee's argument that the violation of the CFIL had not occurred until later when H&R Block decided not to honor its alleged prior promise. The court then proceeded to affirm dismissal of the franchisee's breach of contract claim, relying on the lack of any written evidence granting the third territory and the franchise agreement's unambiguous integration clause.

VICARIOUS LIABILITY

FRANCHISOR NOT LIABLE FOR TEXT MESSAGE MARKETING CAMPAIGN CONDUCTED BY FRANCHISEES

Taco Bell Corp. has won an important ruling in a California federal district court against class action claims involving unauthorized text messages. In *Thomas v. Taco Bell Corp.*, 2012 U.S. Dist. LEXIS 107097 (C.D. Cal. June 25, 2012), the court granted summary judgment dismissing the claims against the franchisor, despite its role in the franchisee advertising association that had approved the text messaging component of the promotion. The texting was alleged to violate a federal statute prohibiting certain unauthorized communications.

In granting summary judgment, the district court found that Taco Bell's Marketing Fund Policy, which was alleged to give it "unfettered control," did not mean the franchisor indeed controlled the ad campaign for vicarious liability purposes. Even if the franchisor may have "held the purse strings" for the local advertising group, that fact alone would not give the franchisor power to stop the franchisees' conduct. The court also ruled that even administrative approval of funding was not sufficient evidence of "control over the manner and means by which the campaign was designed and executed." This ruling was made despite the additional facts that Taco Bell had a corporate representative on the local advertising group which conducted the campaign, the franchisor representative had a vote, and the representative allegedly knew about the texting plan before it occurred. In short, the court ruled that knowledge, approval, and fund administration did not equate to franchisor control.

JURISDICTION AND PROCEDURE

FRANCHISE AGREEMENT WAIVER OF JURY TRIAL UPHELD

A franchisor's motion to strike a franchisee's demand for jury trial was granted after a California federal district court found a contractual jury waiver to be enforceable. In *Century 21 Real Estate LLC v. All Professional Realty, Inc.*, 2012 U.S. Dist. LEXIS 93895 (E.D. Cal. July 6, 2012), the court considered Century 21's motion to strike the demand for a jury trial made by its former franchisee, All Professional Realty, Inc. Century 21 had filed an action based on All Professional's use of Century 21's trademarks after the parties' real estate brokerage franchise agreements were terminated for unpaid fees. All Professional subsequently filed a demand for jury trial, although it had contractually waived that right in the franchise agreements.

By All Professional's own admission, it did not "carefully review" the agreements, even though it signed statements to the contrary. The court also noted that the jury waiver provision was located directly above the signature line, and it was distinguishable from surrounding terms because it was in bold print and capital letters. The court looked to federal law standards in its determination that Century 21 fulfilled its burden to prove the jury waiver clause was entered into knowingly, voluntarily, and intelligently. The court found that there was not a drastic disparity in bargaining power, the parties were educated, experienced professionals, All Professional had the ability to negotiate, and the waiver was readily visible. Consequently, the court refused to invalidate the waiver.

FRANCHISE SALES

MARYLAND FEDERAL COURT EXAMINES FRAUD AND ANTITRUST CLAIMS

A federal court recently dismissed a franchisee's antitrust claims but permitted its fraud claims to proceed. In *Ohio Learning Ctrs., LLC v. Sylvan Learning, Inc.*, 2012 U.S. Dist. LEXIS 102784 (D. Md. July 24, 2012), a Maryland federal court considered claims for fraud and antitrust violations arising out of plaintiffs' purchase of a Sylvan Learning Center franchise. The plaintiffs' fraud claims alleged that, in connection with the sale of the center at issue, the defendants made numerous misrepresentations and material omissions as to the true financial condition of the center in order to effect a quick sale. The franchisor brought a motion to dismiss, arguing that the plaintiffs were fully aware of the financial condition of the center and that there was no fiduciary duty requiring the defendants to disclose certain financial information. The court disagreed, however, noting that the Maryland Franchise Act subjects franchisors to civil liability for failure to disclose a material fact to a prospective franchisee. The defendants also argued that the parties' license agreement precluded any of the plaintiffs' misrepresentation claims based on statements not contained in the agreement, as the instrument included an integration clause. The court again disagreed, holding that an integration clause will not preclude a plaintiff from bringing a tort action for fraud based on false pre-contract promises. The court thus refused to dismiss the plaintiffs' fraud claims.

The plaintiffs also alleged violations of the federal Sherman Act and state Valentine Act, which prohibit conspiracies in restraint of trade. Specifically, the plaintiffs argued that the defendants favored another party by allowing that party to purchase territories surrounding the plaintiffs, thus forcing them out of business. In considering the defendants' motion to dismiss those claims, the court noted that mere allegations of parallel business conduct are not sufficient to state an antitrust claim. Finding that the plaintiffs did not allege any additional facts that would demonstrate the existence of an actual agreement to conspire, or at least eliminate independent, self-interested conduct as an explanation for defendants' parallel behavior, the court granted the defendants' motion to dismiss with regard to the antitrust claims.

PRACTICE OF FRANCHISE LAW

NEW JERSEY COURT DISQUALIFIES FIRM BASED ON CONFLICT OF INTEREST

In a decision with implications for lawyers representing franchisees, a New Jersey court recently disqualified a firm because of a conflict of interest. In *Mody v. The Quiznos Franchise Company*, 2012 N.J. Super. LEXIS 1719 (N.J. Super. Ct. App. Div. July 18, 2012), the New Jersey appellate court disqualified the Marks & Klein, LLP ("M&K") law firm from representing the plaintiffs in a lawsuit against Quiznos after M&K hired an attorney, Andrew Bleiman, who had represented various Quiznos-related entities in litigation relating to franchise disputes. Significantly, the court noted that Bleiman had represented Quiznos in a prior lawsuit involving substantially the same issues and facts that were being litigated by the plaintiffs. The appellate court determined that because Mr. Bleiman was an attorney with primary responsibility in the prior lawsuit, a clear conflict of interest existed that barred the M&K law form from representing the plaintiffs in the current action.

CHOICE OF LAW

NEW JERSEY FEDERAL COURT GRANTS FRANCHISOR SUMMARY JUDGMENT UPHOLDING ITS TERMINATION OF FRANCHISEE FOR FAILURE TO PAY FEES

A federal court recently granted summary judgment to a franchisor despite rejecting the franchisor's choice of law argument. In *Red Roof Franchising, LLC v. AA Hospitality Northshore, LLC*, 2012 U.S. Dist. LEXIS 90564 (D.N.J. June 28, 2012), the United States District Court for the District of New Jersey upheld the termination of a franchisee who ceased making payments under its franchise agreement before completely abandoning the business. The franchisee had operated a Red Roof Inn in Minnesota under an agreement that contained a Texas choice of law provision. Prior to the end of the agreed-upon term, the franchisee ceased operating the business as a Red Roof Inn and began operating it under a different name. Red Roof then terminated the franchise agreement and brought suit for breach of contract, alleging that the franchisee (and two guarantors) failed to pay outstanding franchise fees and continued to use Red Roof's proprietary information and marks following their termination. In response, the franchisee claimed that Red Roof breached the franchise agreement in several respects, and that those failures excused its nonpayment of the required fees. Red Roof sought summary judgment on its claim for breach of the franchise agreement and argued that Texas law should govern any common law issues.

The court first determined that it would apply New Jersey law to the breach of contract claims, despite the Texas choice of law provision in the franchise agreement. The court noted that, although New Jersey law generally enforces choice of law provisions, the franchise at issue was located in Minnesota, which meant that Minnesota had a greater interest in the interpretation of the franchise agreement. The court further observed that the Minnesota Franchise Act voided the contract's choice of law clause, a result that Red Roof itself acknowledged. Applying New Jersey choice of law principles, the court next concluded that it would apply New Jersey law to the contract claims, given that there was no conflict between New Jersey and Minnesota law on the subject.

The court then granted summary judgment on Red Roof's breach of contract claim with respect to the fees that accrued prior to the abandonment of the franchise. The court noted that the franchisee could not respond to Red Roof's alleged breaches by discontinuing its own performance under the franchise agreement while continuing to take advantage of the contract's benefits. The court reasoned that even if Red Roof breached the contract, the franchisee had the option of either terminating the contract and ceasing to perform, or continuing to perform and suing for damages. The court denied summary judgment on Red Roof's claim that the franchisee continued to reap the benefits of the franchise agreement after its termination by using Red Roof's marks and confidential information. Red Roof had not presented any facts in support of this allegation, and a genuine issue of material fact existed as to how the franchisee could operate as a different hotel while still using Red Roof's proprietary materials.

STATE FRANCHISE LAWS

REVISIONS TO OHIO BUSINESS OPPORTUNITY LAW COULD AFFECT SOME FRANCHISORS

Ohio recently revised its business opportunity law, effective September 30, 2012. Notably, the scope of the law was expanded to increase the threshold for the definition of the initial payment, clarify the process for agreement cancellation, and prohibit any "venue or choice of law provision that deprives a purchaser who is an Ohio resident" from the benefits of the law. Although any franchisor who complies "in all material respects" with the FTC's franchise rule is exempt from the Ohio business opportunity law, any franchisor who does not materially comply with the FTC franchise rule and offers franchises in Ohio without complying with the Ohio business opportunity law may be subject to remedies including rescission, damages, and attorneys' fees.

Along with the attorneys indicated on the next page, summer associates D.J. Ringquist, Anjuanna Napune, and Karli Peterson contributed to Issue 156 of *The GPMemorandum*.

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