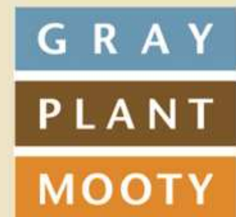

The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

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

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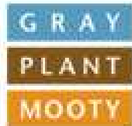
DATE: October 18, 2012—No. 160

Here are summaries of recent decisions of interest to franchisors.

TERMINATIONS

MICHIGAN FEDERAL COURT GRANTS FRANCHISORS' MOTION FOR SUMMARY JUDGMENT AND DISMISSES FRANCHISEES' CLAIMS

In *Dunkin' Donuts Franchising LLC v. Oza Brothers, Inc.*, 2012 U.S. Dist. LEXIS 140595 (E.D. Mich. Sept. 28, 2012), a Michigan federal court granted summary judgment in favor of the franchisors (represented by Gray Plant Mooty) in a case against their former franchisees for breach of contract based on the underreporting of sales, tax fraud, and tax evasion. Oza Brothers owned a Dunkin' Donuts/Baskin Robbins combination franchise in Michigan. Dunkin' began an investigation after receiving a tip that Oza Brothers was not reporting sales made to auto dealerships. The investigation also uncovered various inconsistencies in Oza Brothers' corporate tax returns. Dunkin' terminated the franchise agreement based on these actions, which were material breaches of the agreement, and brought suit against Oza Brothers to enforce the termination. Oza Brothers filed counterclaims alleging fraud, innocent misrepresentation, breach of contract, promissory estoppel, and defamation. Dunkin' amended its complaint to bring a claim for breach of contract based on Oza Brothers' failure to pay rent and brought a motion for a preliminary injunction in order to enjoin its continued use of Dunkin's trademarks. Both Dunkin' and Oza Brothers filed cross motions for summary judgment.

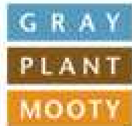


In granting Dunkin's motion for summary judgment, the court found that the franchise agreement allowed Dunkin' to terminate the agreement in the event that the franchisees intentionally underreported gross sales. The court noted that Oza Brothers' president gave conflicting testimony regarding whether the sales were reported to Dunkin', and decided this was evidence of intentional underreporting. The court also found the corporate tax returns showed underreporting of income to the IRS, which constituted a material breach of the franchise agreement warranting termination. In rejecting Oza Brothers' assertion that no taxing authority had determined that a tax deficiency existed, the court held that Dunkin' did not have to wait for the franchisees to be indicted before terminating the franchise agreement. The court then granted Dunkin's motion for a preliminary injunction. In addition, the court dismissed Oza Brothers' counterclaims because it failed to provide any argument supporting its claims.

COURT DENIES INJUNCTION TO FRANCHISEE WHO FAILED TO MEET CURRENT PERFORMANCE STANDARD AFTER RENEWAL

Finding that the defendant franchisee failed to show likelihood of success on the merits, the United States District Court in Nebraska recently denied a motion for a preliminary injunction brought by a Home Instead franchisee who sought to keep operating under two expired franchise agreements. *Home Instead, Inc. v. Florance*, 2012 U.S. Dist. LEXIS 134554 (D. Neb. Sept. 20, 2012). The court relied solely on the interpretation of the language in the franchise agreements in denying the franchisee's request to restore its pre-expiration "operational status quo." The court stated that it did not need to consider the collective balance of other factors normally required for an injunction, such as irreparable harm. Rather, it found that the probability of success on the merits was "nil" because the franchise agreements did not support the franchisee's position.

Prior to expiration, Home Instead offered to renew the franchise agreements but required that the franchisee sign a new agreement with a higher performance standard. The franchisee pointed to a section of the franchise agreement that stated the franchisee must maintain minimum gross sales of $30,000 per month after the end of the fifth year "of the operation of the Franchised Business through the end of the term of this Agreement or any renewal term of a renewal Franchise Agreement." The franchisee argued this language meant the performance standard would remain at $30,000 per month for as long as the franchises were renewed. The court determined that the use of the word "minimums" when describing gross sales at $30,000 created a floor, not a ceiling. Nothing prohibited the franchisor from increasing the minimum amount; instead, the agreements stated that the right to renew was conditioned on the franchisee's agreement to the current standards. The findings also were supported by the fact that, in a previous 2002 renewal, the parties had expressly retained the royalty fee structure for future renewals but did not expressly retain the performance standards.



ANTITRUST

TYING CLAIM AGAINST FRANCHISOR ULTIMATELY FAILS ON OTHER GROUNDS

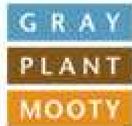
A case that has stood as one of the only recent precedents for an antitrust tying claim in franchising was dismissed last week by the court in *Burda v. Wendy's Int'l, Inc.*, 2012 U.S. Dist. LEXIS 145447 (S.D. Ohio Oct. 9, 2012). Last week's decision favors the franchisor, after the same court twice had refused to dismiss the plaintiff franchisee's tying claims, as reported in Issues 124 and 136 of *The GPMemorandum*. This time, on motion for summary judgment, Wendy's prevailed on all claims, including the challenge to the franchisor's involvement in the supply of products to the system.

Despite this being known all along as an antitrust case, the most interesting aspect of the summary judgment ruling related to Wendy's termination of the franchisee. The court held that the franchisor could terminate Burda's franchisee immediately for multiple defaults within a six-month period, even without providing the contractual 30 days to cure on the last default. The "independent right to terminate" based on multiple defaults also was not modified by the final default notice, which, like the earlier notices, referenced the normal time to cure. Moreover, Wendy's also had the right to terminate immediately based on the franchisee's insolvency. As to the antitrust tying claim, which the court earlier had refused to dismiss, summary judgment was granted because the evidence ultimately showed the plaintiff in prior agreements had released all claims against the franchisor. The fact that plaintiff Burda was a licensed lawyer was an important factor for the court in holding the releases enforceable.

ARBITRATION

COURT ALLOWS FRANCHISOR'S ACTION TO FORCE ARBITRATION AGAINST INDIVIDUAL MEMBER OF FRANCHISEE ASSOCIATION

An Arizona federal district court this month ruled that a franchisor could continue to seek to compel arbitration against a member of its franchisee association, even though the association itself had first sued the franchisor in another state. *Cold Stone Creamery, Inc. v. Nutty Buddies, Inc.*, 2012 U.S. Dist. LEXIS 142955 (D. Ariz. Oct. 3, 2012). The Arizona case filed by Cold Stone seeks a declaratory judgment against franchisee Nutty Buddies, Inc. to compel arbitration of the dispute at the heart of a separate state-court action brought earlier in Florida by the Cold Stone franchisee association, the National Independent Association of Cold Stone Creamery Franchisees, Inc. (NIACCF). NIACCF had sued Cold Stone for allegedly failing to provide accounting information regarding third party suppliers to its franchisee members. When the franchisor filed its federal



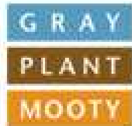
court action to require individual arbitration of those issues, Nutty Buddies filed a motion to dismiss, arguing that the NIACCF lawsuit was the "first-filed," and that NIACCF is not a party to the franchise agreements that contain arbitration clauses, so it cannot be compelled to arbitrate. At the franchisor's request, the Florida action was stayed by the federal court while the Arizona court decided whether to allow the action to force individual franchisees to arbitrate their claims.

The Arizona court sided with Cold Stone and denied Nutty Buddies' motion to dismiss. Although the court did not address whether it would, in fact, compel arbitration eventually, the court found that the arbitration clause in the franchise agreement was broad enough to extend to the dispute involved in the NIACCF action. The franchise agreement required that the parties arbitrate all disputes "related in any way to this Agreement or the relationship between the parties." As for Nutty Buddies' "first-to-file" argument, the court held that the doctrine did not apply because the actions must have identical parties, and Cold Stone had sued Nutty Buddies as an individual franchisee; the association was not a party to the Arizona action.

MOTION TO COMPEL INDIVIDUAL ARBITRATION GRANTED

In *Kairy v. Supershuttle International, Inc.*, No., 2012 U.S. Dist. LEXIS 134945 (N.D. Cal. Sept. 20, 2012), the United States District Court for the Northern District of California granted a franchisor's motion to stay proceedings and to compel individual arbitration of franchisees' claims. The franchisees, who are former airport shuttle drivers, brought suit in federal court alleging that Supershuttle violated the Fair Labor Standards Act and applicable state law by failing to pay minimum wages and overtime. Supershuttle moved to compel arbitration on the grounds that the franchise agreements specifically called for arbitration in the event of any controversy between the parties, and most of the agreements provided that the arbitrations had to proceed on an individual, not class-wide basis. In opposing the motion, the franchisees argued that Supershuttle had waived arbitration and that the arbitration agreements were unconscionable.

The court found that Supershuttle did not waive its right to enforce the class action waivers in the franchise agreements, reasoning that it would have been futile for Supershuttle to try to compel individual arbitration any earlier. California and Ninth Circuit law previously prohibited similar arbitration agreements with class action waivers, and Supershuttle moved promptly to invoke the arbitration provisions once newer Supreme Court precedent made it clear that they could be enforced as written. The court further held the franchisees failed to demonstrate they would suffer prejudice in arbitration. The court also found the arbitration provisions not unconscionable, given that the franchisees received a 14-day period before signing the agreements and the agreements' potentially burdensome fee-splitting requirements could be severed.



DAMAGES TO FRANCHISOR

COURT RULES FOR PLAINTIFF FRANCHISOR ON SUMMARY JUDGMENT

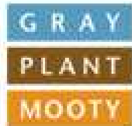
In *Six Continents Hotels, Inc. v. CPJFK, LLC*, 2012 U.S. Dist. LEXIS 131675 (E.D.N.Y. Sept. 11, 2012), the franchisor of the Crowne Plaza Hotels system was awarded a large judgment against a terminated hotel franchisee that had failed to meet its financial obligations. The judge granted the franchisor's unopposed motion for summary judgment on liability. The court ruled that franchisor Six Continents was entitled to terminate the agreement and collect damages. The court went on to find Six Continents could collect unpaid fees and liquidated damages, and it approved the formula set forth in the license agreement to calculate liquidated damages.

As to the specific amount of damages, at a magistrate judge's request, the franchisor submitted a supplemental memorandum and declaration from its credit and collections manager. The magistrate found the franchisor's submissions sufficient to provide a basis for the specified damages. The submission on unpaid fees of over $326,000 was properly supported by a "Fact Sheet" showing each credit and charge on the franchisee's account, the court found, and the submission supporting liquidated damages of $1,973,689.37 properly tracked language in the license agreement and was compliant with the applicable state law of Georgia, which requires liquidated damages to bear a reasonable proportion to the probable loss sustained by the plaintiff.

TRADEMARKS AND TRADE ISSUES

DISPUTE OVER MERITS OF FRANCHISE AGREEMENT TERMINATION IS NOT ENOUGH TO DEFEAT SUMMARY JUDGMENT ON TRADEMARK INFRINGEMENT

The United States District Court for the Southern District of Ohio recently granted summary judgment in favor of Choice Hotels on a claim for trademark infringement by a terminated Econo Lodge franchisee. In *Choice Hotels International, Inc. v. Jagaji, Inc.*, 2012 U.S. Dist. LEXIS 128048 (S.D. Ohio Sept. 10, 2012), the hotel franchisor sent its franchisee notices of default, citing the franchisee's failure to respond to guest complaints and its failure to pay amounts due under the franchise agreement. Choice subsequently terminated the franchise agreement when the franchisee failed to cure its defaults. Despite termination of the franchise agreement, the franchisee continued to use the Econo Lodge trademark on the hotel's signage and in advertisements promoting the hotel. The franchisee persisted in its use of the marks even after Choice sent a trademark infringement letter, ordering the former franchisee to cease all further uses of the Econo Lodge trademarks.



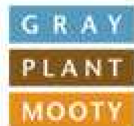
In response to Choice's motion under trademark law, the franchisee asserted that material factual disputes precluded summary judgment, including disputes as to whether the franchisee breached the franchise agreement and whether Choice was justified in terminating the agreement and revoking the franchisee's right to use the trademarks. The court found that, regardless of the merits of the underlying termination, there was no factual dispute as to whether the former franchisee's authorization to use the trademarks had been terminated by Choice. Thus, the franchisee's continued use of the marks after revocation of its license constituted infringement, and Choice was entitled to summary judgment on the claim.

JURISDICTION AND PROCEDURE

COURT TRANSFERS TERMINATION ACTION AFTER FRANCHISEE AND PERSONAL GUARANTORS MOVE TO DISMISS ON JURISDICTION AND VENUE GROUNDS

The United States District Court for the Western District of Kentucky this month transferred an action brought by franchisor KFC Corporation against a terminated corporate franchisee and its personal guarantors, finding that while the court had jurisdiction over the corporation, it did not have personal jurisdiction over its personal guarantors. Therefore, the court transferred the entire action to the United States District Court for the Northern District of Texas. *KFC Corp. v. Texas Petroplex, Inc.*, No. 3:11-cv-00479 (W.D. Ky. Oct. 5, 2012).

In determining that the franchisee was subject to personal jurisdiction in Kentucky, where KFC is headquartered, the court noted that the franchise agreements stated they were made and accepted in Kentucky, and that the franchisee's representatives had signed the agreements and returned them to KFC in Kentucky, where KFC's representatives signed them. It also determined that the franchisee knew it was entering into a long-term business with a Kentucky corporation and that it would be required to adhere to menu, advertising, and facility standards that emanated from KFC's Kentucky headquarters. To the court, it mattered not that the franchisee sent its royalties payments to states other than Kentucky, as it found that there was still "little doubt" that the payments were ultimately being made to the franchisor in Kentucky. However, the court also determined that the personal guarantors did not fall within Kentucky's long-arm statute because—unlike the corporate franchisee and the franchisor—the guarantors and KFC did not contemplate regular contact with each other when the guarantors executed the guarantees. Because the court determined that it was in the interest of justice to transfer the personal guarantors' cases to Texas, it decided to also transfer the case against the corporate franchisee for efficiency's sake due to the related nature of the claims against all defendants.



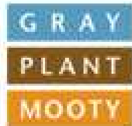
POST-TERMINATION INJUNCTIONS: NONCOMPETE COVENANTS

COURT HOLDS FRANCHISEES IN CONTEMPT BUT FINDS FRANCHISOR FAILED TO PROVE FRANCHISEES WERE VIOLATING NONCOMPETE

In *JTH Tax, Inc. v. Noor*, 2012 U.S. Dist. LEXIS 138657 (E.D. Va. Sept. 26, 2012), the franchisor filed a motion for contempt against the terminated franchisees for violating a default judgment order that, in part, enjoined the franchisees from operating a tax preparation business in violation of the franchise agreement's noncompete provision and required the franchisees to return certain information and materials belonging to the franchisor. In support of its motion, the franchisor showed that, among other things, the terminated franchisees were preparing tax returns, soliciting the franchisor's customers, and retaining customer lists, customer tax returns, and the franchisor's operations manual in violation of the court's order. Following a hearing on the franchisor's motion—at which the franchisees failed to appear—the court held the terminated franchisees in contempt of court for not turning over the franchisor's materials. But the court also found that the franchisor had failed to provide clear and convincing evidence that the franchisees were still operating a competing business in violation of the restrictions set forth in the covenant not to compete. Nonetheless, as a matter of equity, the court extended its injunction to run for two years from the time that the franchisees had come into compliance with the covenant.

COURT GRANTS INJUNCTION REQUIRING FRANCHISEES TO STOP VIOLATING COVENANT NOT TO COMPETE

A North Carolina federal court recently held that a franchise is a legitimate interest that warrants protection by a covenant not to compete. *Econo-Lube N' Tune, Inc. v. Orange Racing, LLC*, 2012 U.S. Dist. LEXIS 129219 (W.D.N.C. Sept. 10, 2012). The franchisees operated an Econo-Lube franchise and had agreed not to compete or have an interest in any similar business. When the franchisor learned the franchisees had an interest in a competing business, the franchisor served them with a notice of default. The franchisees then abandoned the franchise but began operating the same business within a mile of their former location. The franchisor sued and moved for an injunction, which the court granted after the franchisees and their attorneys failed to appear at the hearing. In its opinion, the court decided that the franchisor was likely to prevail. According to the court, the franchisor would be irreparably harmed if its former franchisees are allowed to continue operating. It would also deprive the franchisor of the customers that were established during the franchise relationship and make it harder to place a reputable franchisee in the area.



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