The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

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

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CASE SUMMARIES

Below are summaries of recent case decisions of interest to franchisors. On page 9, we also summarize in *The GPMemorandum—International* a recent arbitration decision out of Canada on the important topic of system change.

POST-TERMINATION INJUNCTIONS: NONCOMPETE COVENANTS

EIGHTH CIRCUIT DENIES INJUNCTION TO STOP COMPETITION BY FORMER FRANCHISEE, AND DISTRICT COURT ALLOWS COUNTERCLAIM

The United States Court of Appeals for the Eighth Circuit last month upheld a district court's denial of injunctive relief for a franchisor that had waited too long to enforce a former franchisee's post-termination covenant against competition. *Novus Franchising, Inc. v. Dawson*, 2013 U.S. App. LEXIS 16103 (8th Cir. Aug. 5, 2013). The district court subsequently allowed the franchisee's counterclaims under the Minnesota Franchise Act to proceed. *Novus Franchising, Inc. v. Dawson*, 2013 U.S. Dist. LEXIS 117717 (D. Minn. Aug. 20, 2013). This case began in 2012, when Novus Franchising, Inc. filed suit and moved for a preliminary injunction to enforce the franchise agreement's post-term noncompetition provisions and to prohibit the former franchisee from using Novus's trademarks and products in his ongoing automotive glass repair business. Although the Minnesota district court granted Novus's request to prohibit Dawson from using the franchisor's trademarks and products, the court denied the request to enforce the post-term covenant, concluding that Novus would not suffer any irreparable harm.

On appeal, Novus claimed that Minnesota courts infer irreparable harm from the breach of a valid and enforceable noncompete clause. In affirming denial of the injunction, the Eighth Circuit reasoned that the lengthy delay between the time Dawson ceased paying royalties and the time Novus sought injunctive relief—a period of over seventeen months—rebutted any inference of irreparable harm. Further, the appellate court questioned whether the franchisor's alleged injuries of loss of customers or customer goodwill were truly irreparable, or whether monetary damages were sufficient.

In response to the franchisor's filing of the action, Dawson asserted counterclaims alleging common law fraud and a violation of the Minnesota Franchise Act. After the Eighth Circuit's decision on the injunction issues, the district court separately ruled that none of the counterclaims were barred by Minnesota's three-year statute of limitations. As to Dawson's Minnesota Franchise Act claim, the court held that the "discovery rule" applies to a claim for misrepresentation or fraud, meaning that Dawson could proceed on the basis that he did not discover the facts underlying the fraud until within the three-year statutory period. The court further held that when a cause of action contains a "damages" element, the statute of limitations does not begin to run until at least some damage has been sustained. In applying this rule, the court concluded that Dawson did not begin to sustain damages until almost two years after he learned of the alleged misrepresentation and well within the statutory period.

EMPLOYMENT

FRANCHISOR WINS LATEST ROUND IN THE *AWUAH* SAGA

The battle continues in the case of *Awuah v. Coverall North America*. As regular readers of *The GPMemorandum* will recall, *Awuah* is a class action matter involving janitorial services franchisees. The lawsuit asserts that the class of franchisees should be considered to be employees, instead of as franchisees and independent contractors, for purposes of applying minimum wage and overtime laws. As first reported in Issue 130 of *The GPMemorandum* (May 2010), the franchisee class survived summary judgment on its claims, sounding alarm bells throughout the franchising community. As noted in Issues 131 and 136, however, Coverall overcame the original adverse ruling on potential liability, by securing favorable rulings on the franchisees' damages case. The most recent ruling in *Awuah* involves ten arbitration claimants that were separated from the class because the arbitration clauses in their franchise agreements were found to be valid and enforceable. *Awuah v. Coverall N. Am.,* U.S. App. Lexis 18165 (1st Cir. Aug. 30, 2013). When the judge in the underlying district court matter issued a ruling that threatened to expand class of plaintiffs, Coverall asked for and received a 60-day stay of the arbitration proceeding with the ten arbitration claimants, while it considered its appeal options regarding the ruling. In connection with the skirmishing over the issue of class certification, the 60-day stay of arbitration, and a subsequent bench order from the district court instructing the parties to present motions to the court, the district court sanctioned Coverall for what it perceived was a violation of the bench ruling. On appeal of the order for sanctions, however, the First Circuit now has held that the district court's bench order did not explicitly and unambiguously lift the 60-day stay and that Coverall's argument to the arbitrator was reasonable based on the plain words of the bench order. The order for sanctions against Coverall therefore was vacated.

DAMAGES TO FRANCHISOR

COURT AWARDS FRANCHISOR $3.1 MILLION IN ATTORNEYS' FEES BASED ON CONTRACTUAL FEE-SHIFTING PROVISION IN FRANCHISE AGREEMENT

A federal court in Missouri recently granted a significant award of attorneys' fees to a franchisor based on the contractual fee-shifting provision contained in the franchise agreement between itself and the franchisee. In *Coral Group, Inc. v. Shell Oil Co.*, 2013 U.S. Dist. LEXIS 113219 (W.D. Mo. Aug. 12, 2013), the court agreed to award over $3.1 million in attorneys' fees and expenses incurred over an eight-year period defending against claims related to Coral Group's operation of Shell gasoline stations and convenience stores. In a previous ruling that had been upheld by the Eighth Circuit, the court had dismissed Coral Group's complaint as a sanction for spoliation of evidence. The court concluded that the dismissal of the complaint qualified Shell as the "prevailing party" under the contract's terms, even though it did not allege that Coral Group had violated any contractual obligations. Although Shell had not specifically asked for attorneys' fees in their answer to the complaint, the court concluded it could properly seek an award based on the contractual attorneys' fees provision by motion at the conclusion of trial.

After considering the amount of fees and the large number of hours that had been billed by defense counsel, the court concluded that the amount sought by Shell was reasonable. The court noted that Shell was a sophisticated consumer of legal services who would carefully review its bills and dispute excessive fees. The court found that defense counsel's practice of regularly invoicing its fees over the course of the eight years of litigation—as well as the fact Shell paid each of those invoices in full—suggested that the amount was reasonable. The amount was also reasonable in light of the nature of the case, which was a complicated business dispute that initially involved a claim for $65 million in damages, according to the court. Coral Group had itself litigated the case tenaciously as a "bet the company" lawsuit, so the court stated that Coral Group could not complain about the amount of time spent on defense. Finally, the court noted that the outcome of the case—dismissal with prejudice based on Coral Group's bad faith conduct—was itself a result that justified the size of Shell's large bill.

CONTRACTS

ECONOMIC LOSS DOCTRINE BARS FRANCHISEE TORT CLAIMS PREMISED ON PRE-AGREEMENT MISREPRESENTATION

A Wisconsin federal district court dismissed a terminated franchisee's tort based claims premised on a pre-agreement misrepresentation by the franchisor, but refused to dismiss—for the time being—the franchisee's unjust enrichment claim. *ERA Franchise Sys., LLC v. Hoppens Realty, Inc.*, 2013 U.S. Dist. LEXIS 107078 (W.D. Wis. July 31, 2013). Prior to the execution of a franchise agreement, a representative from ERA allegedly told the franchisee that it would receive support and training from ERA during the franchise relationship. The franchisee claimed that ERA made the statement knowing that it was not true, and that it did not receive support and training. After the franchisee stopped paying royalties, ERA terminated the franchise agreement and initiated a lawsuit for breach of contract and trademark infringement. The franchisee asserted a number of counterclaims, including claims for breach of contract, unjust enrichment, intentional misrepresentation, conversion, and violation of the Wisconsin Fair Dealership Law.

Applying the economic loss doctrine, which bars tort claims for purely economic losses arising out a contractual relationship, the court granted ERA's motion to dismiss the franchisee's claims for intentional misrepresentation and conversion. The court held that although Wisconsin law does not recognize the economic loss doctrine in contracts for services, New Jersey law does, and the franchise agreement dictated that New Jersey law control on the issue. The court, however, refused to dismiss the franchisee's unjust enrichment claim. It did not agree with ERA's argument that the claim was undermined because the franchisee had continued to receive the benefit of operating as an ERA franchisee for at least two years after ERA's alleged breach.

NEW JERSEY FEDERAL COURT HOLDS THAT INTEGRATION CLAUSE BARS CLAIMS BASED ON PRECONTRACTUAL REPRESENTATIONS

In *Joseph McSweeney Enterprises, LLC v. Mr. Softee Sales and Manufacturing, LLC*, 2013 U.S. Dist. LEXIS 122279 (D.N.J. Aug. 17, 2013), the United States District Court for the District of New Jersey granted Mr. Softee and its affiliates' motion to dismiss a franchisee's claims for fraud, breach of the New Jersey Consumer Fraud Act (CFA), breach of warranty, and breach of contract based on an integration clause in the franchise agreements. The franchisee claimed that the ice cream trucks it purchased from Mr. Softee's affiliate pursuant to its franchise agreements did not function correctly in warmer climates, despite Mr. Softee's presale representations that the trucks had the ability to operate properly for the franchisee's business. Mr. Softee and its affiliate contended that the franchisee failed to state a claim for fraud, breach of the CFA, and breach of warranty because neither the franchise agreements nor the vehicle sales agreement contained any representations or promises regarding the functionality of ice cream trucks, and those contracts contained integration clauses. The franchise agreements merely required the franchisee to purchase a truck meeting Mr. Softee's standards and specifications, and the vehicle sales agreement stated that, with the exception of manufacturer's warranties, the seller made no warranties, express or implied, as to the merchantability of the equipment or its fitness for a particular purpose.

The court held that the integration clauses in the franchise agreements and vehicle sales agreements barred the franchisee from introducing extraneous evidence outside of the contracts. In addition, the "fraud exception" to the parole evidence rule did not apply because the franchisee was not attempting to clarify existing provisions in the parties' contracts, but rather sought to alter the parties' obligations with respect to matters wholly extraneous to the agreements. With regard to the breach of contract claim, the court held that the franchisee failed to plead the required elements necessary to sustain the claim because it failed to identify any obligation under the contract that Mr. Softee failed to perform. Accordingly, the court granted Mr. Softee's motion to dismiss the complaint in its entirety.

TERMINATIONS

COURT ISSUES PRELIMINARY INJUNCTION AGAINST FRANCHISEES WHO FAILED TO FOLLOW PROMOTION

A United States District Court in Colorado last week issued a preliminary injunction against Steak 'n Shake franchisees who were terminated for failing to honor the system's mandatory promotional programs. *Steak 'n Shake Enters., Inc. v. Globex Co.*, 2013 U.S. LEXIS 125330 (D. Colo. Sept. 3, 2013). Specifically, the franchisees refused to comply with the chain's "$4 meal" menu, and a codefendant had failed to open stores required under an area development agreement. The injunction order prohibits the defendants from operating certain terminated restaurants and using the Steak 'n Shake trademarks.

Despite ordering deidentification of the restaurants, the court did find that the franchisor was required to show that its termination was "proper" before the trademark injunction would be granted. The terminations were proper, the court held, because the former franchisees knowingly refused to adhere to the system's maximum prices for specified menu items. That violation of the franchise agreement, along with the area developer's failure to open the requisite number of stores, provided sufficient "likelihood of success on the merits" to support the preliminary injunction on the breach of contract and trademark infringement claims.

FRANCHISE SALES

MARYLAND DISTRICT COURT DENIES FRANCHISEE'S EARNINGS CLAIMS

In *WW, LLC v. The Coffee Beanery, Ltd.*, 2013 U.S. Dist. LEXIS 100673 (D. Md. July 17, 2013), the United States District Court for the District of Maryland granted in part and denied in part Coffee Beanery's motion for summary judgment relating to the franchisee's claims alleged under the Maryland Franchise Act. WW alleged that Coffee Beanery violated Section 14-227 of the Act, which creates civil liability if the person who sells or grants a franchise makes an untrue statement or omission of a material fact to induce an unaware buyer to purchase a franchise. WW claimed that Coffee Beanery made several misrepresentations or omissions in the UFOC relating to its business and franchising experience, the criminal background of one of its employees, as well as certain required contracts and programs. The court found that there were genuine issues of material fact relating to a majority of WW's misrepresentation claims under the MFA. However, the court held that WW's misrepresentation claim did not include an earnings claim because it only addressed alleged misrepresentations in the UFOC.

Subsequently, WW moved the court to reconsider its order with respect to the earnings claim. *WW, LLC v. The Coffee Beanery, Ltd.*, 2013 U.S. Dist. LEXIS 122345 (D. Md. Aug. 28, 2013). The court agreed to consider an earnings claim as part of the misrepresentation claim, but still granted summary judgment in favor of Coffee Beanery. WW alleged that a representative of Coffee Beanery misrepresented potential net earnings, and that a pro forma misstated the average revenues of Coffee Beanery cafes. However, the franchisee had testified that he believed the comments made by the representative were "puffing" and that he did not consider the significance of the pro forma numbers provided. Additionally, WW had disclaimed any reliance on representations regarding potential revenues and profits in the franchise agreement. Therefore, the court determined that the claim failed for WW's lack of evidence of reliance on the alleged misrepresentation. The court also stated that even if reliance had been demonstrated, case law established that misrepresentations regarding projected future earnings or profitability are not actionable. Therefore, the court granted summary judgment in favor of Coffee Beanery on the earnings claim.

VICARIOUS LIABILITY

COURT GRANTS DISMISSAL OF DISCRIMINATION CLAIMS AGAINST FRANCHISOR

A federal district court in Arizona recently held that a franchisor was not liable for Title VII claims brought by an employee of one of its franchisees. In *Courtland v. GCEP-Surprise, LLC*, 2013 U.S. Dist. LEXIS 105780 (D. Ariz. July 29, 2013), the plaintiff sued a franchisee as well as the franchisor, Buffalo Wild Wings, alleging that she was subject to sexual discrimination, harassment, and retaliation by members of the restaurant's management staff. Buffalo Wild Wings moved for summary judgment on the plaintiff's claims and argued that it could not be held liable for her allegations of employment discrimination because it was not her employer, nor was the franchisee its agent for purposes of vicarious liability.

In granting summary judgment, the court held that Buffalo Wild Wings was not liable because the record did not establish that it controlled the labor relations of its franchisee. The court first applied the joint employer test, under which a franchisor can be held liable for the discriminatory conduct of a franchisee if both businesses exercise significant control over the terms and conditions of a claimant's employment. The court determined that Buffalo Wild Wings did not qualify as a joint employer because the franchisee had complete independence in making employment decisions related to the plaintiff and other staff. The court further found that the franchisor's general supervision over the franchisee's products and operations was insufficient to establish a joint employment relationship absent its involvement in day-to-day employee management. In addition, Buffalo Wild Wings could not be held vicariously liable under an agency theory because the franchisee had sole responsibility for hiring, training, supervising, scheduling, compensating, reviewing, and terminating employees. Finally, there was no evidence in the record that the plaintiff reasonably relied upon representations by the franchisor that it was her employer such that liability could be imposed under a theory of apparent authority.

CHOICE OF FORUM

COURT FINDS NEW JERSEY FRANCHISE PRACTICES ACT APPLIES TO DEVELOPMENT AGREEMENT AND DECLINES TO ENFORCE FORUM CLAUSE

The United States District Court for the District of New Jersey recently denied a franchisor's motion to dismiss based on an area development agreement's forum selection clause, on the ground that the contract had created a "franchise" and controlling state law did not enforce such clauses against New Jersey franchisees. The parties in *Navraj Restaurant Group, LLC v. Panchero's Franchise Corp.,* 2013 U.S. Dist. LEXIS 115199 (D.N.J. Aug. 14, 2013), had entered into an area development agreement under which the developer had the right to recruit and solicit franchisees in New Jersey. The contract contained a forum selection clause that required any claims arising out of the agreement or the parties' relationship to be brought in Cook County, Illinois. Nonetheless, Navraj brought suit against Panchero's in federal court in New Jersey, alleging that Panchero's had made false and misleading statements meant to induce Navraj to sign the agreement, and thereafter breached the contract.

Panchero's moved to dismiss the complaint based on the forum selection clause. While the New Jersey Franchise Practices Act presumes that a forum selection clause in a contractual relationship between a franchisor and franchisee is invalid, Panchero's argued that the development agreement had not created a "franchise." The court disagreed, noting that the agreement obligated Navraj to pay a "franchisee fee," explicitly granted it the right to use Panchero's trademarks, and required it to open a franchise of its own in New Jersey. Thus, the agreement met each of the Act's statutory requirements for creating a "franchise." Finally, the court held that Panchero's could not overcome the forum selection clause's presumption of invalidity under New Jersey law because it had not shown that the clause was "not imposed because of its superior bargaining power."

ARBITRATION

FEDERAL COURT REMANDS CASE TO ARBITRATION

A federal court in Louisiana has ruled that the arbitrator is the appropriate person to decide both substantive questions and questions of arbitrability under a franchise agreement requiring arbitration of "all disputes." *Planet Beach Franchising Corp. v. Zaroff*, 2013 U.S. Dist. LEXIS 121908 (E.D. La. Aug. 27, 2013). This case began when the owners of four Planet Beach salons, all operated under separate franchise agreements, filed a demand for arbitration claiming that Planet Beach allegedly made a number of material misrepresentations and omissions in its sales documents and elsewhere during the process of selling franchises to the franchisees between the years 2005 and 2008. Planet Beach filed a motion in federal court to compel arbitration, contending that the terms of the franchise agreements did not allow the franchisees to consolidate their claims and assert one demand for arbitration. The franchisees opposed that motion and filed a motion to dismiss.

The issue before the federal court was who should determine whether the franchisees could consolidate their claims and move forward with one arbitration proceeding—the court or the arbitrator. Planet Beach contended that it was for the court to decide the issue. The court disagreed. It determined that the arbitration clauses were broadly worded in that they provided for arbitration of "all disputes" and claims "relating to this Agreement or any other agreement entered into between the parties . . . ." The court reasoned that the parties had agreed to submit their dispute to arbitration, including the question of arbitrability, and therefore it was for the arbitrator to decide whether the franchisees could assert all of their claims in one arbitration action.

SYSTEM CHANGES

CANADIAN ARBITRATION PANEL CONCLUDES REQUIRED SOFTWARE IS PART OF FRANCHISE SYSTEM

In a recent award, a panel of three arbitrators in Canada concluded that H & R Block Canada was entitled to require franchisee Gerger Enterprises to use computer tax preparation software provided by Block. *Gerger Enters. Ltd. v. H & R Block Canada, Inc.*, Private Arbitration Award (Aug. 1, 2013). The dispute arose when Block decided that it was desirable to have uniform tax preparation software used by all of its franchisees, which would, among other things, enable expanded communication between the company and its many franchised offices. Block therefore amended its operations manual to require use of its software by all of its franchisees. Gerger objected on the grounds that its franchise agreements could not be amended through changes or additions to the manual, which Gerger argued was intended to deal only with less substantive matters. Although the franchise agreements did not contain a specific provision obligating Gerger to use software designated by Block, the panel agreed with Block that the obligation arose from the meaning of the "H & R Block System," which the franchise agreements required Gerger to follow in providing services. Thus, the panel concluded that the obligation to use the H & R Block System included the obligation to use Block's software once that software was required by the manual.

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