GRAY PLANT MOOTY

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: November 7, 2013—No. 174

Below are summaries of recent case decisions of interest to franchisors, along with a summary of recent franchise law developments in Maryland.

CLASS ACTIONS

COURT APPROVES SETTLEMENT IN CLASS ACTION LAWSUIT FILED AGAINST FRANCHISOR

A class action settlement has been approved in *Swift v. DirectBuy, Inc.*, 2013 U.S. Dist. LEXIS 152618 (N.D. Ind. Oct. 24, 2013), in which current and former member-customers of buying club franchisor DirectBuy sued the company alleging that they did not enjoy savings commensurate with their membership fee. The plaintiffs alleged that DirectBuy failed to disclose material information regarding the true prices for its products and the fact that DirectBuy received payments from vendors, manufacturers, and suppliers but did not pass along these savings to members. After the court certified the class, the parties reached a settlement that requires DirectBuy to pay $1.9 million, including $900,000 in attorneys' fees. The settlement provided that the individual members could receive a cash distribution or a discount of $10 off future purchases. Several class members objected to the settlement amount as too low. After the court conducted a fairness hearing, in which the objectors failed to appear, the court issued an opinion approving the settlement.

In assessing the settlement, the court noted that it satisfied the requirements of Federal Rule of Civil Procedure 23(c)(2)(B), which requires that class members receive notice of the settlement. The notice reached 99% of class members, which exceeded the 70% to 95% threshold recommended by the Federal Judicial Center. Turning to the adequacy of the settlement, the court

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found it was fair, reasonable, and adequate. In assessing a class action settlement, a court generally weighs five factors: (1) the strength of plaintiffs' case compared to the defendants' offered settlement amount; (2) the likely complexity, length, and expense of the litigation; (3) the amount of opposition to settlement among affected parties; (4) the opinion of competent counsel; and (5) the stage of the proceedings and the amount of discovery completed at the time of settlement. In this case, the court focused on the fact that class members would be compensated immediately. This was important because DirectBuy's financial condition was "dire" and its indebtedness exceeded the value of its tangible assets. The court found that, if the parties continued to litigate, it would be uncertain whether DirectBuy could satisfy any judgment. Finally, in affirming the award of $900,000 in attorneys' fees, the court considered the merits of the dispute, the substantial risk of nonpayment to counsel, and the complexity of the case in concluding the fee award was fair and reasonable.

FRAUD

ILLINOIS APPELLATE COURT AFFIRMS DISMISSAL OF FRANCHISEE'S FRAUD CLAIMS

Franchisor Ace Hardware Corporation recently prevailed on appeal—as it had in the lower court—against claims that it had committed fraud in selling two franchises. *Avon Hardware Co. v. Ace Hardware Corp.*, 2013 Ill. App. LEXIS 743 (Ill. App. Oct. 28, 2013). The circuit court had dismissed both franchisees' claims because cautionary language in Ace's pro forma and UFOC documents rendered reliance on the franchisor's alleged statements immaterial as a matter of law. The Illinois Court of Appeals affirmed.

The appellate court held that Ace Hardware's documents did not contain false statements of material fact; thus, any alleged reliance on the information provided by Ace during the sale process was unreasonable. Ace Hardware had provided data regarding the financial performance of some stores in the chain, but it had clearly warned that the data was not comprehensive and had not been independently verified. Based on these and other warnings, Ace was found not to have concealed any material information from the franchisees.

FEDERAL COURT DISMISSES FRANCHISEE'S FRAUD AND MISREPRESENTATION CLAIMS BECAUSE THE FRANCHISE AGREEMENT DIRECTLY CONTRADICTS ALLEGED MISREPRESENTATIONS

In *BP West Coast Products LLC v. SKR, Inc.,* 2013 U.S. Dist. LEXIS 151764 (W.D. Wash. Oct. 22, 2013), a federal court in Washington dismissed a gas station franchisee's claims for fraud and negligent misrepresentation, and its claims under the Washington Franchise Investment Protection Act and Washington Gasoline Dealer Bill of Rights Act.

The claims were based on BP's allegedly inaccurate statements regarding the estimated gross margins that the franchisee could earn on the sale of gasoline and other products.

In dismissing the claims, the Washington court noted that for both fraud and negligent misrepresentation, reliance is a critical element, and it must be justifiable and detrimental to the person relying on the information. The court found that the franchisee could not have reasonably or justifiably relied on BP's alleged misrepresentations because the franchise agreement clearly stated that BP provided no representations or warranties, express or implied, as to profit or income the franchisee might derive from the franchised business. The court further noted that the franchisee was not detrimentally harmed because subsequent projections that the franchisee created for lenders differed from BP's alleged misrepresentations and were based on estimates provided by third parties and the franchisee's independent research. Finally, the court noted that, in common law and statutory fraud claims, the statement must relate to a "representation of an existing fact." Because the estimated gross margins allegedly provided by BP related to future performance and did not constitute an "existing fact," the franchisee's fraud claims failed.

POST-TERMINATION INJUNCTIONS

NEW YORK FEDERAL COURT GRANTS PRELIMINARY INJUNCTION TO FRANCHISOR BASED ON RESCISSION OF FRANCHISE AGREEMENT

The United States District Court for the Eastern District of New York last month entered a preliminary injunction against franchisees that diverted profits from their five 7-Eleven convenience stores in violation of their franchise agreements. *7-Eleven, Inc. v. Khan*, 2013 U.S. Dist. LEXIS 146696 (E.D.N.Y. Oct. 10, 2013). 7-Eleven terminated the franchise relationship, without giving the franchisees an opportunity to cure, after an investigation revealed that the franchisees had repeatedly underreported their sales and defrauded 7-Eleven out of royalty payments over a four year period. When the franchisees continued to operate their stores using 7-Eleven's trademarks, 7-Eleven sought a preliminary injunction directing them to surrender their stores and ejecting them from the premises. The franchisees opposed the motion and filed a cross-motion for an order enjoining the termination, asserting that the termination was improper because they did not receive notice and an opportunity to cure their alleged breaches.

The court held that 7-Eleven was within its rights to rescind the franchise agreements and granted its motion for a preliminary injunction. In so ruling, the court relied upon the principles of contract rescission under New York common law. It concluded that the nature of the fraudulent transactions committed by the franchisees were so serious that they went to the "root of the matter or the essence of the contract." At the hearing on the motion, 7-Eleven's witnesses testified in detail regarding the franchisees' rampant failure to properly record sales, suspicious payroll practices, and pattern of inventory shortages. Consequently, the court determined that 7-Eleven was likely to succeed on the merits of establishing that it properly terminated the franchise agreements without providing notice or an opportunity to cure. 7-Eleven also made a clear showing of irreparable harm stemming from the franchisees' continued occupancy of their stores and interference with 7-Eleven's property rights and reputation.

FLORIDA FEDERAL COURT ALSO GRANTS PRELIMINARY INJUNCTION AFTER FRANCHISOR'S IMMEDIATE TERMINATION WITHOUT ADVANCE NOTICE

The United States District Court for the Middle District of Florida also granted 7-Eleven a preliminary injunction in *7-Eleven, Inc. v. Kapoor Brothers Inc.*, 2013 U.S. Dist. LEXIS 149063 (M.D. Fla. Sept. 13, 2013). The court found that, because of this franchisee's incurable conduct, the franchisor did not have to comply with franchise agreement provisions requiring advance notice of the termination and the opportunity to cure. Fairly soon after Kapoor Brothers entered into two franchise agreements, 7-Eleven discovered that Kapoor Brothers had underreported sales by improperly voiding transactions on its registers, failing to report inventory purchases to 7-Eleven, and knowingly employing persons who were ineligible to work in the United States. Kapoor Brothers did not dispute any of these findings. Although the franchise agreements contained advance notice and cure provisions, 7-Eleven issued a notice immediately terminating the contracts without an opportunity to cure on the ground that Kapoor Brothers had engaged in a pattern of willful and fraudulent breaches. Despite receiving the notice, Kapoor Brothers continued to operate the stores using 7-Eleven's marks.

The franchisor then filed suit and asked the court to issue a preliminary injunction preventing Kapoor Brothers from continuing to use its trademarks and to enforce the franchise agreement's post-term non-compete provisions. 7-Eleven argued that it was not required to comply with the advance notice and cure provisions because Kapoor Brothers' conduct was willful, fraudulent, incurable, and undermined the mutual trust necessary for the parties' continued business relationship. In granting the motion, the court held there was nothing in the franchise agreements that made the advance notice cure provisions the *exclusive* remedies for material breaches. 7-Eleven did not have to comply with those provisions, the court held, with respect to breaches that "go to the essence of the contract," and are "so exceedingly grave as to irreparably damage the trust between the contracting parties." Moreover, the court held that 7-Eleven had met the irreparable harm requirement for a preliminary injunction because it had introduced evidence of consumer confusion about Kapoor Brothers' use of the trademarks, and harm to 7-Eleven's goodwill "by the numerous post-termination customer complaints made against the Defendant's stores." The court commented that a franchisor could meet the irreparable harm standard for trademark violations merely by "the prospect of loss of [its] ability to control [its] reputation."

BANKRUPTCY STAY PREVENTS INJUNCTIVE RELIEF AGAINST FRANCHISEE'S CORPORATE OPERATING COMPANY

The United States District Court for the District of Maryland recently granted in part and denied in part a franchisor's motion for a preliminary injunction against a terminated individual franchisee, but declined to enjoin the franchisee's corporate operating company. *Ledo Pizza Sys., Inc. v. Singh*, 2013 U.S. Dist. LEXIS 153110 (D. Md. Oct. 24, 2013). After being terminated for failing to pay past due royalties and fees, Singh, a former franchisee of the Ledo Pizza chain, opened a competing pizza franchise at the same location as his former Ledo Pizza restaurant. Ledo filed a motion for preliminary injunction seeking to enjoin Singh's continued use of Ledo's trademarks and to enforce the franchise agreement's post-termination covenant against competition as well as other post-termination obligations.

The court first ruled in Ledo's favor by enjoining Singh from infringing on Ledo's trademarks and operating a competing pizza business. The court, however, also denied Ledo injunctive relief as to other post-termination obligations under the franchise agreement, such as returning copies of Ledo's operating manual and modifying the restaurant's interior. According to the court, the scope of the injunctive relief granted was sufficient to remedy Ledo's primary injuries. The court also reaffirmed its previous denial of injunctive relief against Singh's corporate operating company, which was in bankruptcy proceedings, due to the automatic stay of litigation triggered by such proceedings. It is unclear from the opinion whether the court's denial of relief against the corporate defendant would result in the competing business continuing its operations under the management of the corporate defendant.

CHOICE OF FORUM/VENUE

FEDERAL COURT IN NEW JERSEY HOLDS THAT MINNESOTA FRANCHISE ACT DOES NOT PRECLUDE LITIGATING IN FORUMS OTHER THAN MINNESOTA

Although the Minnesota Franchise Act ("MFA") may preclude an out of state franchisor from using a forum selection clause to prevent a Minnesota franchisee from filing a lawsuit in Minnesota, a New Jersey federal court ruled recently that the MFA does not mandate that all litigation involving Minnesota franchisees must be venued in Minnesota. In *Ramada Worldwide, Inc. v. Grand Rios Investments, LLC*, 2013 U.S. Dist. LEXIS 152140 (D.N.J. Oct. 23, 2013), Ramada initiated litigation in its home state of New Jersey against a Minnesota-based franchisee. The franchisee argued that section 80C.21 of the MFA precludes any choice of law provision that purports to waive a Minnesota franchisee's rights under the MFA and that Ramada included a mandatory forum selection clause for Minnesota franchisees when it acknowledged in its franchise agreement that section 80C.21 "prohibits us from requiring litigation to be conducted outside Minnesota."

The court rejected the franchisee's argument, noting that its interpretation of the MFA would require all cases and controversies involving a Minnesota franchisee to be venued in Minnesota. The court found that the franchisee consented to and waived any objection to *nonexclusive* venue in New Jersey, and that nothing in the franchise agreement indicated any attempt to deny the franchisee its rights under the MFA. The court noted that the MFA preserved a Minnesota franchisee's right to bring its own lawsuit in Minnesota, but nothing in the MFA precluded a franchisee from also consenting to a different venue should the franchisor initiate the action there. Because nothing in the MFA required transfer to Minnesota, and because the franchisee failed to demonstrate that transferring venue would accomplish anything other than to shift the inconvenience of the forum from the franchisee to Ramada, the court denied the franchisee's motion to transfer.

CALIFORNIA FEDERAL COURT DISMISSES CASE FOR IMPROPER VENUE

A federal court granted a franchisor's motion to dismiss for improper venue in *Musavi v. Burger King Corp.*, 2013 U.S. Dist. LEXIS 154467 (C.D. Cal. Oct. 25, 2013). After Burger King terminated Musavi's franchise agreements, the parties entered into a Limited License Agreement that permitted Musavi to operate the terminated franchises for a limited time until they could be sold. After the franchises failed to sell, Musavi filed suit in California, where his franchises were located, and challenged the enforceability of the Agreement. Burger King moved to dismiss or transfer venue based on the Agreement's forum selection clause naming Florida courts the exclusive venue for disputes.

Musavi argued that the forum selection clause should be invalidated under the California Franchise Relations Act, which protects franchises operating in California from the imposition of out-of-state venues for claims arising under a franchise agreement. However, the court held that the Limited License Agreement did not constitute a franchise agreement and that Musavi specifically and willingly gave up his rights under the franchise agreements by entering that contract. The court noted that the purpose of the statutory limitations on venue is to prevent California franchisees from being unfairly forced to litigate outside of the state under a "take it or leave it" franchise agreement, and found that the Limited License Agreement was not such an agreement.

STATE FRANCHISE LAWS

MARYLAND BAR FRANCHISE COMMITTEE WILL NOT BACK FRANCHISE LAW PROPOSAL; SPONSOR WILL NOT INTRODUCE BILL

There have been further developments following the October 3, 2013, meeting of the Maryland State Bar Association's Franchise Committee, at which Jon Cardin, a member of the Maryland House of Delegates who also is a candidate for Maryland Attorney

General, presented proposed revisions to several sections of the Maryland Franchise Law. (Under the proposal, the time the Attorney General's office would be allowed to process franchise renewals and amendments would have been substantially curtailed, Maryland based franchisors would be exempt from compliance with the law when making sales to out of state residents, franchisee's guarantors who reside in Maryland would have been entitled to the protections of the law, reasonable reliance on alleged misrepresentations would have to be evaluated as a matter of fact, and franchisees who prevailed on franchise law claims would have been entitled to recover their attorneys' fees.) After discussion with the committee, which included Securities Commissioner Melanie Lubin and franchise chief, Dale Cantone, Delegate Cardin agreed to revise his draft and he encouraged the Attorney General's office to develop a way of dealing with franchisor frustrations concerning the renewal and amendment process.

On October 31, 2013 the bar association committee, which included Carl Zwisler and Mark Kirsch as representatives from Gray Plant Mooty, considered revisions to the draft, which only addressed three issues: the exemption for out of state sales by Maryland based franchisors, attorneys' fees for franchisees that prevail on franchise law claims, and the establishment of a statutory franchise advisory committee. After discussion among members, the committee split their votes on whether to endorse the proposal four to three. Because MSBA requires nearly unanimous support from the committee before taking a position on state legislation, the legislation would not have received MSBA support. Delegate Cardin's representative at the meeting told the committee that without MSBA support, he would not introduce the proposed franchise legislation in the next legislative session.

MARYLAND ATTORNEY GENERAL ANNOUNCES FRANCHISE ADVISORY COMMITTEE, EXTENDS DATE FOR FILING FINANCIAL STATEMENTS

During the same October 31, 2013, MSBA Franchise Committee meeting, Commissioner Lubin and Deputy Commissioner Cantone reiterated their pledge to form an advisory committee to review their office's policies and procedures, as well as the state's franchise regulations, with the intent of streamlining the renewal process. The first meeting of that group is being planned for December.

Commissioner Lubin also announced that their office had agreed that it would no longer require a franchisor's financial statements to be current within 90 days when filed in Maryland. In an interpretative opinion, the Commissioner announced that her office would take "no action" if a franchisor's financial statements meet the FTC's 120 day standard. Thus, Maryland joins the FTC and most of the other registration states in permitting older financial statements to be included in franchise registrations and renewals, without the need for filing supplemental unaudited financial statements.

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