The GPMemorandum

TO: **OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS**

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

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Below are summaries of recent case decisions of interest to franchisors.

TERMINATIONS

MISSOURI DISTRICT COURT UPHOLDS TERMINATION OF FRANCHISE BASED ON FRAUD

The United States District Court for the Eastern District of Missouri recently upheld a franchisor's decision to terminate a group of franchisees that fraudulently concealed the true ownership of their operating company when entering into their franchise agreement. *Dunkin' Donuts Franchising LLC v. Sai Food & Hospitality, LLC*, 2013 U.S. Dist. LEXIS 181752 (E.D. Mo. Dec. 31, 2013). Gray Plant Mooty represents the franchisor in this case. Dunkin' terminated the parties' franchise agreements and their related development agreement and sublease after an investigation revealed that the franchisees had falsely represented that certain unapproved individuals would be removed as members of their operating entity. Dunkin' brought suit to enforce the termination, and the franchisees raised counterclaims for, among other things, wrongful termination, violation of the Missouri Franchise Act, and promissory estoppel. Following a bench trial, the franchisees moved for judgment on partial findings, arguing that the evidence failed to demonstrate that they intended to defraud Dunkin' and that Dunkin' impermissibly allowed them to develop a second franchise location when it intended to terminate their contracts.

The court denied the franchisees' motion, granted Dunkin' judgment on all claims in the case, and enjoined the franchisees from continuing to use Dunkin's trademarks and trade dress. Finding that the true ownership structure of the corporate franchisee was a material matter in Dunkin's decision to enter into the initial franchise agreement, the court concluded

that the franchisees' misrepresentations constituted fraud justifying immediate termination under the terms of the contract. In light of cross-default provisions contained in the parties' development agreement and sublease, the court held that Dunkin' was also justified in terminating those contracts. The court further determined that the franchisees were not entitled to any extended notice period under the Franchise Act because the statute exempts terminations based on fraud from its requirements. Finally, the court declined to award the franchisees any relief on their promissory estoppel counterclaim for the expenditures they made in developing their second store, reasoning that Dunkin' was entitled to a reasonable amount of time after completing its investigation to make a decision regarding termination.

FOURTH CIRCUIT AFFIRMS DISTRICT COURT'S DECISION THAT EXPIRATION OF A FRANCHISE AGREEMENT DID NOT CONSTITUTE TERMINATION

The Fourth Circuit affirmed in part the decision of the Western District of Virginia that certain post-term restrictive covenants did not apply to a former franchisee, finding that the expiration of the franchise agreement did not constitute a termination. *Hamden v. Total Car Franchising Corp.*, 2013 U.S. App. LEXIS 23514 (4th Cir. Nov. 22, 2013). Former franchisee Hamden operated a paintless dent repair business for the entire fifteen year term of his franchise agreement. Electing to not renew the Franchise Agreement, Hamden informed Total Car Franchising ("TCF") that he would pursue his own business. After TCF notified Hamden that it would pursue an injunction preventing such conduct, Hamden sought a declaratory judgment from the district court. The district court held that the term "termination," as used in the franchise agreement and a Non-Competition & Confidentiality Agreement, did not encompass the natural expiration of the franchise agreement; thus, the restrictive covenants contained in the agreements were not binding on Hamden. TCF challenged this holding on appeal.

The Fourth Circuit affirmed the district court's ruling, reasoning that the express language of the franchise agreement required some affirmative act to constitute a termination and TCF failed to include any language in the agreement indicating that termination also arises passively through expiration. Further, the language contained in the parties' confidentiality agreement contemplated that the restrictive covenants would be triggered if the franchise agreement was terminated prior to expiration. As a result, the Fourth Circuit upheld the district court's decision that certain restrictive covenants were not enforceable against Hamden. But the circuit court reversed the lower court's decision relating to restrictive covenants that applied during and after the term of the franchise agreement irrespective of how the franchise relationship ended.

VICARIOUS LIABILITY

NEW MEXICO DISTRICT COURT FINDS FRANCHISOR MAY BE VICARIOUSLY LIABLE FOR DEATH OF FRANCHISEE'S EMPLOYEE

A federal district court in New Mexico held that a franchisor may be liable for its franchisee's failure to provide a safe working environment after an armed robbery resulted in the death of the franchisee's employee. In *Estate of Anderson v. Barreras*, Bus. Franchise Guide (CCH) ¶ 15,181 (D.N.M. Nov. 13, 2013), the plaintiff brought a wrongful death action against the franchisee and the franchisor, Denny's, Inc., alleging that they were liable for the employee's death by failing to properly train personnel on emergency procedures, failing to implement adequate security measures, failing to exercise due care, and willfully ignoring the foreseeability of the crime that occurred. Denny's moved for summary judgment alleging that it did not owe a duty to the franchisee or its employees to safeguard the work premises from the criminal acts of third parties. Denny's acknowledged that it imposes certain standards on franchisees to protect its trademarks and reputation, but argued that this amount of control was insufficient to make it vicariously liable for the negligent acts of its franchisee.

In denying the motion for summary judgment, the court held that the facts did not establish as a matter of law that Denny's was not involved in the day-to-day operation of the franchisee's restaurant. Denny's pointed out that recent cases have narrowed the circumstances in which courts find vicarious liability, as most look only to whether the franchisor controls the specific aspect of the franchisee's business alleged to have caused an injury or death. It was undisputed that Denny's did not have the right to control security at the restaurant. The court concluded that although modern cases have recognized a more narrow "instrumentality rule," it was obligated to follow the traditional right-to-control approach adopted by the Supreme Court of New Mexico because the dispute was governed by New Mexico law. Applying that test, the court found a number of facts potentially demonstrating Denny's control over the franchisee's activities beyond the extent necessary to protect its trademarks, including, among other things, its right to (1) inspect the restaurant regularly for quality control, hazards, and hospitality; (2) approve restaurant site development, construction, and remodeling; (3) impose standards for food quality, timing, and service; (4) impose training requirements; (5) terminate the franchise agreement if the franchisee failed to comply with its standards and requirements; and (6) dictate the franchisee's hours of operation.

The court also explained that the manner in which the parties designated their relationship in the franchise agreement was not controlling. Instead, the court had to consider the agreement as a whole, and in this instance, the plaintiff had identified a sufficient number of provisions that created a jury question on the issue of Denny's right of control over the franchisee's restaurant.

ARBITRATION

COURT EXAMINES ARBITRABILITY OF WAGE ACT CLAIMS IN THE *AWUAH* DISPUTE

As part of the continuing saga of *Awuah v. Coverall N. Am., Inc.*, 2013 U.S. Dist. LEXIS 171870 (D. Mass. Dec. 5, 2013), a Massachusetts federal district court recently re-examined the arbitrability of some of the plaintiffs' state wage claims. At prior phases of the *Awuah* litigation, a class of plaintiffs was certified and later obtained a final judgment in their favor. This certified class excluded certain Coverall franchisees who had signed a franchise agreement with Coverall containing an arbitration provision. Following the Massachusetts Supreme Judicial Court's 2012 decision in *Crocker v. Townsend Oil Co.*, 979 N.E.2d 1077 (2012), these excluded plaintiffs brought a motion for reconsideration of their obligation to arbitrate their state wage claims. In *Crocker*, the Massachusetts Supreme Judicial Court held that wage claims under the Massachusetts Wage Act may not be waived unless the waiver expressly references Wage Act claims. Relying on *Crocker*, the excluded *Awuah* plaintiffs argued that their arbitration clause did not expressly reference wage claims and was unenforceable.

In ruling on the motion, the court agreed with the plaintiffs that state law requires an arbitration clause to expressly reference the Massachusetts Wage Act. The court went on, however, to deny the motion for reconsideration based on language in a prior *Awuah* decision by the First Circuit. In *Awuah v. Coverall N. Am. Inc.,* 703 F.3d 36 (1st Cir. 2012), the court held that any Massachusetts law imposing special notice requirements on arbitration agreements was preempted by the Federal Arbitration Act (FAA). In its ruling last month, the district court found that it was compelled to follow this precedent and hold that the FAA preempts Massachusetts' requirement that the Wage Act be expressly referenced in an arbitration clause. The court observed, however, that it disagreed with this outcome. The court reasoned that the FAA should only preempt state laws that discriminate against arbitration agreements in particular. Because Massachusetts law requires the Wage Act to be expressly named in other types of agreements beyond arbitration agreements—such as releases—the federal court stated that it would have held that the arbitration agreement was unenforceable.

PRACTICE OF FRANCHISE LAW

COURT REJECTS CHALLENGE TO ARBITRATION AWARD BY FRANCHISEE WHO CLAIMED THAT FRANCHISOR'S LAWYER ENGAGED IN UNETHICAL CONDUCT

In *Doctor's Associates, Inc. v. Windham*, 2013 U.S. Dist. LEXIS 546 (Conn. App. Nov. 26, 2013), the Connecticut Court of Appeals found that alleged violations of the Connecticut Rules of Professional Conduct by the franchisor's lawyers, even if they actually occurred, did not constitute sufficient grounds to overturn an arbitration

award. Doctor's Associates had initiated arbitration in this case, seeking to terminate a Subway franchise agreement based on Windham's failure to complete required store upgrades. Windham failed to make an appearance in the arbitration, despite receiving adequate notices regarding the proceeding. The hearing went ahead without Windham and an award was rendered in Doctor's Associates' favor. Windham then filed suit to overturn the award on the grounds that Doctor Associates' attorney allegedly violated ethical rules by failing to inform the arbitration panel that the parties were negotiating to resolve the dispute and, moreover, that an award in Windham's favor had been entered in a similar but unconnected matter. After the trial court affirmed the arbitration award and dismissed Windham's application to vacate it, he filed an appeal.

The appeals court found that the franchisor's attorney did not violate ethical rules by not notifying the arbitration panel of the results of the unrelated arbitration or by not telling it about the previous settlement negotiations between the parties. The court also commented that it was not the lawyer's responsibility to present facts or arguments favorable to Windham during the uncontested arbitration hearing. The court also held that even if the allegations of improper behavior had been true, they could not themselves form the basis of a challenge to the award. "The Rules are designed to provide guidance to lawyers and to provide a structure for regulating conduct through disciplinary agencies. They are not designed to be a basis for civil liability." Finally, the court noted that in order to overturn an arbitration award, the franchisee would have needed to show that the award was rendered by corruption, fraud, or undue means. Since there was no evidence to support any such conclusion, the appeals court affirmed the confirmation of the award and rejection of Windham's application to vacate.

ADVERTISING

FRANCHISE DISPUTE OVER ADVERTISING FUND NOT SUBJECT TO DISMISSAL

A federal court in Indiana declined to dismiss a breach of contract claim concerning the collection of advertising and marketing funds by the franchisor of a members-only buying club franchise. In *Arcangelo, Inc. v. DirectBuy, Inc.*, 2013 U.S. Dist. LEXIS 164941 (N.D. Ind. Nov. 20, 2013), the district court concluded that the language of the franchise agreement was not sufficiently unambiguous to resolve the fee dispute as a matter of law. Arcangelo had filed suit claiming that DirectBuy charged excessive fees for advertising and marketing under the franchise agreement, which explicitly capped the amount of franchisee contributions to a marketing fund at three percent of gross new membership sales. Two separate provisions in the franchise agreement addressed DirectBuy's marketing efforts, one titled "Marketing and Advertising," and the other "Marketing Materials." DirectBuy contended that the "Marketing Materials" section addressed costs associated with the placement of advertising, whereas the "Marketing and Advertising" section provided for the creation and development of the marketing fund that is the subject of the three percent cap.

The court was not persuaded by DirectBuy's argument and found too much overlap in the language of each section to allow an unambiguous interpretation of how the franchise agreement applied to the specific charges disputed. The parties disagreed about whether certain fees were properly subject to the cap on marketing fund contributions or better characterized as "sales leads" that fell under a separate advertising category. The court concluded that more factual background was required concerning the history of the marketing fund, the practices and methods for DirectBuy's assessment of fees to franchisees generally, and its history with Arcangelo in this case. Because the lawsuit was primarily a dispute over the proper interpretation of the parties' franchise agreement, the court dismissed other tort claims alleged by Arcangelo, but found that the contract claim could not be resolved on a motion to dismiss and could proceed.

PRELIMINARY INJUNCTIONS

CALIFORNIA COURT OF APPEAL UPHOLDS ORDER DISSOLVING PRELIMINARY INJUNCTIVE RELIEF IN FAVOR OF FRANCHISEE

A California Court of Appeal recently affirmed a trial court's ruling that subsequent evidence of franchisee misconduct warranted the dissolution of a preliminary injunction. *Husain v. McDonald's Corp.*, 2013 Cal. App. Unpub. LEXIS 9072 (Cal. Ct. App. Dec. 17, 2013). Early in the litigation, in which the franchisees were seeking to prevent the termination of three of their franchises, both parties moved for preliminary injunctions. The trial court granted the franchisees' motion, concluding that there was a reasonable likelihood that the franchisees would prevail on the merits and that, given the financial burden that the loss of income would impose, the balance of harms weighed in the franchisees' favor. Later, evidence uncovered during discovery strongly suggested that the franchisees had falsified records and testified untruthfully. Upon a motion by McDonald's, the trial court dissolved its grant of preliminary injunctive relief in the franchisees' favor, granted McDonald's a preliminary injunction, and ordered sanctions dismissing the franchisees' complaint with prejudice.

In two separate opinions, the California Court of Appeal affirmed the trial court's preliminary injunction reversal, but vacated the sanctions and ordered a new trial. The Court of Appeal held that the trial court had not abused its discretion when, after reassessing the franchisees' credibility, it determined that the franchisees were no longer likely to succeed on the merits. Nor did the trial court abuse its discretion by concluding that discovery revelations concerning the franchisees' financial stability undercut the court's original balance of harms analysis. In vacating the sanctions, however, the Court of Appeal held that the ability of McDonald's to bring the franchisees' misconduct to the jury's attention through cross-examination adequately preserved the trial's fairness.

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