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 legal developments of interest to franchisors.

VICARIOUS LIABILITY

AS PART OF RECENT ACTIONS, NATIONAL LABOR RELATIONS BOARD ALLEGES MCDONALD'S IS A "JOINT EMPLOYER" IN UNFAIR LABOR COMPLAINTS FILED AGAINST MCDONALD'S FRANCHISEES

As has been widely reported in the media, the National Labor Relations Board last month filed complaints in 13 regional NLRB offices charging multiple McDonald's franchisees with unfair labor practices relating to union organizing activities at McDonald's franchised restaurants across the country. The NLRB also alleged that McDonald's USA, LLC is liable for the alleged labor violations as a "joint employer" with its franchisees. The claims against the McDonald's franchisees allege a variety of unfair labor practices, including reducing working hours, forbidding communication with union representatives, changing schedules, issuing written warnings and threatening termination in response to employees' efforts to engage in union organizing activities. To support its claims against the franchisor, the NLRB asserted that McDonald's USA, LLC has a franchise agreement with each of its franchisees and "possessed and/or exercised control over the labor relations policies" of the franchisees, and is therefore a joint employer of the franchisee's employees. As a joint employer, the NLRB claimed that McDonald's interfered with, restrained, and coerced employees in the exercise of their rights, and discriminated with regard to the hire or tenure or terms or conditions of employment of the employees, thereby discouraging membership in a labor organization.

The "McDonald's Fact Sheet" issued by the NLRB announcing the filings explains the basis for the joint employer claim. In it, the NLRB states: "*Our investigation found that McDonald's, USA, LLC, through its franchise relationship and its use of tools, resources and technology, engages in sufficient control over its franchisees' operations, beyond protection of the brand, to make it a putative joint employer with its franchisees, sharing liability for violations of our Act*." The NLRB clearly intends to point to McDonald's comprehensive computer system, which tracks labor usage and costs, as one of the primary means of controlling the franchisee's operations, including employment decisions.

On Dec. 29, 2014, McDonald's filed a motion in the NLRB action venued in New York City. In its motion, McDonald's asserts that the conclusory allegations regarding its joint employer status provide insufficient notice of the basis for the alleged joint employer status and deprive McDonald's of its fundamental right to due process. McDonald's seeks an order requiring the Regional Director to specify with particularity the underlying factual basis for the joint employer allegations or strike the allegations from the complaint and dismiss McDonald's. The NLRB has yet to respond.

The first hearing on the NLRB's complaints is set for March 30, 2015.

The NLRB's move to name McDonald's as a joint employer is one of multiple actions it has taken recently that could impact franchisors. A week earlier, the NLRB released new "quickie" election rules that dramatically reduce the time an employer has to prepare for and respond to a union election campaign. One such change requires employers to wait until after an election in order to litigate any disputed issues that are not necessary to determine whether an election is appropriate. As a result, it is unclear whether a franchisor that is named as a joint employer in an election petition could immediately raise jurisdictional issues, or must wait until after the election to challenge its status as an employer. On Jan. 7, 2015, a group led by the U.S. Chamber of Commerce filed a lawsuit challenging the validity of these rules on constitutional grounds. Whether the challenge will be successful will likely not be known, however, before the new rules take effect on April 4, 2015. In addition to the new election rules, the NLRB issued a decision on Dec. 6, 2014, reversing a previous ruling and requiring that employers who generally permit employees access to company email allow employees to use that email system for a variety of protected activities including union organizing.

What does all this mean to franchisors? The NLRB's recent actions make it clear it intends to eliminate barriers to unionization in the franchise space. By making franchisors ostensible "employers" of franchisees and their employees, it opens the door for unions to organize across entire franchise systems instead of individual franchisee locations. Add to this the right to use company email systems for organizing activities and restrictions on an employer's ability to challenge "quick" elections, and the table is set for unions to swell their diminishing ranks with franchisee employees.

FEDERAL COURT IN CALIFORNIA DECLINES TO EXTEND *PATTERSON* RULING OUTSIDE OF A FRANCHISE CONTEXT

The United States District Court for the Central District of California declined to extend the test for imposing employer liability established by the California Supreme Court in *Patterson v. Domino's Pizza, LLC*, S204546 (Cal. Aug. 28, 2014) (reported on in Issue 184 of *The GPMemorandum*) beyond the franchise context. *Ambrose v. Avis Rent a Car Sys., Inc.*, 2014 U.S. Dist. LEXIS 170406 (S.D. Cal. Dec. 8, 2014). Ambrose had entered into an "independent operator" agreement to operate a Budget Rent a Car business. The court found that the agreement was indistinguishable from a franchise except that Ambrose paid no initial fees. Ambrose argued that because Budget had the right to control the manner and means by which she accomplished the results required by the agreement, she was Budget's employee. Budget argued its arrangement with Ambrose was virtually identical to a franchise, and that the *Patterson* ruling should apply.

In *Patterson*, the California Supreme Court acknowledged the standard "right to control" tests used to impose employer liability did not work in the context of franchising, in which system-wide standards and controls are necessary to protect the brand and ensure the uniformity and quality of products and services offered. Rather, the court found a franchisor may be liable as an employer "only if it has retained or assumed a general right of control of factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisees' employees." In this case, Ambrose argued Budget exercised a level of control over its operations exceeding the level necessary to protect the brand by retaining ownership over the vehicles offered for rent by Ambrose, controlling rental rates and lease terms, establishing rental procedures, and dictating the rental facility's hours of operation. As such, Ambrose sought summary judgment on its request for declaratory relief that Budget was its employer. Budget argued it was not Ambrose's employer because it did not retain direct control over her hours of operation, employee appearance standards, work hours, or wage rates. Applying the "right to control" test, the court found that there was an issue of material fact as to whether Budget was Ambrose's employer, and denied both parties' motions for summary judgment.

STATE FRANCHISE LAWS

FEDERAL COURT DENIES MOTION SEEKING TO ENJOIN THE EXPIRATION OF A DISTRIBUTOR AGREEMENT UNDER THE MINNESOTA FRANCHISE ACT

In a case defended by Gray Plant Mooty, a Minnesota federal court recently denied an injunction motion brought by a party claiming to be a putative franchisee under the Minnesota Franchise Act (MFA). *Wave Form Sys., Inc. v. AMS Sales Corp.*, 2014 U.S. Dist. LEXIS 175927 (D. Minn. Dec. 22, 2014). Wave Form was an Oregon corporation that supplied health care providers with laser equipment and services, including medical procedures that use "GreenLight" lasers marketed by AMS Sales Corp. In 2012, Wave Form signed a two-year agreement with AMS that provided nonexclusive use of AMS's trademarks and allowed Wave Form to obtain the fibers necessary for use of AMS's GreenLight lasers. The distribution agreement also required Wave Form to purchase a service plan for the upkeep of its GreenLight lasers. With the distribution agreement set to expire on Dec. 31, 2014, Wave Form filed suit, asking the court to declare that the MFA applied to the agreement. Wave Form moved for a preliminary injunction to prevent the expiration of the contract, arguing that AMS violated the Minnesota statute by failing to renew.

AMS argued first that the MFA did not protect an Oregon company that did not do business in Minnesota, and second, that even if the MFA did apply extra-territorially, Wave Form was not entitled to its protections because there was no indirect franchise fee as required by the law. The court acknowledged that there was some support for a statutory interpretation that the MFA applied to out-of-state plaintiffs, but noted that because the Minnesota legislature intended the law to protect Minnesota franchisees, its application in this case seemed to be a "stretch." Likewise, the court noted that there was some support for both parties' arguments regarding whether the required service plan could constitute an indirect "franchise fee" if the MFA did apply. The court concluded, however, that it did not need to resolve either issue at the preliminary injunction stage because Wave Form had failed to show it would be irreparably harmed if the agreement expired on a date agreed upon by both parties at the outset of the relationship. Any financial harm incurred by Wave Form could be readily compensated with money damages if it prevailed at trial, and Wave Form presented only anticipatory and speculative evidence that its reputation or goodwill would be harmed by the expiration. Because the balance of harm and public interest in forcing AMS to continue an unsatisfactory business relationship also weighed against Wave Form in this case, the court denied the motion for a temporary injunction.

MEDICAL CLINIC LICENSOR LIABLE FOR SALE OF UNREGISTERED FRANCHISE UNDER ILLINOIS LAW

The court in *Chicago Male Medical Clinic v. Ultimate Management, Inc.,* determined that a "consulting agreement" was a franchise under the Illinois Franchise Disclosure Act (IFDA), and awarded the plaintiff rescission of the agreement. 2014 U.S. Dist. LEXIS 174478 (C.D. Cal. Dec 16, 2014). Chicago Male operated a medical clinic under a "Continuing Compensation and Consulting Agreement" with Ultimate Management. Approximately nine months after executing the agreement, Chicago Male sued for rescission. Chicago Male claimed it was a "franchisee" under the IFDA, that it did not receive an FDD, and that it was entitled to damages and rescission of the agreement. Under the Consulting Agreement, Chicago Male was required to pay an initial setup fee of $300,000 and ongoing percentage royalties in connection with the operation of the clinic. In return, Ultimate Management agreed "to provide telephone training for incoming calls, suggested newspaper, magazine circular and radio ads, text for effective window signing, information and aid in setup toll free telephone numbers, call center services, and other suggested marketing plans." It had not registered the Consulting Agreement as a franchise or franchise offer at the time the contract was executed, although Ultimate Management did later prepare and register an FDD in Illinois.

Under IFDA, for a business relationship to be a franchise, there must be a substantial association of the business with the franchisor's trademarks. Although the agreement did not contain strict requirements for Chicago Male to use Ultimate Management's marks, it did require Ultimate Management to provide advertising content and signage text. In addition, Ultimate Management's principal owner had registered the mark "National Male Medical Clinics," which it intended to associate with each clinic on its website, and Chicago Male's clinic was added to the website where the mark was displayed. This, along with the similarity between Chicago Male's business name and the "National Male Medical Clinics" mark was, in the court's view, "sufficient to convey to the public that [Chicago Male] was affiliated with the National Male Medical Clinics brand." As a result, the court found that relationship constituted a franchise and awarded Chicago Male rescission damages, requiring Ultimate Management to pay back the initial setup fee and all royalties received.

ADVERTISING

WISCONSIN FEDERAL COURT GRANTS PRELIMINARY INJUNCTION BARRING FORMER FRANCHISEE FROM BROADCASTING MISLEADING RADIO AD

A federal court in Wisconsin granted a franchisor's motion for a preliminary injunction prohibiting a former franchisee from broadcasting a misleading radio advertisement about the franchisor's business. *Paul Davis Restoration, Inc. v. Everett*, 2014 U.S. Dist. LEXIS 172227 (E.D. Wis. Dec. 12, 2014). Following a series of lawsuits, the franchisor, Paul Davis, sought to enforce an arbitration award against former franchisee Everett. Everett responded by running an ad, which purported to be a "business advisory," construing the franchisor's attempt to enforce the award as illegal conduct. The ad ended by saying it was paid for by "Paul Davis Restoration of NOWI."

The court held that Everett's use of the Paul Davis trade name at the end of the ad was a violation of the Lanham Act. Although Everett removed the trade name from the ad after Paul Davis filed its motion for a preliminary injunction, the court found that the claim was not moot. Due to the parties' litigious history, the court decided that there was a likelihood the violations would recur absent an injunction. It then found that Paul Davis had a high likelihood of success on the merits of its claim that the ad was misleading under the Lanham Act. Although Everett claimed the ad was protected speech under the First Amendment, the court determined it was commercial speech and, therefore, subject to regulation under the Lanham Act. Everett could not legally broadcast an ad claiming that Paul Davis broke the law, the court said, when in fact an arbitral panel had reached the opposite conclusion. After finding that Paul Davis had a strong likelihood of success on the merits, the court noted that the other preliminary injunction factors weighed in favor of Paul Davis as well.

CHOICE OF LAW

COURT STRIKES FRANCHISE AGREEMENT'S CHOICE OF LAW PROVISION

A federal court in the Southern District of Illinois recently struck a franchise agreement's choice of law provision after concluding that the state in which the franchise was located had a materially greater interest in the dispute than the state whose law was chosen by contract. *Show-Me's Franchises, Inc. v. Sullivan*, 2014 U.S. Dist. LEXIS 171507 (S.D. Ill. Dec. 11, 2014). In a case started by Show-Me, Sullivan brought counterclaims alleging violations of the Indiana Deceptive Franchise Practice Act, the Illinois Franchise Disclosure Act, and Indiana common law. He argued that although the parties' franchise agreement contained a choice of law provision that designated Illinois law, the protections of Indiana's franchise laws could not be contracted away.

The court agreed that Indiana public policy might override a contractual choice of law provision where Indiana has a "materially greater interest" in the dispute than the state whose law was chosen to apply. It went on to conclude that while Show-Me was an Illinois corporation and the parties' franchise agreement was at least partly negotiated in Illinois, Indiana had a materially greater interest in the dispute because the franchise was located in Indiana, relevant witnesses and documents were located in the state, and the contract was performed there. After striking the franchise agreement's contractual choice of Illinois law provision and performing a conflict of law analysis, the court held that Indiana's substantive law governed the parties' dispute.

POST-TERMINATION INJUNCTIONS: TRADEMARKS

WISCONSIN FEDERAL COURT GRANTS PRELIMINARY INJUNCTION PROHIBITING FORMER FRANCHISEE'S USE OF SIMILAR TRADEMARK

A federal district court in Wisconsin has granted a franchisor's motion for a preliminary injunction against a former franchisee who continued to use a variation of the franchisor's trademark after entering into a Franchise Termination Agreement. *Dent Doctor, Inc. v. Dent Clinic, Inc.*, 2014 WL 7139831 (E.D. Wis. Dec. 12, 2014). Dent Clinic operated a Dent Doctor franchise from 1993 to 2012 until the parties entered into the termination agreement. The agreement required Dent Clinic to cease using the trademark DENT DOCTOR. In response, it replaced the mark DENT DOCTOR with DENT DR. on their trucks, business cards, and website. Dent Doctor sought a preliminary injunction against Dent Clinic to enjoin the use of DENT DR. Dent Clinic argued that it obtained retroactive licensing rights to use the mark DENT DOCTOR and DENT DR. from nearby Dent Doctor Auto Specialists, a third-party company in Augusta, Wisconsin, that has used the mark DENT DOCTOR since 1984. Dent Clinic argued that Auto Specialists had superior rights in the geographical area where it operated.

The Wisconsin court held that Dent Doctor was likely to demonstrate a likelihood of success on the merits, which required it to show that it owned a protectable mark and that a "likelihood of confusion" existed between the marks or products of the parties. Despite the retroactive licensing agreement, the court found Dent Doctor was likely to show that Auto Specialists' superior rights did not extend to Dent Clinic's geographic location. The court further held that Dent Doctor was likely to succeed in showing a likelihood of confusion because DENT DR. is an abbreviated version of DENT DOCTOR. In addition, the court found confusion was particularly likely in this case because Dent Clinic used to be affiliated with Dent Doctor as a franchisee, and customers may not realize they are no longer affiliated. The termination agreement served as important evidence in the court's finding.

POST-TERMINATION INJUNCTIONS: NONCOMPETE COVENANTS

COURT ENJOINS FRANCHISEES' POST-TERMINATION TRADEMARK INFRINGEMENT BUT DECLINES TO ENFORCE NONCOMPETE AGREEMENT

The United States District Court for the District of Massachusetts granted a franchisor's motion for a preliminary injunction seeking to prevent a group of holdover franchisees from using its trademarks, but permitted the franchisees to continue operating their business as an unaffiliated convenience store until a full adjudication on the merits. *7-Eleven, Inc. v. Grewal*, 2014 U.S. Dist. LEXIS 163712 (D. Mass. Nov. 20, 2014). 7-Eleven terminated the parties' franchise relationship after an investigation revealed that Grewal had falsified its sales data by incorrectly ringing and failing to ring customer transactions. Grewal nevertheless continued to operate the store using 7-Eleven's trademarks. 7-Eleven sought a preliminary injunction to enjoin the infringement, and to enforce the one-year noncompete clause prohibiting Grewal from operating a convenience store at the site of the franchise.

The court first held that 7-Eleven satisfied the elements for injunctive relief with respect to its trademark infringement claim. 7-Eleven demonstrated through witness testimony and video surveillance footage that Grewal failed to accurately prepare and furnish its sales data and that termination of the franchise agreement was therefore warranted.

The court also determined 7-Eleven would suffer irreparable harm from the infringement because it would be unable to protect the quality of its brand. However, the court denied the motion insofar as it sought to enforce the noncompete provision, finding that 7-Eleven had failed to establish that it would suffer irreparable harm if Grewal was permitted to operate a competing convenience store in the same location without using the 7-Eleven marks. The court further reasoned that the balance of hardships weighed in Grewal's favor because it would be forced out of business, whereas 7-Eleven's damages were measurable.

FRAUD

MOTION TO DISMISS FRAUD AND MISREPRESENTATION CLAIMS DENIED

The United States District Court for the Northern District of California recently denied a franchisor's motion to dismiss claims of fraud and misrepresentation, and allowed the franchisee to proceed with claims that the franchisor misrepresented the feasibility of the independent contractor business model. The parties in *Andersen v. Griswold Int'l, LLC,* Case No. 3:14-cv-02560 (N.D. Cal. Dec. 16, 2014), entered into a franchise agreement under which Andersen operated a nonmedical home care business. He claimed that before the sale of the franchise, Griswold made representations regarding the operation of the business, including that it would be operated under an independent contractor model and that he would not have to comply with applicable wage and hour laws when engaging home care workers. Later, California enacted a law requiring that nonmedical home care workers be paid overtime, and Griswold abandoned the independent contractor model, instructing its franchisees to employ the caregivers. Andersen sued alleging, among other claims, fraud and misrepresentation.

Griswold moved to dismiss the fraud and misrepresentation claims on the basis that it was unable to predict the change in California law and that other statements made to Andersen were mere puffery. The court disagreed and found that, although the change in California law was a prediction of a future event and thus not actionable, Andersen's claims survived because he alleged Griswold represented to him that federal laws would protect the independent contractor model even if state law changed and that Griswold concealed from him that the model was being challenged in other jurisdictions. Griswold also was found to have made some representations too specific to be puffery.

COURT EXAMINES PLEADING REQUIREMENTS FOR FRAUD

A New York court recently denied a franchisor's motion to dismiss claims brought by its franchisee. *Schwartzco Enters., LLC v. TMH Management, LLC*, 2014 U.S. Dist. LEXIS 160856 (E.D.N.Y. Nov. 17, 2014). Schwartzco brought multiple causes of action alleging that the franchisor and related individuals participated in a fraudulent scheme in the sale of franchise and area developer rights for The Meat House system, violating numerous state laws and regulations. According to Schwartzco, the franchisor made material misrepresentations, including providing false financial statements and earnings claims to induce Schwartzco to invest. One claim alleged misrepresentations by an individual defendant, Brown, in violation of the New York Franchise Sales Act, which is designed to prevent fraud in the sale of franchises. In response, Brown brought a motion to dismiss under Rule 9(b) of the Federal Rules of Civil Procedure, which requires a party alleging fraud to state the circumstances of the fraud with particularity. The court decided that it did not need to address whether the proposed claim against Brown was subject to Rule 9(b), because Schwartzco set forth factual allegations sufficient to state violations under either the heightened pleading requirements or the general liberal notice pleading requirements.

DAMAGES TO FRANCHISOR

GEORGIA COURT HOLDS FRANCHISOR MAY RECOVER LOST FUTURE ROYALTIES

The Georgia Court of Appeals held that a franchisor could claim lost future royalties based on the franchisee's breach of the franchise agreement, but denied the recovery because the franchisor had not established its lost future royalties with sufficient specificity. *Legacy Academy, Inc. v. JLK, Inc.*, 2014 Ga. App. LEXIS 833 (Ga. Ct. App. Nov. 20, 2014). JLK, a franchisee for a Legacy Academy childcare center, informed its franchisor that it intended to terminate the parties' relationship, and then it continued operations under a different name. Legacy Academy sued for past-due royalties through the agreement's 2022 end date. The trial court held that Legacy Academy could not recover future royalties and that it failed to provide sufficient evidence quantifying its future damages.

On appeal, the court noted a split around the country on whether a franchisor may recover lost future royalties, but reversed and held that a franchisor was entitled to such a recovery. The appellate court stated that in order to recover lost future royalties, a franchisor must establish its damages with specificity. Thus, Legacy Academy was required to show the royalty payments that it would have earned, and subtract from that figure the amount that it would save due to the termination of the franchise agreement. Ultimately, the court determined that Legacy Academy did not sufficiently establish the amount of its savings, and therefore affirmed the decision to deny recovery of lost future royalties on the basis of insufficient evidence.

Along with the attorneys indicated on the next page, Mark Mathison and Pamela Kovacs, attorneys in our firm's Employment and Labor law group, contributed to this issue.

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