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The GPMemorandum

TO: **OUR FRANCHISE CLIENTS AND FRIENDS**

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

Quentin R. Wittrock, Editor of *The GPMemorandum*

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Here are some of the most recent legal developments of interest to franchisors:

ARBITRATION

ARBITRATOR "MANIFESTLY DISREGARDED" THE LAW IN ENTERING AWARD IN FAVOR OF FRANCHISOR

In *Coffee Beanery, Ltd. v. WW, L.L.C.*, 2008 WL 4899478 (6th Cir. Nov. 14, 2008), the United States Court of Appeals for the Sixth Circuit vacated an arbitration award that had been entered in favor of franchisor Coffee Beanery, Ltd., as the appeals court held that the arbitrator manifestly disregarded the law. The court concluded that the United States Supreme Court's recent decision in *Hall Street Assocs., L.L.C. v. Mattel, Inc.*, 128 S. Ct. 1396 (2008), did not limit the review of arbitration awards under the well-established "manifest disregard" standard. That standard provides a court the ability to review an arbitration award if an arbitrator manifestly disregards the law.

The franchisee sued claiming that, among other things, Coffee Beanery intentionally misrepresented its franchise business and violated the Maryland Franchise Registration and Disclosure Law in not disclosing in its prospectus the grand larceny felony conviction of one of its principals. Although Coffee Beanery admitted that it had not disclosed this information, it contended that it was not required to do so under the Maryland Act. The Maryland Act requires a franchisor to disclose "'whether any person identified in the prospectus has been convicted of a felony . . . if the felony or civil action involved fraud, embezzlement, fraudulent conversion, or misappropriation of property.'" The arbitrator concluded that the grand larceny conviction did not fall within the

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disclosure requirements of the statute, and found that the non-disclosure did not cause any harm to the franchisee. The arbitrator found in favor of Coffee Beanery on all of the franchisee's claims, and a federal district court affirmed the arbitration award.

The Sixth Circuit reversed the district court, on the grounds that the arbitrator's decision was a manifest disregard of the Maryland law. The Sixth Circuit found that grand larceny in Maryland constitutes a misappropriation of property, and as such the franchise statute explicitly required disclosure of the conviction. The court vacated the arbitrator's award, and the franchisee may now pursue its claims in court rather than arbitration.

FRAUD

GEORGIA FEDERAL COURT HOLDS THAT FRANCHISEES ADEQUATELY STATED CLAIMS FOR FRAUD AND RICO VIOLATIONS, BUT ANTITRUST CLAIMS BASED ON ALLEGED "KICKBACKS" TO FRANCHISOR FAILED

On October 27, 2008, the United States District Court for the Northern District of Georgia decided a trilogy of virtually identical cases, *Moe Dreams, LLC, et al. v. Sprock, et al.*, 2008 WL 4787493 (N.D. Ga. 2008), *Peterson, et al. v. Sprock, et al.*, 2008 WL 4787351 (N.D. Ga. 2008), and *Massey, Inc., et al. v. Moe's Southwest Grill, LLC, et al.*, 2008 WL 4767788 (N.D. Ga. 2008), in which it addressed civil RICO claims, fraud claims and claims under the Robinson-Patman Act. In all three cases, the plaintiffs—comprised primarily of investors and franchisees—initiated an action for claims arising out of the franchise agreements they entered into with the defendant franchisors. The plaintiffs each asserted claims based on allegations that the franchisors: (1) made material misrepresentations in the Uniform Franchise Offering Circulars and the franchise agreements; (2) intermingled individual and corporate assets; and (3) failed to disclose kickback payments from suppliers.

In each case, the plaintiffs argued that the franchisors engaged in a pattern of racketeering activity in violation of the Georgia Civil RICO Act. In denying the franchisors' arguments that the plaintiffs failed to properly plead their RICO claims, the court held that although the plaintiffs did not clearly and succinctly allege each predicate act and each element of their RICO claims, the complaints contained sufficient information, when considered in their entirety, to allow the franchisors to determine the facts that comprised the claims. The court, therefore, found that the plaintiffs met their burden of pleading the RICO claims.

Each of the plaintiffs also argued that the franchisors made material false representations of fact and omitted mandatory disclosures in the UFOCs and franchise agreements. The plaintiffs alleged that, among other things, the franchisors failed to

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disclose and/or concealed kickback payments that they were receiving from suppliers. The plaintiffs also identified several alleged false statements that were made by the franchisors. The court rejected the franchisors' arguments that the plaintiffs failed to allege fraud with particularity after determining that the complaints adequately provided the franchisors with specific allegations of fraud, including the source of the alleged fraudulent misrepresentations.

Finally, each of the plaintiffs argued that the franchisors' receipt of alleged "kickbacks" from suppliers constituted a violation of Section 2(c) of the Robinson-Patman Act. The court, however, held that the plaintiffs did not adequately plead a claim under the Robinson-Patman Act and failed to meet the two requirements necessary for antitrust standing. Specifically, the court found that the plaintiffs' alleged injury was not the type of injury the price discrimination law was designed to prevent, that the plaintiffs failed to allege any improper intent or conduct on the part of the suppliers who made the payments to the franchisors, and that other suppliers or customers of the plaintiffs were the proper plaintiffs to bring an antitrust action based upon the franchisors' alleged conduct.

DAMAGES TO FRANCHISOR

TEXAS COURT AWARDS LOST FUTURE PROFITS TO FRANCHISOR

In the latest rejection of the doctrine first announced by the California Court of Appeals in *PIP v. Sealy*, the Texas Court of Appeals has awarded a franchisor its lost future profits suffered as a result of a franchisee's breach of contract. In *Progressive Child Care Systems, Inc. v. Kids 'R' Kids International, Inc.*, 2008 WL 4831339 (Tex. Ct. App. Nov. 6, 2008), a franchisee breached its franchise agreements, leading the franchisor to terminate them. The franchisor then brought suit to recover past due fees as well as fees owed for the remainder of the agreements' terms.

Relying on *PIP v. Sealy*, the franchisee argued that a franchisor could not recover its lost future profits when the franchisor, rather than the franchisee, terminated the franchise agreements. The court rejected that argument and awarded lost future profits. Applying Georgia law, the court concluded that the franchisor, as a matter of traditional contract law, was entitled to be placed in the same position it would have enjoyed had the franchisee complied with the terms of the franchise agreements. In this case, had the franchisee performed for the remainder of the term, the franchisor would have continued to receive payments.

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PRELIMINARY INJUNCTION: TRADEMARKS

COURT REJECTS ARGUMENT THAT CONTINUED USE OF TRADEMARKS WOULD NOT CAUSE IRREPARABLE HARM

A recent decision by the United States District Court for the Southern District of Indiana addressed a novel argument by a terminated franchisee to justify its continued use of its franchisor's trademark. In *Country Inns & Suites by Carlson, Inc. v. Nayan, LLC*, 2008 WL 4735267 (S.D. Ind. Oct. 28, 2008), CIS had terminated the franchisee for failure to pay amounts owed under its license agreement. When the franchisee continued to operate using CIS trademarks, CIS brought suit. Gray Plant Mooty represented the franchisor.

The franchisee conceded that CIS was likely to succeed on the merits of its claim because the franchisee had failed to make required payments under the license agreement. The franchisee contended, however, that CIS could not show that it would be irreparably harmed by the franchisee's continued use of the trademarks because the franchisee's default was purely a monetary one. The franchisee argued that its continued use of the marks would not harm CIS's customer goodwill or reputation because, at most, prospective customers would be confused only as to the franchisee's payment of required license fees. The court flatly rejected that argument, reaffirming the Seventh Circuit's "well-settled presumption that irreparable harm generally follows from trademark infringement." The court found that the nature of the franchisee's default was irrelevant. Instead, CIS would suffer irreparable harm as a matter of law if a terminated franchisee were permitted to continue displaying CIS's trademarks after termination. Such use would confuse the public as to the franchisee's continued affiliation with CIS, thus causing irreparable harm to CIS. Accordingly, the court enjoined the franchisee from further use or display of CIS' trademarks.

ANTITRUST

DISTRICT COURT DENIES FRANCHISEE'S THIRD ATTEMPT TO ASSERT TYING CLAIM

The United States District Court for the District of Connecticut recently dismissed the third amended complaint of a convenience store franchisee who challenged the franchise system's primary merchandise vendor for alleged violations of federal and state antitrust laws and the Connecticut Unfair Trade Practices Act. *Bansavich v. McLane Co., Inc.*, No. 3:07cv702 (D. Conn. Oct. 31, 2008). Plaintiff Bansavich, a Mobil on the Run franchisee, challenged the requirement that franchisees participating in the system's "Exclusive Product Program" purchase certain products from approved suppliers. Specifically, Bansavich alleged that defendant McClane, the only primary merchandise vendor that supplies the required merchandise in Connecticut, engaged in

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an illegal tying arrangement by refusing to sell to Bansavich any of McLane's products unless Bansavich also agreed to purchase its tobacco products.

Noting that dismissal of a tying claim is appropriate where a plaintiff has improperly limited a product market to exclude potential substitutes, the district court held that Bansavich's alleged relevant market, the market for the "Required Products" and the "Exclusive Products," "is facially unsustainable" and that plaintiff "has impermissibly limited the product market to exclude potential substitutes" without providing any plausible explanation as to why the market was limited. Moreover, citing *Queen City Pizza v. Domino's Pizza*, 124 F.3d 430, 443 (3d Cir. 1997), the district court held that "particular contractual constraints assumed by a plaintiff are not sufficient by themselves to render interchangeable commodities non-interchangeable for purposes of relevant market definition." Accordingly, the district court dismissed the plaintiff's third amended complaint.

GOOD FAITH AND FAIR DEALING

CLAIM FOR MISUSE OF ADVERTISING FEES SURVIVES MOTION, BUT GOOD FAITH AND FAIR DEALING CLAIM OVER NEW RIVAL LOCATION FAILS

In *Sunshine Restaurant Partners, L.P. v. Shivshakti One, Inc.*, 2008 WL 2809096 (S.D. Fla. Nov. 5, 2008), the United States District Court for the Southern District of Florida granted an International House of Pancakes subfranchisor's motion to dismiss a franchisee's claim for breach of the covenant of good faith and fair dealing regarding the construction of a new location in a site the franchisee wanted, finding the construction fell in line with the contract between the parties. However, the court denied the subfranchisor's motion to dismiss the contract claim, finding that the franchisee had adequately alleged that the advertising fees were being misused.

The franchisee's claim for breach of the licensing agreement was based on its allegation that the subfranchisor was using mandatory advertising fees to promote its own stores, but not the franchisee's store. This survived the motion to dismiss because the court found that the claim rose "above the level of the speculative." Although the subfranchisor argued that the licensing agreement gave it broad discretionary rights to spend the money in the manner it saw fit, the court found that a "cognizable argument" could be made that such an interpretation was so broad that it was inconsistent with the intent of the parties in entering the agreement.

The franchisee also brought a claim for breach of the covenant of good faith and fair dealing based on its allegation that the subfranchisor opened a location on a site the franchisee had wanted. The court found that the opening of the store did not breach an express term of the licensing agreement but rather specifically complied with the

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agreement's only provision governing the opening of new locations – that they be at least two miles away from the franchisee's existing site. Absent a breach of an express term of the underlying contract or a derogation of the express terms of the same, the court found that a breach of covenant claim could not survive.

STATE FRANCHISE LAWS

CALIFORNIA COURT REFUSES TO APPLY CHOSEN LAW OF FRANCHISOR'S HOME STATE

In *It's Just Lunch International LLC. v. Island Park Enterprise Group, Inc.*, 2008 WL 4683637 (C.D. Cal. Oct. 21, 2008), a federal district court in California decided not to enforce a Nevada choice of law provision set forth in the franchise agreement in the face of a franchisee's counterclaims under the California Franchise Investment Law (CFIL) and the New York Franchise Sales Act (NYFSA). This case shows the difficultly franchisors have in enforcing choice of law provisions as to claims brought by franchisees under the CFIL and NYFSA – especially where the franchisors and/or franchisees reside or do business in these states.

In this case, the franchisor, a dating service franchise system incorporated in Nevada, had filed suit against a New York franchisee in federal court in California for failing to pay franchise fees and otherwise violating the terms of their franchise agreements. The franchisees counterclaimed, alleging violations of the CFIL and (in the alternative) the NYFSA, asserting that the franchisor had made fraudulent statements in connection with the sale of the franchises with respect to expected sales and profits. The franchisor moved to dismiss the counterclaims on the grounds that they were barred by the choice of law provision designating Nevada law. The court applied a California choice of law analysis in determining whether Nevada had a substantial relationship to the parties, whether Nevada law was contrary to a fundamental policy of California, and, if there was a fundamental conflict with California law, whether California had a materially greater interest than Nevada in determining the issue.

The court found that the franchisor had a substantial relationship with Nevada because it was incorporated in that state. However, the court refused to apply the choice of Nevada law to either the CFIL and NYFSA claims because the expressed fundamental policies of California and New York provide "a heightened degree of protection to prospective franchisees regarding misrepresentations about a franchise system." Because the counterclaimants were "franchisees claiming the need for protection against a franchisor's misrepresentations and other unfair practices," the court determined that Nevada law (which did not provide the protections established by California and New York) should not be applied to their claims. In addition, the court found that the franchisor failed to meet its burden in demonstrating that California and

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New York did not have materially greater interests in enforcing their laws than did Nevada with respect to the CFIL and NYFSA counterclaims. It reached that conclusion because, while the franchisor was incorporated in Nevada, it had its offices in California, two other counterdefendants resided in California, and the counterclaimants themselves operated the franchise in New York.

CALIFORNIA COURT DISMISSES OR STAYS FRANCHISEE'S CLAIMS ARISING OUT OF SAME FACTS AS IN PRE-EXISTING COLORADO CASE

In *SDMS, Inc. v. Rocky Mountain Chocolate Factory Inc.*, 2008 WL 4838557 (S.D. Cal. Nov. 6, 2008), the United States District Court for the Southern District of California considered claims brought by terminated franchisees under the California Unfair Business Practices and Unfair Competition Acts. The franchisees alleged that the sale of products by Rocky Mountain to discount retail outlets such as Costco.com, without disclosure to the franchisees prior to execution of the franchise agreement, violated their rights under the California statutes. At the outset the court acknowledged that a similar case involving the same parties was pending in the United States District Court for Colorado. The court ruled that if Colorado law governed the allegations in the franchisees' California-law claims, those claims must be dismissed. The court also determined that several of the franchisees' claims in the California case were precluded because they involved facts and issues addressed in the Colorado case. Additionally, to the extent that issues raised in the California case should have been asserted as compulsory counterclaims in Colorado, the California court stayed consideration of those claims the Colorado case has ended. Nevertheless, the court evaluated whether the franchisees had failed to state valid California-law claims and concluded that a claim requesting disgorgement and restitution under the California Unfair Competition Act would survive a motion to dismiss, provided that it is not ultimately required to be dismissed as a claim which should have been brought in the Colorado case.

The parties' franchise agreement contained a Colorado choice of law clause, but the Rocky Mountain UFOC stated that this clause "may not be enforceable under California law." The California court held that even if this UFOC language created an unenforceable choice of law clause for lack of a "meeting of the minds," application of California law would not be automatic. The franchisor had filed a claim for damages against the franchisees in Colorado. In the absence of a valid choice of law clause in a diversity case, a court could base the applicable law on the forum state's choice of law rules. Although Colorado and California followed the same conflict of law principles in this regard, the court stayed the resolution of the choice of law issue pending the outcome in Colorado.

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Minneapolis, MN Office

John W. Fitzgerald, Co-Chair (612-632-3064)
Megan L. Anderson (612-632-3004)
Wade T. Anderson (612-632-3005)
Phillip W. Bohl (612-632-3019)
* Jennifer C. Debrow (612-632-3357)
Elizabeth S. Dillon (612-632-3284)
* Collin B. Foulds (612-632-3388)
* Michael R. Gray (612-632-3078)
Laura J. Hein (612-632-3097)
Kelly W. Hoversten (612-632-3203)
Franklin C. Jesse, Jr. (612-632-3205)
Cheryl L. Johnson (612-632-3271)
* Jeremy L. Johnson (612-632-3035)
Gaylen L. Knack (612-632-3217)

Kirk W. Reilly, Co-Chair (612-632-3305)
Gregory R. Merz (612-632-3257)
* Craig P. Miller (612-632-3258)
Bruce W. Mooty (612-632-3333)
John W. Mooty (612-632-3200)
* Kevin J. Moran (612-632-3269)
Max J. Schott II (612-632-3327)
Daniel R. Shulman (612-632-3335)
* Jason J. Stover (612-632-3348)
Michael P. Sullivan, Sr. (612-632-3351)
Michael P. Sullivan, Jr. (612-632-3350)
Henry Wang (612-632-3370)
Lori L. Wiese-Parks (612-632-3375)
Quentin R. Wittrock (612-632-3382)

Washington, D.C. Office

Robert Zisk, Co-Chair (202-295-2202)
* Jimmy Chatsuthiphan (202-295-2217)
* Ashley M. Ewald (202-294-2221)
* Jeffrey L. Karlin (202-295-2207)
* Iris F. Rosario (202-295-2204)
* Stephen J. Vaughan (202-295-2208)
* Katherine L. Wallman (202-295-2223)
* David E. Worthen (202-295-2203)
Eric L. Yaffe (202-295-2222)
* Carl Zwisler (202-295-2225)

**** Wrote or edited articles for this issue.***

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GRAY, PLANT, MOOTY, MOOTY & BENNETT, P.A.

500 IDS Center
80 South Eighth Street
Minneapolis, MN 55402-3796
Phone: 612-632-3000
Fax: 612-632-4444

2600 Virginia Avenue, N.W.
Suite 1111 – The Watergate
Washington, DC 20037-1905
Phone: 202-295-2200
Fax: 202-295-2250

franchise@gpmlaw.com

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