The Franchise Memorandum | By Lathrop GPM

To: **Our Franchise and Distribution Clients and Friends**

From: **Lathrop GPM's Franchise and Distribution Practice Group**
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Welcome to *The Franchise Memorandum by Lathrop GPM*. Below are summaries of recent legal developments of interest to franchisors.

Renewals

Fifth Circuit Reverses Trial Court's Excusal of Area Representative's Tardy Renewal Notice

The Fifth Circuit Court of Appeals has reversed a Texas court's ruling excusing an area representative's untimely renewal notice and rendered judgment for the franchisor. *Pizza Inn, Inc. v. Clairda*y, 979 F.3d 1064 (5th Cir. 2020). Clairday and Pizza Inn were parties to two area development agreements under which Clairday held two five-year options to renew. Clairday failed to timely notify Pizza Inn of his intent to exercise the second renewal option. Pizza Inn did not honor the tardy notice of renewal and did not renew. A jury awarded damages after finding that Pizza Inn had breached the agreements. Determining that the notice of renewal was sufficiently timely under the doctrine of equitable intervention, the district court upheld the verdict and awarded Clairday attorneys' fees. Pizza Inn challenged (1) the application of the equitable-intervention doctrine, (2) the damages award, and (3) the award of attorneys' fees.

The Fifth Circuit held that the district court applied the equitable-intervention doctrine incorrectly, noting that because strict compliance with the agreement did not result in an unconscionable hardship, equitable intervention was inapplicable. Clairday asserted three hardships that, in his view, made it unconscionable to enforce the renewal deadline strictly: a partial forfeiture of the $1,250,000 purchase price of the Agreements, a forfeiture of future profits, and the shuttering of a Pizza Inn franchise store. The court found that Clairday did not suffer a forfeiture of his initial $1,250,000 investment because Clairday received the full agreed equivalent of the price he paid for his option when the option expired. Therefore, Clairday lost no more than his power to exercise the option. Next, Clairday's loss of the opportunity to turn a profit did not shock the conscious to the extent that it should be found unconscionable and trigger the court to apply the narrow equitable exception. Finally, Clairday's final asserted hardship — shuttering a Pizza Inn franchise store — also fell short of the high threshold he needed to prove unconscionability because the store was a distinct entity, subject to its own contracts, and not associated with the area developer agreements. Such an attenuated connection was insufficient to attach the store's closure to Pizza Inn's decision not to renew the agreements. Accordingly, because Clairday did not suffer unconscionable hardship, the court reversed the district court and rendered judgment for Pizza Inn.

Terminations

Sixth Circuit Affirms Summary Judgment Enforcing Franchise Agreement Termination and Awarding Liquidated Damages

The Sixth Circuit Court of Appeals recently affirmed a Michigan federal court's grant of summary judgment enforcing Little Caesar's termination of franchise agreements for related multi-unit franchisees based on nonpayment and repeat defaults. *Little Caesar Enters., Inc. v. Little Caesars ASF Corp*., 2021 WL 37544 (6th Cir. Jan. 5, 2021). Lathrop GPM represented Little Caesar in the case. Little Caesar terminated the franchise agreements after the franchisees accrued more than $200,000 in debt for, among other things, unpaid royalties, and failed to cure their defaults. In an order granting summary judgment for Little Caesar, the district court enforced the franchise agreements' termination and, in addition to other relief, awarded Little Caesar liquidated damages equal to up to three years' worth of royalties and advertising fees, which amounted to $2.6 million.

The Sixth Circuit affirmed the district court's decision. On appeal, the franchisees raised a host of arguments, including that Little Caesar had waived its right to terminate the agreements by allowing the franchisees to continue to operate their franchises after sending a notice of termination. The Sixth Circuit affirmed the district court's holding that there was no evidence of such a waiver because Little Caesar's termination notice contemplated that the parties could continue their relationship while any dispute over termination was litigated. The Sixth Circuit also had little trouble rejecting the franchisees' other assignments of error, finding that they had waived their arguments by failing to timely raise them before the district court and that there was no "exceptional" basis for overlooking that defect.

Joint Employer

Pennsylvania Federal Court Dismisses Joint Employer Claims Against McDonald's

A federal court in Pennsylvania dismissed all claims against a franchisor because the plaintiff failed to plausibly allege that the franchisor and its franchisee were joint employers. *Doe v. McDonald's USA, LLC*, 2020 WL 7133517 (E.D. Pa. Dec. 3, 2020). Sixteen-year-old Jane Doe brought claims for discrimination, hostile work environment, and intentional infliction of emotional distress against McDonald's and its franchisee, alleging McDonald's and the franchisee were joint employers and thus jointly liable for the franchisee's manager's misconduct. McDonald's moved to dismiss for failure to state a claim. The district court agreed with McDonald's and dismissed all claims against it.

The court analyzed three factors to determine whether McDonald's maintained sufficient control over the manager such that it was a joint employer. The court concluded that all of the factors weighed against Doe. First, the court reasoned that although the franchise agreement mandated hours of operation, required specific uniforms, and provided other operational practices and policies, Doe failed to allege that McDonald's had control to hire or fire the restaurant's employees. Second, the court determined that Doe failed to allege that McDonald's provided training to the manager at issue or that it participated in employee discipline at the restaurant where the misconduct occurred. Lastly, the court found that, although Doe alleged that McDonald's maintained control of employee records, she failed to allege that it could access payroll, personnel files, or sales-related records. The court concluded that Doe failed to plead facts to support a joint employer relationship between McDonald's and the franchisee and therefore, McDonald's could not be held liable for the manager's misconduct.

Massachusetts Federal Court Declines to Dismiss Parent Company Based on Plausible Allegations of Joint Employer Status

In another case involving joint employer allegations, a federal court in Massachusetts denied a motion to dismiss brought by Enterprise Holdings, Inc. (Enterprise), finding that the plaintiff Mamadou Bah plausibly alleged Enterprise was his joint employer. *Bah v. Enter. Rent-A-Car Co. of Bos., LLC*, 2020 WL 6701324 (D. Mass. Nov. 13, 2020). Plaintiff was an assistant manager employed by Enterprise-Boston, an independent regional subsidiary of Enterprise, and alleged that Enterprise-Boston and Enterprise violated the Fair Labor Standards Act and the Massachusetts Overtime Law when he was moved from exempt to non-exempt status and not afforded back pay. Enterprise moved to dismiss, arguing that it did not jointly employ Bah under the FLSA. The court disagreed finding that pursuant to the *Baystate* test applied by the First Circuit Bah alleged facts sufficient to support an inference that Enterprise was his joint employer.

Under the FLSA, when two or more employers jointly employ someone, the joint employers are held jointly and severally liable. In deciding if a defendant is an employer, the courts look to the economic reality of the totality of the circumstances bearing on whether the putative employee is economically dependent on the alleged employer. To do so, *Baystate* directs courts to consider four factors. The DOL regulations promulgated on January 21, 2020 regarding the interpretation of joint employer under the FLSA were consistent with the approach in *Baystate*, which the court applied to Bah's claims. First, the court considered whether Enterprise had the power to hire and fire employees, and found that Enterprise's guidelines did not give Enterprise this ability. Second, the court considered whether Enterprise supervised and controlled employee work schedules or conditions of employment. Here, the court found Enterprise's guides, policies, and procedures controlled the conditions of employment by addressing employee time off, creating uniform job descriptions, and implementing uniform authority for assistant managers across all regional subsidiaries. Third, in analyzing whether Enterprise determined the rate and method of payment, the court found Enterprise did impose policies addressing pay structure, time off, and exempt status on a nationwide basis. Fourth, in considering whether Enterprise maintained employment records, the court found Enterprise maintained records of employee benefits, clocked hours, and time off. Therefore, under the totality of the circumstances, Bah alleged facts plausibly supporting Enterprise's status as a joint employer under the FLSA. The court denied Enterprise's motion to dismiss.

Fraud/Misrepresentation

Michigan Federal Court Rules Against Franchisee on Most Fraud Claims

A federal court in Michigan has relied upon contractual disclaimers to reject most of the fraud-related claims asserted by a failed massage franchisee, but did award damages amounting to the initial franchisee fee based upon the franchisor's misrepresentations in its FDD regarding the number of closed units. *MTR Capital, LLC v. LaVida Massage Franchise Dev., Inc.*, 2020 WL 6536954 (E.D. Mich. Nov. 6, 2020). MTR Capital brought common law and statutory claims against LaVida based upon allegedly false financial performance representations. Although no Item 19 disclosures were provided in the FDD, Joaquin Esquivia, the owner of MTR, received a spreadsheet that modelled income and expenses. Esquivia also reviewed a press release and LaVida's website, both of which touted the franchise's growth potential. After exchanging questions and answers, which included a specific warning from LaVida that it could not guarantee MTR's profitability, MTR entered into the franchise agreement with LaVida. Within a year, MTR sued LaVida for fraudulent inducement and misrepresentation, negligent misrepresentation, violation of Florida's Deceptive and Unfair Trade Practices Act, and violation of the Florida Franchise Act.

After a full trial, the court found in favor of MTR on its Florida Deceptive and Unfair Trade Practices Act violation but in favor of LaVida on all other claims and, importantly, on all claims based upon financial performance representations. LaVida's failure to accurately state the number of closed franchises in Item 20, even though unintentional, violated the FTC Rule and therefore violated the Florida statute. The court also determined, however, that the presence of an integration and disclaimer provision in the franchise agreement undermined MTR's claim that it relied upon the spreadsheet model to project its potential profitability. The provision required MTR to agree that it had received no income projections or representations, that it was not guaranteed any success, that it understood there was a high degree of risk in investing in a franchise, that it had conducted its own independent investigation, and that it had been asked at the time of signing the franchise agreement to identify any financial performance representations it was relying upon in entering into the franchise agreement. At the time of signing, MTR identified no such representations and even initialed the relevant page signifying it had been read. The court held that these facts precluded any claim of reliance. With respect to the FDD misstatements, the evidence showed LaVida had poor recordkeeping and not that LaVida intended to deceive MTR. Lastly, MTR did not convince the court that LaVida's website and press release were more than puffery. Ordinary diligence required MTR to investigate further before relying on the press release or website.

North Carolina Federal Court Dismisses Fraud and Other Claims Against Restaurant Franchisor

Meanwhile, a federal court in North Carolina granted motions for summary judgment filed by a franchisor and its owners on claims for fraud, misrepresentation, breach of the duty of good faith and fair dealing, breach of fiduciary duty, and a violation of North Carolina's Unfair and Deceptive Trade Practices Act. *Trident Atlanta, LLC v. Charlie Graingers Franchising, LLC*, 2020 WL 6889208 (E.D.N.C. Nov. 23, 2020). The lawsuit was filed by former franchisees and area representatives of the Charlie Graingers restaurant system based on allegedly misleading statements that the franchisor had made regarding the strength of the business and concept, including assertions that it had the "cleanest Restaurants in America," a "low cost-low overhead foolproof restaurant concept" that was "guaranteed to be successful," and that it provided "world-class" and "endless" support to franchisees. The court granted Charlie Graingers' motion for summary judgement, dismissing the franchisees and area representatives' claims that Charlie Graingers had engaged in wrongdoing.

In dismissing the claim that Charlie Graingers had breached its fiduciary duty to the plaintiffs, the court first held that there was no evidence of a relationship of trust and confidence between Charlie Graingers and the franchisees and area representatives from which a fiduciary duty would arise. After noting that North Carolina courts have found evidence of a fiduciary relationship when one party dominates the other, the court specifically found the plaintiffs were highly sophisticated executives who engaged in substantial independent investigation of the investment and were represented by counsel. Hence, there was no evidence that Charlie Graingers had the upper hand.

In analyzing the UDTPA claim and other claims of fraud and misrepresentation, the court noted that the plaintiffs must have actually and reasonably relied on Charlie Graingers' statements. To show actual reliance, plaintiffs must have affirmatively incorporated the alleged misrepresentation into their decision-making process. The court held that the plaintiffs did not actually rely on Charlie Graingers' statements, in part because the various plaintiffs' key decision makers testified that they had not received and read, or were not influenced by, the documents containing the Charlie Graingers statements. Moreover, under North Carolina law, reliance is unreasonable as a matter of law when a plaintiff relies upon a representation that directly contradicts the express terms of a written contract. The court found that

Charlie Graingers' franchise agreements contained numerous express terms that dispelled any confusion that may have been caused by the allegedly misleading statements, including provisions regarding the finite scope of assistance that Charlie Graingers was obligated to provide, and Charlie Graingers' inability to predict franchisees' financial performance. The court additionally noted the franchise agreements' strong merger clauses also made any reliance on extra contractual statements unreasonable. Finally, after holding that many of the alleged misrepresentations could also be rightly dismissed as "mere puffery," the court concluded that the franchisees could not have reasonably relied on the allegedly misleading statements. Thus, the court granted the motions for summary judgment in favor of Charlie Graingers and its owners.

Encroachment

Franchisee's Claim that Franchisor Breached the Implied Covenant Survives Motion to Dismiss

A federal court in Colorado has denied a motion to dismiss a franchisee's claim that the franchisor breached the implied duty of good faith and fair dealing. *Kazi v. KFC US, LLC*, 2020 WL 6680361 (D. Colo. Nov. 12, 2020). The franchise agreement in question stated that KFC would not operate, or permit a third party to operate, another KFC within a one-and-a-half mile radius of Kazi's restaurant. In March 2019, after execution of the franchise agreement, KFC issued a policy allowing franchisees to request an impact study if KFC intended to permit the development of a new location within 10 miles of an existing location. Under these guidelines, KFC would either (i) permit development of the location if the potential impact was less than 10% on the existing location, (ii) conduct further review if the potential impact was between 10% and 15% on the existing location, or (iii) not permit development if the potential impact was more than 15% on the existing location. In April 2019, KFC notified Kazi of a potential new location outside of his protected territory, but within 10 miles of his unit. Kazi requested an impact study. KFC conducted the study, which showed a potential impact of about 13%. Believing the results of the KFC study were wrong, Kazi commissioned his own study, which showed a potential impact of between 33% and 36%. Kazi requested KFC not grant a franchise for the proposed location, but KFC refused. Kazi then filed a lawsuit claiming breach of the express contract terms, breach of the implied covenant, and other claims. KFC sought to dismiss all claims.

Kazi first sought to have the court agree that the guidelines were a part of the franchise agreement, and that a breach of the guidelines was therefore a breach of the contract. Since the franchise agreement could only be amended in writing and signed by both parties, and the parties had not signed guidelines, the court held the guidelines did not amend the franchise agreement and dismissed Kazi's claim for breach of the express terms of the contract. The court then considered Kazi's claim that KFC breached the implied covenant of good faith and fair dealing. KFC argued that the implied covenant cannot prevent a party from exercising its express rights under the franchise agreement. The court pointed out, though, that the franchise agreement simply stated that KFC would not place a location within a one and half mile radius of the restaurant, and did not grant KFC unfettered rights to place locations outside that radius. The implied covenant required KFC to act reasonably and not inconsistently with the parties' expectations, according to the court. By issuing the guidelines, KFC had told its franchisees how it would act when considering another franchise location within 10 miles of an existing location. KFC argued that it had not breached the implied covenant because it had followed the guidelines by doing the study. However, since the franchisee's own study contradicted KFC's, the court found that the franchisee had alleged sufficient facts that could support a conclusion that KFC's study was deficient and, if true, the guidelines were not followed. As a result, the court denied KFC's motion to dismiss this claim.

Trademark

Missouri Federal Court Partially Grants Franchisees' Motion to Dismiss Franchisor's Lanham Act Claims and Stays Proceedings on Surviving Claims Pending Resolution of Parallel Proceedings in North Carolina State Court

A federal court in Missouri partially granted franchisees' motion to dismiss a franchisor's Lanham Act claims and stayed the proceedings on the surviving claims pending the resolution of parallel proceedings in North Carolina state court. *Window World Int'l, LLC v. O'Toole*, 2020 WL 7041814 (E.D. Mo. Nov. 30, 2020). Window World, a franchisor of home remodeling products, was sued by dozens of its franchisees in North Carolina state court for various claims, some of which related to the franchisees' rights to use Window World's trademarks. Window World later sued three of those franchisees in federal court in Missouri for sending a letter to their customers that included Window World's trademarks and falsely claimed that their product warranties would expire if the customers did not contact the franchisees. Window World asserted that the letter constituted false advertising, trademark infringement, and trademark dilution under the Lanham Act. The franchisees moved to dismiss all of Window World's claims or to stay the proceedings pending the resolution of the North Carolina proceedings.

The court dismissed Window World's false advertising claim, finding that the allegedly deceptive statement was unlikely to influence a purchaser's decision. It also dismissed Window World's trademark dilution claim because the dilution alleged did not involve an "unaffiliated product." However, the court rejected the franchisees' argument that a licensee could not commit trademark infringement and thus declined to dismiss Window World's infringement claim. Finally, the court decided to stay the federal proceedings until the North Carolina court ruled on the threshold issue of the scope of the franchisees' trademark license.

Contracts

Missouri Appellate Court Reverses Application of Franchise Agreement Fee Provision to Claim of Fraudulent Inducement

The Missouri Court of Appeals reversed an award of attorneys' fees to a franchisor made by the trial court, finding that the franchisor's recovery was barred by a settlement agreement, and even if not barred, would have been limited to success on only breach of contract claims under the franchise agreement. *AEFC, Inc. v. Vietti*, 2020 WL 7381536 (Mo. Ct. App. Dec. 16, 2020). Plaintiff AEFC licenses the "Adam & Eve" brand to franchisees who use it to sell lingerie and adult-themed novelty products. Following the deterioration of AEFC's relationship with franchisee Vietti Enterprises and its president Tammy Vietti, the parties entered into a settlement agreement. Unlike the franchise agreement and its personal guarantee, the settlement agreement contained no attorneys' fees provision. By executing the settlement agreement, the parties agreed to terminate the franchise agreement and agreed to a two-year period of noncompetition. The very next day, Vietti's husband opened a competing business at the site of Vietti's Adam & Eve store. AEFC sued Vietti for fraudulently inducing it to enter the settlement agreement, seeking damages and rescission. It also advanced several alternative theories of recovery, including breach of the franchise agreement, personal guarantee, and settlement agreement. At trial, AEFC abandoned its claim for rescission of the settlement agreement and most of its alternative claims, seeking recovery only for fraudulent inducement or, in the alternative, breach of the settlement agreement. The jury found Vietti liable for damages of $106,626.61 for fraud and so did not consider the breach claim. The trial court then awarded AEFC $350,708.00 in fees.

Vietti appealed the fee award, arguing that it was improper in light of the fact that AEFC did not prevail on any breach of contract claim. The appellate court agreed. First, it noted that the parties stipulated to post-trial consideration of attorneys' fees only if AEFC prevailed on a contractual claim — which it did not. Second, the court rejected AEFC's argument that the attorneys' fees provisions of the franchise agreement and personal guarantee justified the fee award, pointing out that the settlement agreement expressly terminated the franchise agreement and personal guarantee. That termination remained effective, because AEFC abandoned its request for rescission of the settlement agreement. As a result, AEFC had no basis for recovery under the fee provisions of the franchise agreement or personal guarantee.

Rulemaking

Lathrop GPM Franchise Team Argues FTC Rule Does Not Require Material Changes; Evidence Does Not Support Need for Revision

As a part of its decennial review of the Franchise Rule, which is required by a series of executive orders, the FTC invited interested parties to participate in a Virtual Public Workshop on November 10, 2020 to discuss potential changes to the Rule. Lathrop GPM was one of nine law firms and independent lawyers asked to comment on proposed changes, in particular, changes to the FDD format. While acknowledging that current FDD requirements do result in long documents, and applauding efforts by the FTC and NASAA to make the document easier to navigate and understand, Lathrop GPM cited available research indicating that the vast majority of franchisees surveyed indicate that they do read and understand FDDs and franchise agreements. The research does not support the need to change the FDD format.

In response to the FTC's request for comments on the full range of potential changes to the Franchise Rule, which surfaced during the Workshop and in comments submitted to the FTC in 2019 as a part of the Rule Review, Lathrop GPM submitted comments challenging the desirability of mandating Financial Performance Representations. The firm's comments also argued that by requiring the use of a Summary Disclosure Document, as well as a full FDD, the goals of the disclosure rule would be undermined. If readers understood that an executive summary contains the most important information, many or most would not read the complete FDD. Moreover, despite its length, the FDD is itself a summary of information, so any further summarizing would create the impression that the additional information is likely to be only marginally relevant.

Lathrop GPM's comments were one of 122 comments submitted. They may be found here.

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