



## *The GPMemorandum*

**TO: OUR FRANCHISE CLIENTS AND FRIENDS**

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

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This section of *The GPMemorandum* addresses non-judicial developments, trends, and best practices of interest to franchisors. Reports of recent judicial developments begin on page 3.

### **FTC POSTS NEW FAQs**

On May 18, 2009, the FTC posted five new Frequently Asked Questions on its website (FAQs 29-33). All 33 FAQs and the FTC staff's respective responses can be found at <http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml>. The release of the new FAQs occurred on the same day that Craig Tregillus, FTC Franchise Rule Coordinator, participated in an "Ask the Regulators" session at the International Franchise Association's 42nd Annual Legal Symposium. Consequently, Mr. Tregillus was able to give those in attendance a first-hand introduction to these important new FAQs.

FAQ 29 is most welcome to franchisors and their attorneys. Recognizing the costs of revising FDDs and that FAQs are intended to provide guidance on gray issues (i.e., issues not directly addressed by the amended FTC Franchise Rule, the Statement of Basis and Purpose, or the Compliance Guide), the FTC staff has taken the position that even if an FAQ necessitates a change to a franchisor's FDD, the franchisor will not be obligated to amend its FDD until it is otherwise required to do so under the Rule or state law. In other words, as a matter of policy, the FTC will not recommend an enforcement action against a franchisor based on a new FAQ, provided the franchisor updates its FDD, as appropriate, before any new filing in a registration state, before any quarterly updates required under the Rule, and, in any event, no later than its next annual update mandated under the Rule. To facilitate the process outlined in FAQ 29, all new FAQs will include an issuance date.

Included below is a summary of the other new FAQs.

- FAQ 30 – The FTC staff clarifies that a franchisor must include the financial statements of its parent in Item 21 if that parent is the sole supplier of a good or service without which a franchise cannot be operated.
- FAQ 31 – While the Rule requires a franchisor to update its FDD within 120 days of the close of its fiscal year, as a matter of enforcement policy, the FTC staff would not recommend enforcement against a franchisor who continues to use a validly registered FDD in a particular franchise registration state after the 120-day period, provided the state registration remains in effect.
- FAQ 32 – Franchisors may not use audited financial statements in Item 21 if an auditor has issued a qualified opinion because those statements do not comply with FIN 46R, issued by the Financial Accounting Standards Board. In that case, the financials are not prepared in accordance with U.S. GAAP, as required.
- FAQ 33 – Despite the long-standing, state-accepted practice by some franchisors of including financial performance representations (FPRs) or, previously, “earnings claims”, in an attachment to the FDD, all FPRs must be in Item 19 itself, rather than in an attachment.

While this article provides an overview of new FAQs 29-33, franchisors and their attorneys should review the full text, as well as the other FAQs posted by the FTC.

### **NASAA ADOPTS FINAL VERSION OF COMMENTARY ON 2008 FRANCHISE REGISTRATION AND DISCLOSURE GUIDELINES**

Following its adoption of the 2008 Franchise Registration and Disclosure Guidelines in June 2008, the North American Securities Administrators Association, Inc. (NASAA) released a proposed Commentary to those guidelines and accepted comments to the same until October 23, 2008. After reviewing and analyzing the comments it received, NASAA on April 27, 2009, adopted a final version of the Commentary, a copy of which can be obtained at [www.nasaa.org/Industry\\_Regulatory\\_Resources/Franchise/](http://www.nasaa.org/Industry_Regulatory_Resources/Franchise/). While NASAA made some minor revisions and clarifications to the proposed Commentary in creating the final version, none were substantial. Franchisors and their attorneys should be sure to review this Commentary because it provides “practical guidance about complying with state franchise disclosure and registration requirements under NASAA’s 2008 Franchise Registration and Disclosure Guidelines.” Specifically, it incorporates several UFOC Commentary items that are still applicable, and addresses Guidelines-related questions and issues posed by franchise counsel, state examiners, and others.

## RECENT CASES

Here are summaries of recent cases of interest to franchisors:

### DAMAGES TO FRANCHISOR

#### U.S. COURT OF APPEALS UPHOLDS AWARD OF LIQUIDATED DAMAGES TO FRANCHISOR

In a case litigated by Gray Plant Mooty, the Eleventh Circuit Court of Appeals last month affirmed the grant of summary judgment to a franchisor seeking recovery of liquidated damages owed under a hotel franchise agreement. In *Country Inns & Suites by Carlson, Inc. v. Interstate Properties, LLC*, 2009 WL 1298401 (11th Cir. May 12, 2009), the court of appeals considered the franchisee's arguments that the liquidated damages clause at issue could not be enforced because it did not take into account the amount of time remaining on the franchise agreement in calculating liquidated damages, did not reduce the liquidated damages award to present value, and determined liquidated damages based on gross revenues rather than the franchisor's actual profits.

The court of appeals affirmed the district court's order in all respects, and stated that it found the franchisee's arguments to be "unpersuasive." The court agreed with the district court that the liquidated damages that the franchisee agreed to pay were not grossly disproportionate to the damages that might reasonably be expected to follow from a breach. The court also found that the liquidated damages clause did not operate as an impermissible bar on the franchisee's ability to transfer the hotel.

#### FRANCHISEES' DEFAULT FOR FAILURE TO COMPLY WITH DISCOVERY OVERTURNED

The Sixth Circuit in *Krowtoh II LLC v. Excelsius Int'l Ltd.*, No. 08-5492 (6th Cir. May 19, 2009), overturned a district court's opinion that had defaulted franchisees for their failure to find counsel, timely appear at a court hearing, and comply with discovery. The district court had awarded the franchisor damages in the amount of \$781,226.00, but that judgment to the franchisor failed to withstand appeal.

This case began when the franchisees terminated the relationship after two years of operation. The franchisor sued for breach of contract, misappropriation of trade secrets, unfair competition, and conversion. In overturning the district court's default judgment, the Sixth Circuit noted that the franchisor-plaintiff had suffered no prejudice, and the franchisees' delay in responding to discovery did not constitute prejudice under Sixth Circuit case law. Moreover, the Sixth Circuit found that the defendant's failure to

comply with a court order and discovery were excusable, as the individual responsible for overseeing litigation for the defendant was unfamiliar with the U.S. legal system, since he was from Germany. The appeals court also noted that the franchisor was at fault as well because, for a period of time, the franchisor failed to prosecute its case. For these reasons, the Sixth Circuit overturned the district court's decision defaulting the franchisees, and the case was remanded to the lower court.

### FEDERAL COURT UPHOLDS FRANCHISOR'S ARBITRATION AWARD

In *Medicine Shoppe International, Inc. v. Turner Investments, Inc.*, 2009 WL 1295978 (E.D. Mo. May 7, 2009), the district court confirmed a \$475,000 arbitration award in favor of the franchisor, Medicine Shoppe International (MSI). The American Arbitration Association had ruled that MSI was entitled to its past-due license fees, attorneys' fees and costs, and future licensing fees due to the franchisee's decision to close the franchise 13 years into the 20-year franchise term.

Turner Investments moved to vacate the award, arguing that the arbitrator disregarded the law by failing to consider MSI's alleged breach of the franchise agreement and lack of sufficient evidence of lost profits. In rejecting these arguments, the court found that Turner's points actually were assertions of alleged factual errors. Regardless, the court held that neither a disregard of the law nor a disagreement about factual findings is grounds to vacate an arbitration award. Furthermore, without alleging any corruption or bias specific to its arbitration or arbitrators, Turner also argued that the "arbitration process is fundamentally unfair to franchisee respondents." The court rejected this contention out of hand because Turner failed to submit any evidence that the award was procured by corruption, fraud, or undue means.

### CLASS CERTIFICATION

#### ILLINOIS FEDERAL COURT DENIES MOTION FOR CLASS CERTIFICATION

An Illinois federal district court recently dismissed a motion for class certification arising out of the plaintiffs' claim that they were deceived about the ingredients in McDonald's french fries and hash browns. *In re McDonald's French Fries Litig.*, 2009 WL 1286024 (N.D. Ill. May 6, 2009). The plaintiffs had claimed that McDonald's falsely stated that its potato products were gluten, wheat, and dairy-free (i.e., "allergen free") through its Web site and literature available at McDonald's restaurants. The plaintiffs further alleged that they purchased these products based solely on representations that the products were allergen free. Based on this claim, the plaintiffs sought to certify a national class of all persons in the United States who purchased potato products from McDonald's restaurants on or after February 27, 2002, through February 7, 2006, and had been

medically diagnosed with celiac disease, galactosemia, autism, and/or wheat, gluten, or dairy allergies at the time of the purchase.

In denying the motion for class certification, the court found the proposed class was different from the claims in the case and was thus over inclusive. Specifically, the court found that the proposed class members did not consist only of those persons who saw or otherwise knew about McDonald's representations that its potato products were allergen free and who purchased such products on the basis of that representation. Further, the court found that class certification was inappropriate because many of the people purchasing the potato products were not deceived or would have bought the products anyway. The court also held that rewriting the class definition by limiting it to persons with one of the stated diagnoses who purchased potato products in reliance on McDonald's representations—and who would not otherwise have purchased the products—would not solve the certification problem because a separate evidentiary hearing would be required for each claimant. The court determined that the time required for such hearings outweighed the gain to be realized.

## BANKRUPTCY

### FEDERAL BANKRUPTCY COURT FINDS FAILURE TO TRANSFER AGREEMENTS TO CORPORATION LEFT OBLIGATIONS IN NAME OF INDIVIDUAL

A bankruptcy court in North Carolina has refused to apply the automatic stay in bankruptcy to agreements that were never formally transferred to the would-be franchisee corporation. *In re KVS Foodsystems, LLC*, 2009 WL 1241272 (Bankr. E.D.N.C. April 29, 2009). Subway's parent company, Doctor's Associates, had entered into a franchise relationship and sublease agreement for two Subway stores with an individual named Vitus Bradshaw. Bradshaw then formed KVS Foodsystems, LLC (KVS), to operate his two stores, but he never transferred the rights or obligations of the franchise agreement or sublease to KVS. In November 2008, KVS filed for bankruptcy. This reported decision arose from Bradshaw's petition to the court for an automatic stay protecting his Subway subleases as "property of the estate" under Chapter 11 of the Bankruptcy Code.

The court rejected Bradshaw's petition, stating, among other things, that Bradshaw is "neither the Debtor, a third party defendant, nor a co-defendant . . . [and] has a contractual relationship with Subway," and that Bradshaw, not KVS, had failed to pay rent to the franchisor for four consecutive months. Therefore, Doctor's Associates rightfully terminated the subleases. The only remedy, the court stated, is for Bradshaw "to file an individual bankruptcy petition under the appropriate chapter should he determine that it is in his interest to . . . gain the benefit of the automatic stay."

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