



The GPMemorandum

TO: OUR FRANCHISE CLIENTS AND FRIENDS

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

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

PROCEDURE

VIRGINIA DISTRICT COURT ENFORCES WAIVER OF TRIAL BY JURY AND CLAIM TO PUNITIVE DAMAGES CONTAINED IN FRANCHISE AGREEMENTS

The United States District Court for the Eastern District of Virginia this month upheld franchise agreement provisions waiving the franchisee's right to a jury trial and punitive damages claims. *Dunkin' Franchised Restaurants, Inc., et al. v. Manassas Donut, Inc., et al.*, 2008 WL 110474 (E.D. Va. Jan. 8, 2008). (This was a case handled for the franchisor by Gray Plant Mooty.)

In considering the validity of a jury waiver, the court considered: (1) the parties' negotiations concerning the waiver provisions; (2) the conspicuousness of the provision in the contract; (3) the relative bargaining power of the parties; and (4) whether the waiving party's counsel had the opportunity to review the agreement. The court found that the waiver clause was listed in a conspicuous manner—in two places in the franchise agreements—in capital letters and once in bold font. The court also found that there was sufficient evidence to conclude that one of the shareholders of the franchisee was an attorney and had read the franchise agreements, and that the other shareholder was an experienced franchisee who made the decision not to have his attorney

review the agreements before signing them. The court also noted that courts in other franchise cases have upheld similar jury waiver provisions. The court held that these facts supported the conclusion that the franchisee's waiver of the right to a jury trial was both knowing and intentional.

With regard to the waiver of punitive damages, the court found that other courts have upheld similar waivers when they are expressly stated in the franchise agreement. Here, the court determined that, like the waiver of the right to a trial by jury, the waiver was listed in a conspicuous manner in the franchise agreements, leading to the conclusion that defendants knowingly and voluntarily waived any claim for punitive damages.

Finally, the court found no merit to defendants' argument that because their counterclaims seek relief for acts committed by Dunkin' Donuts outside of the contractual relationship between the parties, the waiver provisions within the franchise agreements are inapplicable. Rather, the court found that the language of the waiver clause was broad enough to cover all disputes between the parties, including those disputes arising outside of their contractual relationship. Moreover, the court also found that while defendants' counterclaims were pled as torts, they were more accurately described as contract claims for wrongful termination. Thus, because the counterclaims involve questions of whether Dunkin' Donuts fulfilled its obligations under the franchise agreements, the court found that the waiver provisions apply.

DEFAULT SET ASIDE, BUT FRANCHISORS REMINDED NOT TO RELY ON FRANCHISEES TO DEFEND THEM

A federal district court in Louisiana overturned a default judgment in a case that serves as a warning to franchisors who are named in lawsuits that should have been brought (if at all) only against a franchisee. *Matthews v. International House of Pancakes, Inc.*, 2007 WL 4591232 (E.D. La. Dec. 28, 2007), was an employment-law action in which both the franchisee and franchisor were named as defendants. The franchisor failed to file an answer or other response, and the court entered a default judgment against it.

In moving to set aside the judgment, the franchisor argued that it did not timely respond to the complaint because it believed that, pursuant to the franchise agreement, the franchisee would undertake the defense. According to the court's ruling, the franchisor "assumed" that the franchisee's undertaking of the defense would include answering the plaintiffs' complaint, which the franchisee had reportedly affirmed it would do. The franchisee let the franchisor down. The court held that the franchisor's incorrect assumption was not "willful misconduct" and, because there was no prejudice to the franchisee, the court granted the franchisor's motion to set aside the default.

COURT SETS ASIDE DEFAULT JUDGMENT AGAINST FRANCHISEES, BUT UPHOLDS INJUNCTION AND ORDERS PAYMENT TO FRANCHISOR

In *Super 8 Motels, Inc. v. Deer Lodge Super 8, Inc.*, 2007 WL 4246454 (D.S.D. Nov. 29, 2007), the franchisor's default judgment against its franchisee was set aside conditioned upon the franchisee paying the franchisor \$15,000 in return for the right to participate in a hearing on whether damages should be awarded to the franchisor. The court also left in place the injunctive portion of the default judgment, ruling that the franchisee can no longer use the franchisor's trademarks.

Based on the totality of the circumstances and in balancing the policies of prompt and efficient handling of litigation with the interests of justice that are normally served through a trial on the merits, the court concluded that the franchisor was entitled to the injunctive relief that it had obtained by default. The court reluctantly did set aside the default judgment as to liability due to various practical considerations. Specifically, the court noted that a final judgment had not been entered, and a ruling as to liability is always subject to change before a final judgment is entered. The court also noted that less stringent standards apply where a party seeks relief from a non-final judgment.

GOOD FAITH AND FAIR DEALING

TEXAS BANKRUPTCY COURT FINDS BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

The United States Bankruptcy Court for the Southern District of Texas recently found the franchisor of Diedrich coffeehouses in breach of the implied covenant of good faith and fair dealing for failing to exercise an option in its master lease that would have allowed plaintiff Magna Cum Latte, a Diedrich franchisee, to continue to sublease from Diedrich the premises of one of Magna's franchised coffeehouses. *Magna Cum Latte, Inc. v. Diedrich Coffee, Inc., et al.*, 2007 WL 4412143 (Bankr. S.D. Tex Dec. 13, 2007).

Diedrich sold three existing coffeehouses in Houston, Texas to Magna and entered into related franchise, sublease, and purchase agreements with Magna. Under Diedrich's master leases with the landlords, Diedrich possessed certain options on each of the coffeehouse premises. The subleases between Diedrich and Magna, however, did not "expressly require Diedrich to exercise the options or specify under what, if any, conditions Diedrich could decline the options." When the franchisor chose not to exercise its option for one of the coffeehouses, Magna brought this lawsuit alleging, among other things, breach of the implied covenant of good faith and fair dealing. In applying the implied covenant to the parties' contracts, the court held that Diedrich was not free to act on its desires, but was required to exercise its lease option under the master lease. Diedrich contended that it did not violate the implied covenant because

it gave Magna ample notice of its intention to decline the lease option in its master lease, if Magna would not agree to an amendment to the sublease. The court found that the reasonableness of any notice or counteroffer was irrelevant. If the implied covenant precluded Diedrich from declining the lease option, Diedrich could not escape the implied covenant's demands. The court also found that Diedrich's notice and offer were not made in good faith and that Diedrich's decision to let the lease option expire was not based on mere negligence or mistake, but was a conscious decision inspired by pecuniary interests. The court noted that while Diedrich's pursuit of its own pecuniary interests was not necessarily "bad faith," Diedrich could not pursue its own self interests if in doing so it breached the implied covenant.

In contrast, the court rejected Magna's arguments that Diedrich violated the implied covenant through alleged misrepresentations, omissions, threats, and business decisions made throughout the parties' relationship. The court found that alleged omissions and misrepresentations were irrelevant to the implied covenant claim because they occurred during contract formation, before any performance was required by either party.

CLASS ACTIONS

COURT ALLOWS ONLY ONE OF TWO PROPOSED CLASSES TO BE CERTIFIED

In *Quadrel v. GNC Franchising, LLC.*, 2007 WL 4241839 (W.D. Pa. Nov. 29, 2007), the court considered a motion by current and former GNC franchisees to certify a class action against their franchisor. The plaintiffs alleged that GNC had violated the provisions of a settlement agreement to resolve a previous class action brought in 2001. Under the prior settlement, the franchisor had agreed to take reasonable measures to avoid setting the ultimate discounted retail price on certain sale items below the franchisees' then-current wholesale price, to not accept royalty on such items, and to reaffirm its policy not to interfere with vendor sales directly to franchisees. One new class sought to be certified would have been composed of current and former franchisees who participated in the previous settlement, and a second would have included those opted out of that pact.

After the plaintiffs filed their motion for class certification, the sole representative of Class 2 was dismissed from the case without prejudice, apparently pursuant to the settlement of a related case. Class counsel argued that dismissal was nevertheless inappropriate as to all class members, as a viable class representative had existed at the time the motion for certification was filed. The court disagreed, finding that a viable representative is needed up to the date on which class certification is granted by a court. Because the court had not yet ruled on the class certification motion at the time the only named plaintiff's claims were withdrawn, no justiciable case or controversy existed and the motion for certification as to Class 2 was denied as moot.

The court did, however, grant plaintiffs' motion to certify the Class 1 claims, finding that it met all of the Rule 23 standards.

ARBITRATION

CALIFORNIA COURT DISMISSES DEALER'S SECOND ATTEMPT TO INVALIDATE ARBITRATION CLAUSE

In *Kayne v. Thomas Kinkade Company*, 2007 WL 4287364 (N.D. Cal. Dec. 5, 2007), the court issued another ruling in the long-standing battle between former dealer David Kayne against the Thomas Kinkade Company ("Thomas Kinkade"). Prior to the present action, Thomas Kinkade obtained an arbitration award against Kayne's Georgia corporation in excess of \$631,000. Thomas Kinkade initiated a new action to collect the outstanding balance against Kayne individually under the terms of an Application for Credit and Personal Guaranty he signed. In response, Kayne filed a lawsuit in the Northern District of Georgia seeking to invalidate the arbitration agreement contained in the credit application and guaranty. Kayne lost that action. Kayne then filed the present action in the Northern District of California in a second attempt to invalidate the arbitration agreement. Kayne claimed that the arbitration clause was unconscionable and violated California's unfair competition laws.

The court granted Thomas Kinkade's Motion to Dismiss Kayne's claims on two principle grounds. First, the court held that Kayne's claims were barred under the doctrine of res judicata based upon the prior Georgia action in which Kayne's challenges to the arbitration clause were rejected. The court found that Kayne challenged the existence and enforceability of the arbitration agreement in the prior action. The prior ruling precluded Kayne from re-litigating that issue again, despite his efforts to "re-name" the challenge under the banner of unconscionability. Kayne also argued that the decision in *Nagrampa v. Mailcoups, Inc.*, 469 F.3d 1257 (9th Cir. 2006), provided him with "a new legal avenue to relief in this case." The court disagreed, noting that the *Nagrampa* decision was published over three months prior to the Georgia court's ruling, giving Kayne sufficient time to bring the *Nagrampa* decision to that court's attention.

The court went on to rule that, even if Kayne's claims were not barred by res judicata, his claim of unconscionability failed as a matter of law. Although the court held that the Application for Credit and Personal Guaranty were contracts of adhesion, the court found no procedural or substantive unconscionability in the terms of the contracts, or in the manner they were presented to Kayne. The arbitration clause at issue appeared at the top of a two-page application under the heading "Disputes". It was not "buried" in a multiple page document, as Kayne suggested. In addition, the court found that both parties were equally bound by the arbitration agreement, the chosen rules, the chosen

forum and the award. As such, the court found that the arbitration agreement was not substantively unconscionable.

GUARANTORS BOUND BY FRANCHISE AGREEMENTS' ARBITRATION CLAUSES

In the *Spinks v. Krystal Co.*, 2007 WL 4568992 (D.S.C. Dec. 20, 2007), a federal court in South Carolina granted franchisor Krystal Company's motion to compel arbitration. The case highlights the importance of carefully crafting guaranty agreements.

In the spring of 2004, Spinks Investment, Inc. and franchisor Krystal Company entered into franchise agreements for two shops located in South Carolina. Two years later, Spinks Investment closed and abandoned both franchises. Krystal notified Spinks Investment that it had terminated the franchises and that it would submit the matter to arbitration, pursuant to the franchise agreements' arbitration provision, to recover amounts owed to the franchisor. The personal guarantors of Spinks filed a declaratory judgment action in state court, which Krystal removed to federal court, contending that the guaranty agreements did not include an arbitration clause. They also contended that, even if the guaranty agreements incorporate the franchise agreements' arbitration clause, they did not sign the guaranty agreements in their personal capacity but as officers of Spinks.

The court disagreed. The court found that, under the guaranty agreements, plaintiffs agreed to be personally bound and personally liable for each and every provision in the franchise agreement, and that included the arbitration clause in the franchise agreements. Additionally, the court held that the language in the guaranty agreements indicated that the intention was to bind the plaintiffs personally. The court granted Krystal's motion to compel arbitration and dismissed the case.

This case serves as a reminder of the importance of carefully drafting incorporation by reference clauses in ancillary documents to franchise agreements and making it abundantly clear whether a guarantor is signing a guaranty individually or in a representative capacity.

POST-TERMINATION INJUNCTIONS: NON-COMPETE COVENANTS

SIXTH CIRCUIT UPHOLDS FORUM SELECTION AND NON-COMPETE CLAUSES IN FRANCHISE AGREEMENT

In December 2007, the Sixth Circuit Court of Appeals held that a Michigan district court had improperly denied a franchisor's request for a preliminary injunction prohibiting its franchisees from competing against the franchisor's business for a period of two years based upon the franchise agreement's non-compete clause. *Certified Restoration Dry Cleaning Network, L.L.C. v. Tenke Corp.*, 2007 WL 4372888 (6th Cir. Dec. 17, 2007). The franchisees, citizens of Ohio, had been terminated for failure to pay fees. The franchise agreement contained a post-termination non-compete clause prohibiting the former franchisees from engaging in any restoration dry cleaning businesses for two years within a 25-mile radius from the former franchise territory. After the franchisees indicated their intention to continue providing restoration dry cleaning services to clients they had served before entering into the franchise agreement, the franchisor threatened legal action. The franchisees beat the franchisor to the courthouse, however, as they filed a declaratory judgment action in Ohio state court seeking a determination of their obligations under the franchise agreement. The franchisor immediately removed the case to an Ohio federal court and moved to dismiss under the franchise agreement's forum-selection clause, which listed Michigan as the appropriate forum. The franchisor subsequently filed a separate action against the franchisees in Michigan federal court seeking a temporary restraining order and preliminary injunction enforcing the franchise agreement's non-competition clause.

The Michigan district court denied the franchisor's request for injunctive relief, finding that the franchisor had not demonstrated a substantial likelihood of success on the merits because the non-competition covenant was ambiguous, the record was not sufficiently developed to conclude that the covenant was reasonable, and the comity considerations counseled against granting the injunction while the Ohio action was pending. The franchisor appealed to the Sixth Circuit, and while the appeal was pending, the Ohio district court granted the franchisor's motion to dismiss the franchisees' suit based upon the franchise agreement's forum selection clause.

After reviewing the evidence, the Sixth Circuit held that the Michigan district court had improperly denied the franchisor's request for a preliminary injunction. It found that the terms of the franchise agreement's non-compete clause were "plain and unambiguous" and sufficiently reasonable and limited in time and scope to withstand judicial scrutiny. It also determined that the franchisor would suffer irreparable injury without the issuance of the injunction as franchisees' competition could result in loss of customer goodwill and unfair competition.

The Sixth Circuit also held that the district court had improperly applied the “first-to-file” rule, which encourages comity among federal courts of equal rank, when it held that it would be improper to grant the franchisor’s requested injunction due to the pending Ohio action. “By filing in Ohio courts, [the franchisees] were attempting to forum shop as well as preempt resolution of the parties’ dispute by the proper forum,” the Court wrote. “Thus, the Ohio action was not entitled to any deference under the first-to-file rule.”

VICARIOUS LIABILITY

FRANCHISOR NOT VICARIOUSLY LIABLE FOR WORKPLACE INJURY TO FRANCHISEE’S EMPLOYEE

In *Schreyer v. Bandag, Inc.*, No. 05-CV-1235 (D. Minn. Dec. 5, 2007), the employee, Schreyer, was injured while working for the franchisee, Tire Associates, when a tire being retreaded on a piece of equipment exploded because the equipment was not functioning properly. Schreyer, prevented by Minnesota worker’s compensation law from suing the franchisee-employer, brought a claim of negligence against Bandag, the franchisor. Bandag, in turn, brought a third-party complaint for contribution or indemnity against franchisee Tire Associates, the employer. The federal district court in Minnesota granted Bandag’s motion for summary judgment finding that there was no evidence that the franchisor was liable for Schreyer’s injury. Specifically, the court found that the Bandag did not owe a general duty of care to Schreyer, nor did Bandag voluntarily assume a specific duty of care to Schreyer by conducting safety inspections.

Schreyer argued that because the franchise agreement gave Bandag the right to inspect Tire Associates for safety violations, and to insist that Tire Associates correct them, that Bandag retained control of Tire Associates’ work. The court held that Bandag was not liable because it did not exercise “detailed control” over the “operative detail” of the day-to-day work done at Tire Associates. The court cited numerous cases supporting its conclusion that the right to conduct periodic inspections and require the replacement of defective equipment is not the same as having “detailed control” over the “operative detail” of day-to-day work.

Further, Schreyer argued that even if Bandag did not retain a sufficient degree of control over Tire Associates to give rise to a general duty of care, that Bandag voluntarily assumed a specific duty of care to Tire Associates’ employees by conducting safety inspections. The court disagreed, finding that Schreyer could not demonstrate any of the factors relevant to establish whether an inspection creates a voluntarily assumed duty of care. Notably, there was nothing that Bandag’s inspector could have done to induce Tire Associates to fail to check or fail to monitor the defective equipment. Even though Tire Associates’ employees may have relied on Bandag’s

safety inspections generally, the legal standard required Bandag to have taken specific actions or made specific representations that caused Tire Associates not to take its own measures to ensure that its equipment was working properly. There was no evidence of any such actions or representations by Bandag, thus no specific duty of care existed.

This case further supports the premise that a franchisor's contractual right to conduct safety inspections does not typically create a general or specific duty of care to a franchisee's employees.

PENNSYLVANIA COURT FINDS THAT U.S.-BASED HERTZ CORP. COULD BE HELD LIABLE FOR THE CONDUCT OF HERTZ CANADA, LTD (A CANADIAN COMPANY) UNDER AGENCY RELATIONSHIP

In *Loyle v. Hertz Corp.*, 2007 WL 4555201 (Pa. Super. Ct. Dec. 28, 2007), the plaintiffs rented a vehicle from a Hertz facility located at the international airport in Toronto, Canada after making the reservation by telephone in the United States. Shortly after the plaintiffs returned the vehicle to the Toronto airport, they were detained by police officers for four hours and subjected to a strip and cavity search after Hertz personnel found a loaded handgun in the vehicle. Plaintiffs asserted that the gun did not belong to them and contended that it most likely had been left in the rental car by a previous renter and overlooked by Hertz personnel.

Outraged by how they had been treated, plaintiffs sued Hertz Corporation, which is a company based in the United States, for negligence and emotional distress. In response to the lawsuit, Hertz Corp. brought a motion for summary judgment and argued that the proper defendant was Hertz Canada, Ltd because the conduct had occurred in Canada. Hertz Corp. also argued that because Hertz Canada was a separate and distinct corporate entity, it could not be held liable for the plaintiffs' claimed injuries. The lower court agreed and granted summary judgment in favor of Hertz Corp. The court held that because the plaintiffs had failed to plead that an agency relationship existed between Hertz Corp. and Hertz Canada, there was no basis upon which to hold Hertz Corp. liable for Hertz Canada's actions.

On appeal, the court of appeals reversed the lower court's summary judgment ruling and held that the plaintiffs had set forth facts sufficient to allege the existence of an agency relationship between Hertz Corp. and Hertz Canada. In addition, the court held that a genuine issue of material fact existed over whether an agency relationship existed between the two Hertz entities. The appellate court found that because Hertz Corp. advertised itself as a multi-national company with locations worldwide from which cars could be rented by a simple telephone call in the United States, a reasonable person could conclude that Hertz Corp. was the responsible entity for all locations worldwide, including the Toronto location controlled by Hertz Canada, Ltd.

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