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*, formerly known as *The GPMemorandum*. Below are summaries of recent legal developments of interest to franchisors.

Given the widespread and evolving impact of the COVID-19 pandemic, this issue also includes recent developments and resources related to COVID-19.

Post-Termination Injunctions: Noncompete Covenants

Tennessee Federal Court Preliminarily Enjoins Non-signatory from Violating Franchise Agreement's Noncompete

A federal court in Tennessee recently enjoined from violating a post-termination noncompete a former franchisee, as well as his son and his son's competing business — neither of which were party to the franchise agreements. *AmeriSpec, LLC v. Sutko Real Estate Servs., Inc.*, 2020 WL 3913584 (W.D. Tenn. July 10, 2020). Lathrop GPM represented AmeriSpec in this case. In May 2020, Sutko Real Estate Services, Inc. (SRESI) and its principal Thomas Sutko agreed with franchisor AmeriSpec to the termination of the franchise agreements for SRESI's property inspection franchises. As part of the mutual termination, SRESI and Sutko expressly agreed to comply with the franchise agreements' post-termination noncompete. Two days after SRESI's termination, Sutko's son announced that he had created a new property inspection company called SRE Home Inspections, Inc. AmeriSpec moved to preliminarily enjoin SRESI, Sutko, his son, and his son's new competing business from violating the franchise agreements' noncompete. In the interim, the court granted AmeriSpec's motion for a temporary restraining order, restraining the defendants from unlawfully competing against AmeriSpec.

In granting AmeriSpec preliminary injunctive relief, the court found that, under the Federal Rules of Civil Procedure, both Sutko's son and his competing business could be bound by, and preliminary enjoined from violating, the franchise agreements' noncompete, even though they had not signed the franchise agreement. Because the Sutkos and the new competing business were "in active concert or participation," with SRESI and Thomas Sutko, under Rule 65(d)(2) the son and his business could be enjoined. The court found that Sutko's son had previously handled the day-to-day activities of SRESI's business as its vice president. Evidence suggested that his new competing business was a mere continuation of SRESI, including evidence that it retained SRESI's staff, used a similar name and logo, and sent communications to customers and other contacts of SRESI stating that the franchise

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relationship had ended "in name only." Furthermore, the evidence demonstrated that Sutko had orchestrated the creation of the competing business with his son, including actively facilitating the business's registration of a name similar to SRESI and other logistics of the new business. Evidence also showed that the defendants had tried to access AmeriSpec's proprietary information after agreeing to the franchise agreements' termination.

Texas Federal Court Declined to Enjoin Terminated Franchisee Under Noncompete Clause

A federal court in Texas reached a different conclusion with regard to enforcement of a noncompete covenant, granting in part and denying in part a franchisor's motion for preliminary injunction to enforce post-termination obligations against a former franchisee. *JTH Tax LLC v. White*, 2020 WL 3843691 (W.D. Tex. July 8, 2020). White entered into three franchise agreements with JTH to operate three Liberty Tax franchised businesses, and into another franchise agreement to operate one SiempreTax+ franchised business within a Liberty Tax location. Eventually, White closed the co-branded location and entered into a Mutual Termination Agreement (MTA) with JTH and SiempreTax+ to terminate those respective franchise agreements. The MTA included post-termination obligations from the franchise agreements that required White to (a) cease using the trademarks, (b) stop using literature and forms provided by Liberty or other documents with the trademarks, (c) return the customer list and operations manuals, and (d) not compete in accordance with the post-termination noncompete covenant. The noncompete stated that White could not charge a fee for preparing income tax returns or offer financial products within the prior franchise territory or within 25 miles of the territory. Upon the execution of the MTA, White almost immediately began operating a tax preparation business, Natty's Tax Service, at the same location as the former Liberty Tax/SiempreTax+ co-branded location. JTH swiftly terminated the remaining franchise agreements due to the violation of the noncompete and failure to pay past due amounts, and filed suit against White seeking a preliminary injunction to require White to comply with the terms of the MTA and franchise agreements.

The court granted the part of the preliminary injunction requiring White to (a) return the operations manuals and any customer files in his possession to both franchisors, and (b) cease using any of the Liberty trademarks or any materials received from Liberty bearing the trademarks for any purpose in connection with any tax preparation business. But the court denied the preliminary injunction with respect to enforcement of the noncompete provisions. While the court found JTH and SiempreTax+ would likely succeed on their claims for breach of contract and trademark infringement and dilution, it found that they did not provide sufficient evidence to show a threat of irreparable harm. The court concluded that a lone declaration of a regional manager claiming harm, without any supporting evidence to show that monetary damages would not be sufficient, amounted to mere speculation and did not create a presumption of irreparable harm. The court also concluded the balance of hardships weighed against enforcing the noncompete. Although JTH and SiempreTax+ had a legitimate, protectable interest in the franchise businesses, and an interest in encouraging franchisees to follow the brand standards and terms of their franchise agreements, White faced greater harm in his inability to find work outside of a tax preparation business. White had no prior employment to which he could return and a recent disability made it difficult to find another occupation. Because the scope of the three noncompete agreements would render White unable to work as a tax preparer, the court concluded enforcement would be a debilitating hardship for White that would outweigh any hardships claimed by the franchisors.

Arbitration

Oregon Federal Court Compels Arbitration over Objections of Fraud

A federal court in Oregon compelled arbitration over the objections of franchisees who claimed they were fraudulently induced to enter franchise agreements because of false representations made by the franchisor's counsel. *Black Rock Coffee Bar, LLC v. BR Coffee, LLC*, 2020 WL 4728877 (D. Or. Aug. 14, 2020). Black Rock, a coffee shop franchisor, became embroiled in a dispute over initial franchise fees with a company that had opened three franchised Black Rock coffee shops. In response, Black Rock exercised its option under the territory and franchise agreements to purportedly purchase the franchises. The franchisees then discovered that the purchase provisions in the executed agreements were more favorable to Black Rock than those contained in the FDD form agreements the franchisees initially received. The franchisees rescinded the agreements and sued Black Rock in California state court; Black Rock petitioned an Oregon federal court to compel arbitration. The franchisees urged the federal court to abstain in favor of the state court litigation, citing the first-to-file rule and *Colorado River* abstention doctrine. Alleging that Black Rock's counsel has falsely represented to them that the franchise agreements were the same as the FDD form agreements, the franchisees also argued that Black Rock's "fraud in the execution" rendered the agreements void.

The court did not abstain, finding that the first-to-file rule does not apply to concurrent federal-state proceedings, and that none of the extraordinary circumstances of *Colorado River* abstention were applicable. The court then granted Black Rock's petition to compel arbitration. The court held that Black Rock potentially committed fraud in the inducement (inducing a party to agree to something it otherwise would not have agreed to), but not fraud in the execution (inducing a party to believe the agreement was something other than what it was). Although proof of fraud in the execution could void an agreement — including its arbitration clause — fraud in the inducement still required resolution by the arbitrator. The court concluded that fraud in the execution was not present because the franchisees had a reasonable opportunity to review the essential terms of the agreements when they had days to review the documents prior to signing. The court also found that the purchase option discrepancy was not such an "essential term" that changing it would fundamentally change the nature of the agreements. As a result, there was no fraud in the execution, and no barrier to the court's enforcement of the arbitration provision.

Joint Employer

North Carolina Federal Court Partially Grants Franchisor's Motion for Summary Judgment on Joint Employer Claims

A federal court in North Carolina granted in part and denied in part a franchisor's motion for summary judgment because the franchisee's owner and her employee-spouse could not demonstrate that they were jointly employed by their franchisor. *Elsayed v. Family Fare LLC*, 2020 WL 4586788 (M.D.N.C. Aug. 10, 2020). We previously reported on the court's denial of the franchisor's motion to dismiss in Issue 251 of The Franchise Memorandum. Family Fare entered into a franchise agreement for a gas station convenience store with Almy, LLC, a company owned by plaintiff Lola Salamah and which employed plaintiff Amro Elsayed. Family Fare's business consultant, Pilcher, served as a day-to-day liaison with Almy. Pilcher discovered that a store clerk had stolen thousands of dollars of lottery tickets from the convenience store. When Salamah could not repay the company's share of the losses, Family Fare terminated the franchise agreement. Salamah and Elsayed then each sued Family Fare asserting claims

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for unpaid overtime under the Fair Labor Standards Act, discriminatory firing under Title VII, racially-discriminatory contractual interference pursuant to 42 U.S.C. § 1981, and other claims relating to wrongful eviction. While the court denied Family Fare summary judgment as to the wrongful eviction and other related claims, it granted the motion with regard to the FLSA, Title VII, and Section 1981 claims.

Both the FLSA and Title VII claims turned upon the court's finding that Family Fare was neither Elsayed nor Salamah's employer. The court began by recognizing that the Department of Labor's 2020 rule establishing a new joint employer standard was inconsistent with a previous decision of the Fourth Circuit Court of Appeals, and therefore refused to apply DOL's new joint employer rule. The court concluded, however, that even if it were to apply the new standard, the outcome would not change its determination. First, the court recognized that most courts have not imposed joint employer liability on franchisors and that no court had imposed joint employer liability on a franchisor in the FLSA context. Next, the court evaluated a number of factors to assess whether joint employer liability attached to Family Fare. Looking at control, the court determined that even though Pilcher acted on behalf of Family Fare at Almy's store on a regular basis, his role related to enforcing brand standards and not extensive control over workers' daily experiences. Family Fare neither had the ultimate authority to hire or fire any employees of the store, nor did it control payroll and taxes of Almy's employees. Similarly, Salamah was Family Fare's independent contractor, and not its employee, because she controlled the key aspects of her work such as her schedule, she determined her store's profits and losses, she maintained a managerial role which required significant skills, and she considered herself the employer of the workers at the store. Lastly, Elsayed was unable to prove the Section 1981 claim, because even if the evidence showed that Pilcher had a discriminatory attitude, it did not show that Pilcher had authority to terminate the franchise agreement.

Fraud/Misrepresentation

Maryland Federal Court Grants Summary Judgment Dismissing Franchisee's Counterclaim for Negligent Misrepresentation

A federal court in Maryland has recently granted franchisor Kiddie Academy's motion for summary judgment, dismissing franchisee Wonder World Learning's counterclaim for negligent misrepresentations. *Kiddie Academy Domestic Franchising, LLC v. Wonder World Learning, LLC*, 2020 WL 4338891 (D. Md. July 27, 2020). Wonder World alleged that Kiddie Academy made various misrepresentations regarding the value of the benefit of the Kiddie Academy curriculum, site selection and construction assistance, and financial performance pro formas, arguing that these misrepresentations induced Wonder World to purchase the franchise. The court disagreed, ruling that the alleged statements made by Kiddie Academy did not give rise to cognizable claims for negligent misrepresentations.

Although Wonder World alleged that Kiddie Academy made inaccurate promotional statements (i.e., franchisees did not need any experience in child care as all training would be provided by Kiddie Academy and Kiddie Academy's curriculum was as good as or better than its competitors), the court found these statements to constitute mere "puffery," and did not constitute concrete facts giving rise to a claim for negligent misrepresentations. Wonder World also alleged that the Kiddie Academy site analysis reports contained inaccurate and misleading information, but the court found this assertion was "blatantly contradicted by the record." Additionally, Wonder World claimed that Kiddie Academy provided financial pro formas regarding the development and operation of a Kiddie Academy center in Austin, Texas, that contained misrepresentations. The court rejected these allegations saying that pro formas by their nature

are statements of expectation and not of fact, and further, even assuming that the pro formas constitute false statements, the defendants could not have relied on these statements because the defendants had business experience and repeatedly tinkered with the pro forma over the course of a year. Because the alleged negligent misrepresentations were not statements of fact, were contradicted by the record, or the franchisee had no basis to rely on them, the court granted Kiddie Academy's motion for summary judgment.

Preliminary Injunctions

Delaware Court Held Information Provided to Prospective Franchisee During the Franchise Sales Process Was Not Covered by Franchisor's NDA

A state court in Delaware denied a franchisor's motion for a preliminary injunction based upon claims that a prospective franchisee misappropriated confidential information and started a competing business despite having signed a non-disclosure agreement. *Smash Franchise Partners, LLC v. Kanda Holdings, Inc.*, 2020 WL 4692287 (Del. Ch. Aug. 13, 2020). Todd Perri was initially interested in potentially becoming a Smash Franchisee. Perri researched information that Smash published online about the company, spoke with franchise brokers about Smash, and participated in a pitch deck call and a call where he learned about the unit economics of being a Smash franchise. Smash then required all prospective franchisees to sign an NDA. Although Perri had decided that he wanted to establish a competing business, he signed the NDA in order to continue learning about the Smash franchise system. He also continued to learn about the system from franchisees and corporate executives. Perri never entered into a franchise agreement and proceeded to establish a competing business. Smash sought a preliminary injunction to shut down Perri's business, claiming that Perri had misappropriated confidential information.

The court held that Smash was not entitled to the requested "business-stopping injunction." The NDA excluded any information that was publicly available at the time of disclosure or was disclosed by a third-party that was not prohibited from doing so. The court reasoned that the information received by Perri was publicly available, freely shared by Smash's franchisees who were not parties to the NDA, or provided by Smash without having taken adequate precautions to protect its confidentiality. The court described the information as being designed to attract prospective franchisees and akin to a detailed sales pitch, but not specific enough to reveal critical information about Smash.

COVID-19 Pandemic

COVID-19 Resources for Franchisors and Distributors

Lathrop GPM continues to provide clients with alerts, articles, and other resources to help clients navigate important legal information regarding the COVID-19 pandemic. The following may be of particular interest to franchisors and distribution-based businesses:

- **Insurance Recovery Alert**: Missouri Federal Court Opens Door to COVID-19 Business Interruption Claims by Alexander Brown

This update and resources from Lathrop GPM's cross-disciplinary team are available at the **Lathrop GPM COVID-19 Client Resource website.**

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On January 1, 2020, Gray Plant Mooty and Lathrop Gage combined to become Lathrop GPM LLP.

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