The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

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

Quentin R. Wittrock, Editor of *The GPMemorandum*

Maisa Jean Frank, Assistant Editor

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Below are summaries of recent legal developments of interest to franchisors.

VICARIOUS LIABILITY

NINTH CIRCUIT AFFIRMS FINDING OF NO VICARIOUS LIABILITY FOR TELEPHONE CONSUMER PROTECTION ACT VIOLATION

The United States Court of Appeals for the Ninth Circuit has affirmed a California district court's dismissal of a vicarious liability claim against a franchisor based on an advertising text message sent by its franchisee. *Thomas v. Taco Bell Corp.*, 2014 U.S. App. LEXIS 12547 (9th Cir. July 2, 2014). The plaintiff, who received the text message advertising a Taco Bell product, alleged violation of the Telephone Consumer Protection Act (TCPA), which makes it unlawful to make automated mass-marketing communications to a cell phone. The text message was a promotion by an association of several Taco Bell store operators in the Chicago area and was sent out by a promotion company hired by an advertising agency representing the association. In addition to Taco Bell, the suit named one of the twelve members of the association, but not the entity that actually administered or sent the text message at issue.

The district court ruled out any direct liability against Taco Bell because it did not send the text message itself, but ruled that vicarious liability could theoretically apply under agency principles. The court found, however, that Taco Bell did not control the manner and the means of the text message campaign, which was controlled by the association, advertising agency, and promotion company. The Ninth Circuit agreed with the analysis under the established vicarious liability standard in which a defendant must be found to control the manner and the means of the alleged wrongful act, and agreed that Taco Bell did not control the campaign. The court did not stop there, as it also analyzed whether principles of apparent authority and ratification could provide a basis for a vicarious violation of the TCPA. The Ninth Circuit rejected that theory as well, finding no apparent authority because the plaintiff could not show reasonable reliance or harm resulting from reliance on anything Taco Bell did or said to her. Finally, the court found that Taco Bell did not ratify the text message because there was no principal-agency relationship, a requirement for ratification.

FRANCHISOR NOT LIABLE TO UNIT FRANCHISEE FOR MOST OF MASTER FRANCHISEE'S ACTS

In an opinion generally favorable to the franchisor in a unit franchisee's attempt to impose vicarious liability on the franchisor for the actions of its master franchisee, the United States District Court for the District of Massachusetts recently granted in part and denied in part a franchisor's motion for summary judgment. *Depianti v. Jan-Pro Franchising International, Inc.*, 2014 U.S. Dist. LEXIS 116943 (D. Mass. Aug. 22, 2014). At issue was the unit franchisee's claims of misrepresentation and unfair and deceptive business practices based on the conduct of Jan-Pro's master franchisee. An arbitration clause in the unit franchise agreement required claims against the master franchisee, but not against the franchisor, to be arbitrated. Thus, only the franchisor was the defendant in the case. The court applied the instrumentality test followed by a majority of courts, which imposes vicarious liability only if the franchisor controls or has a right to control "the daily conduct or operation of the particular 'instrumentality' or aspect of the franchisee's business that is alleged to have caused the harm."

Although the master franchisee may have misrepresented that it would provide the unit franchisee $100,000 worth of cleaning accounts annually, Jan-Pro neither controlled nor had a right to control this instrumentality of the claim. Jan-Pro did not control the franchise plan offered by the master franchisee from a menu of franchise plans ranging from $5,000 to $200,000 in cleaning accounts, nor did it impose a requirement on the master franchisee concerning the volume of the unit franchisees' franchise plans. Regarding the unfair or deceptive business practices claims, the court determined that the unit franchisee may have been subject to unfair "underbidding" and to unfair terminations of cleaning accounts, but it could not conclude that Jan-Pro controlled, or had the right to control, the instrumentalities of the master franchisee's business on these pertinent matters. The franchise contract allowed the master franchisee to set its own prices and discounts, and, in practice, the master franchisee made its own decisions on pricing and account termination decisions. However, in response to the franchisee's claims that the amount of franchise fees charged was inherently unfair, the court determined that a reasonable fact finder could conclude that the unit franchisee's contract with the master franchisee was inherently unfair and that Jan-Pro had the right to control that aspect of the master franchisee's business. Jan-Pro had not argued that the unit franchisee's contract terms were fair. The court granted Jan-Pro's summary judgment motion on all but this last claim.

ARBITRATION

AFTER-THE-FACT ARBITRATION POLICY DID NOT CONSTITUTE AN "AGREEMENT TO ARBITRATE", SEVENTH CIRCUIT AFFIRMS

A franchisor's adoption of an arbitration policy a month after lawsuits were commenced against it could not force franchisees to arbitrate prior to pursuing litigation, the United States Court of Appeals for the Seventh Circuit ruled last week. *Druco Rests., Inc. v. Steak n Shake Enters., Inc.*, 2014 U.S. App. Lexis 16869 (7th Cir. Aug. 29, 2014). This case arose in the context of franchisee challenges to Steak n Shake's new pricing and promotion policy, which required adherence to company pricing on menu items as well as participation in promotions. After the franchisees filed suit in Indiana, Steak n Shake invoked franchise agreement language reserving the right for it to "institute at any time a system of nonbinding arbitration or mediation."

As the district court had done, the Seventh Circuit framed the issue as "whether there are valid agreements to arbitrate in the franchise contracts." Noting that federal and state law both favor arbitration in determining the *scope* of an agreement, the appellate court nevertheless found that the same standard does not apply in determining whether the parties ever *agreed to arbitrate*. In this case, the court ruled that at most the franchise agreement contained an "option" that only the franchisor could exercise to institute an arbitration program in the future. The court found the optional arbitration was "vague," "illusory," and "indefinite." Since there was no enforceable, valid agreement to arbitrate first, the franchisees could continue with their lawsuit.

THIRD CIRCUIT RULES THAT THE AVAILABILITY OF CLASSWIDE ARBITRATION IS A QUESTION FOR THE COURTS, NOT AN ARBITRATOR

The Third Circuit has announced a decision regarding the availability of classwide arbitration in an employment agreement that could have significant impact on arbitration agreements in franchising. *Opalinski v. Robert Half Int'l, Inc.*, 2014 U.S. App. LEXIS 14538 (3rd Cir. July 30, 2014). The underlying dispute arose when two former employees of Robert Half International filed a class action complaint against it for alleged violations of the Fair Labor Standards Act. Robert Half moved to compel arbitration of the claims, which the district court granted while also holding that the question of whether the former employees could pursue their claims as a class was for the arbitrator to decide. The Third Circuit disagreed, holding that absent a clear agreement to the contrary, the availability of classwide arbitration is a substantive "question of arbitrability" to be decided by a court rather than an arbitrator.

The Third Circuit noted in its opinion that courts play a limited role in determining the question of "arbitrability." It concluded that because classwide arbitration would implicate the rights of absent class members without their consent, the threshold decision about its availability must be made by the court. Further, the court reasoned classwide arbitration was a distinct *type* of controversy that differed from the individual arbitration envisioned by the Federal Arbitration Act, and therefore it was for a court to determine whether an arbitration agreement applied to this specific type of controversy. These two reasons create a presumption that the availability of classwide arbitration must be determined by the courts, and the Third Circuit concluded that because RHI's arbitration clause was silent on the issue, the presumption had not been rebutted. The reasoning in *Opalinski* follows that of the Sixth Circuit, the only other appellate court to rule on the issue of arbitrability in this context, while recent decisions from the Supreme Court have indicated that it is still an open question.

FEDERAL COURT DECLARES ARBITRATION CLAUSE AMBIGUOUS AND SETS ISSUE FOR JURY TRIAL

A federal court in Maryland has held that an arbitration clause in a franchise agreement is ambiguous and has set a jury trial to determine whether the parties intended to arbitrate the franchisee's claims or litigate them in court. *Trouard v. Dickey's Barbeque Restaurants, Inc.*, 2014 U.S. Dist. LEXIS 106218 (D. Md. Aug. 1, 2014). The franchisee plaintiffs in this case claimed Dickey's understated the start-up costs involved and overstated the expected profits with respect to their franchises. The franchise agreement at issue contained an arbitration clause that required the parties to mediate and then arbitrate "all disputes" between them. The agreement, however, also stated that the franchisees could file suit against Dickey's for violations of the Maryland Franchise Act. After the franchisees complained to Dickey's that it had violated the Act with respect to its pre-contract disclosures, the franchisor preemptively filed a demand for arbitration in Texas, seeking damages for breach of contract and fraud. The franchisees then filed a complaint in federal court in Maryland along with a preliminary injunction motion to prevent Dickey's from proceeding with the arbitration. In response, the franchisor moved to compel arbitration.

The court denied both motions. The "pivotal question," it commented, "was whether either the Franchise Agreement or the Development Agreement includes a valid arbitration provision that pertains to the dispute." The court concluded that the arbitration provision was ambiguous because the language of the conflicting clauses was "susceptible to multiple meanings to a reasonably prudent person" and that there was no additional evidence in the record beyond the contractual language to eliminate the ambiguity. The franchisor could reasonably believe, the court explained, that while the franchisees had the right to litigate their claims in court, they waived that right through the arbitration clause. The franchisees were also equally reasonable in their position that the contracts allowed them to litigate their Maryland Franchise Act claims without reference to the arbitration clause. Since both sides had different interpretations of wholly ambiguous contractual language, the court concluded that "a significant factual dispute exists regarding the intent of the parties with regard to the Arbitration Clause and the interplay between the Arbitration Clause and the Maryland [Franchise Act] Clause in the Franchise Agreement. A jury must decide this issue."

EMPLOYMENT

FRANCHISORS CONTINUE TO FACE "JOINT EMPLOYER" AND "SINGLE ENTERPRISE" WAGE AND HOUR CLAIMS BY FRANCHISEES' WORKERS

The trend of troublesome wage and hour lawsuits against franchisors continues. In recent months, several new cases have commenced that should serve as an ongoing reminder that when it comes to employment, franchisors should take care not to control or become entangled in their franchisees' day-to-day activities. In the recent cases, various franchisors were sued by their franchisees' employees for alleged violations of the Fair Labor Standards Act (FLSA), on the theory that the franchisor was a "single enterprise" or "joint employer" with the franchisee. *Orozco v. Plackis*, 2014 U.S. App. LEXIS 12680 (5th Cir. July 3, 2014); *Cordova v. SCCF, Inc.*, 2014 U.S. Dist. Lexis 97388 (S.D.N.Y. July 16, 2014); *Gilbert v. Freshbikes, LLC*, 2014 U.S. Dist. Lexis 93071 (D. Md. July 9, 2014); *Olvera v. Bareburger Group, LLC*, 2014 U.S. Dist. LEXIS 94401 (S.D.N.Y. July 10, 2014). In asserting these theories, the employees claimed that the franchisors exercised sufficient control of their franchisees' employment matters, through system standards or day-to-day activities, to "employ" the franchisees' employees for purposes of the FLSA.

In *Cordova*, *Gilbert*, and *Olvera*, the courts declined to grant the franchisors' early motions to dismiss. In denying the motions, the courts cited the broad definition of "employer" under the FLSA, which includes "any persons acting directly or indirectly in the interest of an employer in relation to the employee." The courts also noted that no discovery had yet occurred and that their sole task on a motion to dismiss was to determine, based only on the pleadings, whether the complaint adequately stated a wage and hour claim. In *Cordova* and *Olvera*, for example, the Southern District of New York found that the employees plead sufficient facts to proceed on a "joint employer" theory because they alleged that the franchisor issued guidance on how to hire and train employees, set and enforced operational requirements, monitored performance, exercised control over employee work and/or timekeeping practices, and/or required franchisees to keep employment records. Similarly, in *Gilbert,* the Maryland court found that the employees pleaded sufficient facts to state a claim under the "single enterprise" theory of liability, which holds that two separate entities may constitute a single enterprise if they conduct related activities, perform under unified operations or common control, and operate for a common business purpose.

In *Orozco*, however, the franchisor fared better at a later phase of litigation. The Fifth Circuit used a four-part economic realities test to reverse a jury's verdict that the franchisor was a joint employer under FLSA. It considered whether the franchisor: (1) possessed the power to hire or fire the employees; (2) supervised their work schedules or conditions of employment; (3) determined pay; and (4) established employment records. Because there was no evidence of such activity, the appellate court reversed the jury verdict and entered judgment for the franchisor.

DISTRICT COURT ALLOWS FRANCHISEES' CLAIM FOR "EMPLOYEE" PROTECTION UNDER THE FAIR LABOR STANDARDS ACT

Last month, a federal court in New Jersey held that a group of 7-Eleven franchisees alleged sufficient facts in their amended complaint to withstand a motion to dismiss their claim that they were employees of 7-Eleven under the Fair Labor Standards Act (FLSA). *NAIK v. 7-Eleven, Inc.*, 2014 U.S. Dist. LEXIS 107139 (D.N.J. Aug. 5, 2014). In denying 7-Eleven's motion, the court held that the facts, as alleged by the franchisees, weighed in favor of finding an employment relationship when considering the six-factor test articulated by the Third Circuit and the economic reality of the relationship. The court further denied 7-Eleven's motion to dismiss as it related to the franchisees' New Jersey Wage and Hour Law claims, violation of the covenant of good faith and fair dealing, and claim that 7-Eleven engaged in unreasonable standards in violation of the New Jersey Franchise Practice Act. The court did, however, grant 7-Eleven's motion to dismiss the franchisees' New Jersey Law Against Discrimination claims and constructive termination claim under the New Jersey Franchise Practices Act.

The court categorized the 7-Eleven franchisees as employees under the FLSA, first citing 7-Eleven's extensive control over the franchisees' day-to-day activities, including that 7-Eleven controlled product pricing, processed the franchisees' payroll, monitored the franchisees' daily activities through a security system, controlled the stores' radio and television volume levels and heat and air conditioning systems, required franchisees to obtain approval before withdrawing money, and imposed fines as a means of regulating franchisee activity. The court also determined that the initial and renewal lease terms, coupled with the noncompetition provisions contained in the franchise agreement, created permanency to the parties' working relationship which weighed in favor of finding an employment relationship. Moreover, the court held that the franchisees are an integral part of 7-Eleven's business, noting that 7-Eleven could not run its business without its franchisees, and supporting an employee classification. The court concluded its analysis by finding that as a matter of economic reality, the franchisees were dependent upon 7-Eleven. In particular, the court reasoned that 7-Eleven's control went beyond mere enforcement of uniformity standards and instead undercut the franchisees' ability to control the financial condition of their businesses or to exercise any discretion over the operation of their franchises.

FRAUD

TEXAS FEDERAL COURT DISMISSES FRANCHISEE'S BREACH OF CONTRACT AND DECEPTIVE TRADE PRACTICES ACT COUNTERCLAIMS, BUT ALLOWS CLAIMS FOR FRAUD AND NEGLIGENT MISREPRESENTATION

A federal district court recently granted in part and denied in part a franchisor's motion to dismiss counterclaims filed by a former franchisee. *Yumilicious Franchise LLC v. Barrie*, 2014 U.S. Dist. LEXIS 113049 (N.D. Tex. Aug. 14, 2014). Yumilicious brought suit against its franchisee, Why Not, LLC, based on alleged breaches of two franchise agreements. It claimed that Why Not breached the franchise agreements when it closed one of the franchised stores without authorization and when it and its guarantors failed to pay monies owed for royalties and products. Why Not filed counterclaims alleging that Yumilicious had itself breached the franchise agreements by failing to support the franchised stores or provide affordable products, and had also fraudulently induced it into entering the franchise agreements in violation of the Texas Deceptive Trade Practices Act (DTPA) and common law.

The court dismissed Why Not's contract claim because it failed to explain how any of the alleged breaches caused it damage, and it failed entirely to respond to the arguments advanced by Yumilicious that no damages existed. The franchise agreements did not guarantee access to products at a low cost or fair market price, nor did the franchisor guarantee a certain amount of profit. The court also granted Yumilicious's motion with regard to the DTPA claim, which was based on alleged deficiencies in Yumilicious's FDD. It was undisputed that Why Not received the FDD in May 2010, long before Yumilicious filed its action, and was therefore outside the two-year statute of limitations for a DTPA claim. But the court did not dismiss the common-law fraud and negligent misrepresentation claims, which it found were pleaded with enough specificity to meet the heighted pleading standard under the federal rules. Finally, the court dismissed Why Not's claim that the franchise agreements should be declared null and void, because Why Not failed to respond to Yumilicious's argument that any defect in the agreements was ratified over the four years of performance of the contracts. However, because Why Not could still argue that it had a right to rescind the contracts based on its fraud allegations, the court stated that Why Not could amend its claim.

FRANCHISEES ENTITLED TO RESCISSION BASED ON SALES FRAUD

In *Legacy Academy v. Mamilove, LLC*, 2014 Ga. App. LEXIS 556 (Ga. Ct. App. July 16, 2014), the Georgia Court of Appeals affirmed a judgment in favor of franchisees who alleged that their franchisor, Legacy Academy, Inc., fraudulently induced them to enter into a franchise relationship by making a false earnings claim during the parties' pre-contract negotiations. When the franchisees first entered into discussions to open a Legacy daycare franchise, Legacy's representatives gave them a pro forma financial statement showing the net income a new franchisee could expect to earn after the first, second, and third years of operation that was purportedly based on the historic performance of existing franchisees. The representatives later provided an offering circular and franchise agreement to the franchisees and told them that they needed to sign the documents that same day or risk losing their preferred franchise location. The franchisees immediately signed the documents without reading them or consulting an attorney. After their daycare center opened and failed to perform to expectations, the franchisees sued, claiming that Legacy had made a false earnings claim that was prohibited by FTC regulations and seeking rescission of the franchise agreement, among other relief. After the trial court entered judgment on the jury's verdict in favor of the franchisees, Legacy appealed on the grounds that rescission was unwarranted.

In affirming the judgment, the appellate court held that the evidence at trial demonstrated that Legacy's representatives intentionally prevented the franchisees from reading the franchise agreement before signing it in order to conceal from them certain provisions in the agreement stating that Legacy had made no representations, warranties, or earnings claims during the parties' negotiations. The court concluded that the franchisees could not be deemed to have knowingly agreed to such provisions and to have waived their claims as a result. Because the evidence supported the jury's verdict on the rescission claim, the franchise agreement was no longer valid or enforceable and the franchisees were not prevented from proving that they reasonably relied on the fraudulent earnings claim when they executed the agreement.

The court also determined that the franchisees were entitled to pursue a claim under Ga. Code Ann. § 51-1-6, a statute that authorizes a plaintiff to recover damages for the breach of a legal duty arising from a statute that does not itself provide a private right of action. The franchisees' claim was based on Legacy's alleged violations of the FTC Rule's disclosure requirements concerning financial performance representations. The court concluded that there was evidence to support the jury's verdict against Legacy on this claim and upheld the judgment in favor of the franchisees.

Minneapolis, MN Office

John W. Fitzgerald, co-chair (612.632.3064)
* Megan L. Anderson (612.632.3004)
* Sandy Y. Bodeau (612.632.3211)
Phillip W. Bohl (612.632.3019)
Jennifer C. Debrow (612.632.3357)
* Danell Olson Caron (612.632.3383)
Elizabeth S. Dillon (612.632.3284)
Ashley Bennett Ewald (612.632.3449)
Michael R. Gray (612.632.3078)
Kelly W. Hoversten (612.632.3203)
Franklin C. Jesse, Jr. (612.632.3205)
Jeremy L. Johnson (612.632.3035)
* Richard C. Landon (612.632.3429)
Gaylen L. Knack (612.632.3217)
* **Kirk W. Reilly, co-chair (612.632.3305)**
* Craig P. Miller (612.632.3258)
Bruce W. Mooty (612.632.3333)
John W. Mooty (612.632.3200)
Kevin J. Moran (612.632.3269)
Kate G. Nilan (612.632.3419)
Karli B. Peterson (612.632.3278)
* Matthew G. Plowman (612.632.3425)
Max J. Schott II (612.632.3327)
Michael P. Sullivan, Jr. (612.632.3350)
Michael P. Sullivan, Sr. (612.632.3351)
Henry T. Wang (612.632.3370)
Lori L. Wiese-Parks (612.632.3375)
* Quentin R. Wittrock (612.632.3382)

Washington, DC Office

Robert L. Zisk, co-chair (202.295.2202)
* Julia C. Colarusso (202.295.2217)
* Maisa Jean Frank (202.295.2209)
* Jan S. Gilbert (202.295.2230)
* Jeffrey L. Karlin (202.295.2207)
Mark A. Kirsch (202.295.2229)
Peter J. Klarfeld (202.295.2226)
Sheldon H. Klein (202.295.2215)
* Janaki J. Parmar (202.295.2235)
* Iris F. Rosario (202.295.2204)
Justin L. Sallis (202.295.2223)
Stephen J. Vaughan (202.295.2208)
* David E. Worthen (202.295.2203)
* Eric L. Yaffe (202.295.2222)
* Carl E. Zwisler (202.295.2225)

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

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GRAY PLANT MOOTY

500 IDS Center
80 South Eighth Street
Minneapolis, MN 55402-3796
Phone: 612.632.3000

Suite 700, The Watergate
600 New Hampshire Avenue, N.W.
Washington, DC 20037-1905
Phone: 202.295.2200

franchise@gpmlaw.com