

The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

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

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

DAMAGES – ATTORNEYS FEES

MISSOURI DISTRICT COURT AWARDS ATTORNEYS' FEES AND COSTS IN TERMINATION CASE

In *Dunkin' Donuts Franchising LLC v. Sai Food & Hospitality, LLC*, 2014 U.S. Dist. LEXIS 67512 (E.D. Mo. May 16, 2014), the United States District Court for the Eastern District of Missouri granted a franchisor's motion for attorneys' fees, costs, and expenses following a bench trial in which the court upheld the termination of a group of franchisees on the grounds that they fraudulently concealed the true ownership of their operating company prior to signing their franchise agreements. Gray Plant Mooty represents the franchisor in this matter. As reported in Issue 176 of *The GPMemorandum*, the franchisees in this case had entered into two franchise agreements and a related development agreement with Dunkin' for the development and operation of franchises in Missouri. The franchise agreements included provisions indicating that the franchisees would pay to Dunkin' all costs and expenses, including reasonable attorneys' fees, incurred by Dunkin' in enforcing any provisions of the contract. Each agreement also included a personal guarantee signed by the individual franchisees pursuant to which they agreed to guarantee, jointly and severally, their operating company's obligations under the franchise agreement. Following the conclusion of the trial Dunkin' filed a motion to recover its attorneys' fees and costs.

Having previously granted Dunkin' judgment on all claims in the case, the court granted Dunkin's motion for fees and costs in full against the defendants and the guarantors. The court rejected the franchisees' argument



that Dunkin' was required to prove the quantum of its attorneys' fees at trial as an element of its claims, noting that the franchisees had assented to the post-trial briefing schedule, that the procedure was commonly followed by other courts, and that they had received ample time to review and challenge the documents supporting Dunkin's fee petition. The court further concluded that the hours and rates claimed by Dunkin' were reasonable under Massachusetts law, which governed the agreements. Finally, the court determined that the language of the personal guarantees was clear and that Dunkin' was entitled to enforce them.

PATENTS

SUPREME COURT THIS WEEK ISSUES TWO DECISIONS FAVORING DEFENDANTS IN PATENT LITIGATION

Patent litigation remains a topic of discussion in franchise circles, as more and more franchisors have been named as defendants in large cases involving some element of their franchise system technology. This week the United States Supreme Court issued two unanimous decisions likely to benefit franchisors facing patent infringement allegations. In *Nautilus, Inc. v. Biosig Instruments, Inc.*, No. 13-369 (U.S. June 2, 2014), and *Limelight Networks, Inc. v. Akamai Technologies, Inc.*, No. 12-786 (U.S. June 2, 2014), the Supreme Court clarified the enforceability of certain patents and the reach of liability under certain circumstances.

In *Nautilus*, the Court addressed the "definiteness" requirement of patent law. In patent-speak, the "definiteness" requirement states that a patent must put the public on notice of what it covers. A patent can be held invalid if it is "indefinite." Until the Court's ruling on Monday in the *Nautilus* case, a patent's claim was sufficiently definite so long as it was "amenable to construction," and not "insolubly ambiguous." The Court held that the "insolubly ambiguous" test does not satisfy the Patent Act's definiteness requirement. Instead, "a patent is invalid for indefiniteness if its claims, read in light of the specification delineating the patent, and the prosecution history, fail to inform, with reasonable certainty, those skilled in the art about the scope of the invention." This "reasonable certainty" test appears to increase the potential that a patent may be invalidated as indefinite.

The *Limelight* decision addressed the concept of "induced infringement," which has been alleged in franchising. Prior to Monday's decision, a party could be liable for inducing infringement when "a defendant carries out some steps constituting a method patent and encourages others to carry out the remaining steps—even if no one would be liable as a direct infringer in such circumstances." Thus, even if no one individual or entity was practicing a patent, the prior Federal Circuit test held entities liable in certain circumstances if they performed just some of a claim's elements. This theory has been



used by plaintiffs in some of the so-called “patent troll” cases filed against franchisors. The Supreme Court this week reversed the Federal Circuit and made clear that in order for a party to be held liable for inducing infringement, there must be at least one individual or entity that actually practices every element of a claim. The *Limelight* decision adds certainty to the law and eliminates one theory of liability particularly popular in software patent infringement cases.

Any franchisor facing patent troll litigation should welcome this week’s rulings, particularly the decision in *Limelight*, in that franchising inherently involves the use of software by multiple actors at different levels.

LIMITATION OF ACTIONS

ELEVENTH CIRCUIT CONCLUDES THAT FRANCHISEE’S KICKBACK-SCHEME CLAIMS WERE NOT BARRED BY A ONE-YEAR LIMITATIONS PROVISION

On interlocutory appeal, the Eleventh Circuit reversed in part a district court’s grant of summary judgment for a franchisor on the basis that the appellant-franchisee’s claims of illegal and undisclosed kickbacks were barred by the one-year contractual limitations period. *Massey, Inc. v. Moe’s Southwest Grill, LLC*, 2014 U.S. App. LEXIS 8765 (11th Cir. May 9, 2014). The appeal stems from an action filed by 39 Moe’s franchisees which sought to recover monies provided by approved suppliers to Moe’s CEO and affiliates. In purchasing a franchise, each of the three appellant franchisees received a 2002 or 2003 UFOC disclosing the requirement to purchase certain products from the franchisor’s approved suppliers, but denying the franchisor or its affiliates would derive any income from these purchases. Each franchisee later received a copy of Moe’s 2005 UFOC, which, like those in 2002 and 2003, noted the obligation to buy certain products from approved suppliers, but disclosed that one of Moe’s approved suppliers was indirectly related to the CEO and that the CEO had an ownership interest in that supplier and other suppliers. The 2005 document removed the statement that the franchisor’s affiliates would not derive income from sales to franchisees.

In granting the franchisor’s motion for summary judgment, the district court held the updated disclosures in 2005 provided the appellant-franchisees with notice of their alleged claims and, therefore, such claims were barred by the franchise agreement’s one-year limitations provision. On appeal, the Eleventh Circuit disagreed concluding that a question of material fact existed as to when the franchisees discovered the facts giving rise to the alleged kickback scheme, noting that scienter, possible negligence, and membership in an unlawful enterprise were all facts that needed to be “discovered” before the contractual limitations period began to run. The Eleventh Circuit reasoned that a jury could conclude that the subtle modifications made to the 2005 UFOC did not provide sufficient notice of the facts needed to substantiate the alleged claims.



TERMINATIONS

VAGUE ALLEGATIONS REGARDING LACK OF FRANCHISOR MARKETING INSUFFICIENT FOR FRANCHISEE TO SURVIVE SUMMARY JUDGMENT

The United States Court of Appeals for the Third Circuit recently affirmed a trial court's grant of summary judgment in favor of a hotel franchisor on its breach of contract claim, and on the franchisee's counterclaims, despite the franchisee's claims that the franchisor first breached its obligations under the franchise agreements. *Red Roof Franchising, LLC v. Patel*, 2014 U.S. App. LEXIS 8078 (3d Cir. Apr. 29, 2014). Red Roof terminated Patel's franchise agreements in New Jersey and Minnesota as a result of uncured failure to pay royalties and other amounts due. Red Roof then initiated separate lawsuits to enforce termination of the franchise agreements and to recover damages for breach of contract. Patel conceded that he had failed to pay the amounts owing but argued his obligation to pay was negated by Red Roof's prior breach. Specifically, he alleged Red Roof failed to administer its guest reservation system and marketing programs as required under the franchise agreements. He also claimed the reservation system had been inoperative for up to one and a half days, on eight or nine occasions over "several years". Patel also alleged that Red Roof failed to create "any new advertising or marketing programs that generated new customers for the hotel," and operated existing programs ineffectively.

The district court granted summary judgment in favor of Red Roof. On appeal, the Third Circuit held that Patel's proffered evidence regarding Red Roof's alleged breach did not create a genuine dispute of material fact that would act to prevent the summary judgment. The court cited previous decisions holding that an affiant must "set forth facts, rather than opinions or conclusions" to defeat summary judgment. Moreover, Patel also failed to present sufficient evidence on "an equally crucial element" of his opposition—the showing that he sustained damages as result of Red Roof's breach.

COURT DENIES FRANCHISEE'S MOTION TO DISMISS COUNTERCLAIMS

In *Bans Pasta, LLC v. Mirko Franchising, LLC*, 2014 U.S. Dist. LEXIS 71466 (W.D. Va. May 23, 2014), a federal court in Virginia denied franchisee Bans Pasta's motion to dismiss franchisor Mirko's counterclaims for breach of contract and other claims. We reported on a previous decision in this case in Issue 178 of *The GPMemorandum*. Franchisee Bans Pasta accused Mirko Franchising and its representatives of negligently or fraudulently inducing it to enter into the franchise agreement. Bans Pasta notified Mirko in March 2013 that its bad acts constituted a constructive termination of the franchise agreement. But Bans Pasta continued through August 2013 to operate the Mirko Italian restaurant franchise using the Mirko's trademarks. At that time, Bans Pasta



notified Mirko that it had rescinded the franchise agreement. Almost immediately thereafter, Bans Pasta started operating a different Italian restaurant at the location of its former franchise. Mirko then terminated the franchise agreement, and Bans Pasta sued for rescission and asserted other claims. Mirko filed counterclaims for breach of contract and other claims, and Bans Pasta moved to dismiss them.

In denying Bans Pasta's motion to dismiss, the court held that Mirko had adequately pled its breach of contract claim that Bans Pasta had (1) used Mirko's trademarks for the period of March through August 2013, (2) failed to continue to operate the restaurant, (3) failed to pay certain monies, and (4) failed to return Mirko's confidential manuals. Bans Pasta disputed that Mirko could state a claim for breach of contract because Mirko had terminated the franchise agreement. The court disagreed and held Mirko could recover past-due and future royalties. Bans Pasta also claimed Mirko's claim was not viable because Mirko had averred that it had provided support to Bans Pasta through August 2013 and thus, Mirko had authorized Bans Pasta's use of the trademarks. The court held, however, that Mirko had apparently pled these facts in the alternative. That is, at issue was whether Bans Pasta had rescinded the franchise agreement in March 2013 when it told Mirko that its actions constituted a constructive termination. If Bans Pasta rescinded at that time, but continued to operate using the Mirko's trademarks, then Mirko could show that Bans Pasta had breached the agreement. The court therefore denied the motion to dismiss.

JURISDICTION AND PROCEDURE

MINNESOTA FEDERAL COURT LACKS PERSONAL JURISDICTION OVER FRANCHISOR'S DIRECTORS

In *Sanford v. Maid-Rite Corp.*, Civil File No. 13-2250 (D. Minn. Apr. 21, 2014), the court dismissed the plaintiffs' Minnesota Franchise Act ("MFA") claims against the defendant directors of franchisor Maid-Rite for failure to demonstrate minimum contacts necessary to establish personal jurisdiction. Sanford alleged two factors in support of personal jurisdiction over the defendant directors: a prima facie case for the directors' personal liability under the MFA, and the identification of the directors in Franchise Disclosure Document filed in Minnesota. In support of the first factor, Sanford claimed that Maid-Rite provided information inconsistent with the FDD in violation of the MFA. Under the MFA, control persons are liable for the corporation's MFA violations, unless they had no knowledge of the violation. Sanford claimed the directors had actual or constructive knowledge of the violations and were therefore potentially liable. In support of the second factor, Sanford argued that because the directors' names were included in the FDD, each of them had been put on actual notice that an FDD was being prepared, further establishing minimum contacts.



In response, the court found that potential liability under the MFA does not obviate the requirement that minimum contacts be established. In other words, potential liability under the MFA alone is not a contact. Additionally, the court observed the FDD merely listed the directors' names and job descriptions—it was not signed by them, and there was no allegation that the directors individually wrote or filed the FDD, or otherwise initiated contact with the forum. As a result, the court determined that it lacked personal jurisdiction over the directors and dismissed Sanford's claims against them.

FRANCHISE TRANSACTIONS

LENDER'S PRIVATE FORECLOSURE SALE TO FRANCHISOR DEEMED COMMERCIALY REASONABLE UNDER CALIFORNIA UCC

In *Jack in the Box, Inc. v. Mehta*, 2014 U.S. Dist. Lexis 68519 (N.D. Cal. May 19, 2014), the court approved the request of Jack in the Box ("JIB") to modify an existing order authorizing JIB to operate restaurants owned by previously terminated franchisees, as the court approved a private foreclosure sale of the restaurant assets by GE Capital Bank ("GECB"), a secured creditor of the franchisees, to JIB. Mehta's franchise agreements and leases were terminated by JIB due to payment defaults. In a lawsuit, JIB obtained a "turnover order" allowing it to take over operation of Mehta's restaurants. JIB then sought to modify the order to allow a private foreclosure sale by GECB to JIB.

Mehta objected to the proposed sale, arguing that it would not result in the highest and best price for the restaurant assets. In California, a secured creditor such as GECB has many options available to it upon a default by its obligor. Under the commercial code, it may "sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing." A disposition of collateral is commercially reasonable if made in the usual manner on any recognized market, is made at the price current in any recognized market at the time of the disposition, or is made otherwise in conformity with reasonable commercial practices. Whether a transaction disposing of collateral was reasonable is generally a question of fact that depends on all of the circumstances existing at the time of sale.

In the present case, JIB negotiated a private deal with GECB to purchase GECB's collateral, comprised primarily of restaurant equipment and fixtures. The court found the private foreclosure sale to be commercially reasonable because (1) the asset purchase agreement was negotiated at arms-length between two sophisticated parties, (2) the price paid by JIB was the highest value since the equipment was being sold "in place" to allow for the continued operation of the restaurants, and (3) the terms of the purchase agreement were consistent with the terms of the California commercial code provisions. In short, the court found the private foreclosure sale between the franchisor and the secured creditor to be commercially reasonable under the circumstances.



ARBITRATION

FEDERAL COURT IN NEW HAMPSHIRE FINDS FRANCHISOR DID NOT FORFEIT RIGHT TO ARBITRATE DISPUTE BY SEEKING PRELIMINARY INJUNCTION

The United States District Court for the District of New Hampshire recently granted a franchisor's motion to compel arbitration, finding it had not waived its rights to arbitrate a dispute by having first sought preliminary injunctive relief. *Pla-Fit Franchise, LLC v. Patricko, Inc.*, 2014 U.S. Dist. LEXIS 69047 (D.N.H. May 20, 2014). Pla-Fit sued its former franchisee, Patricko, seeking injunctive relief for trademark infringement, a declaratory judgment that Patricko had violated the post-termination non-compete provisions of the franchise agreements between the parties, and damages for breach of contract. Patricko responded with counterclaims. Shortly thereafter, the parties reached an agreement that resolved the infringement issues, mooting the injunction motion, but were not able to reach an agreement on the remaining claims. Pla-Fit then filed a motion to compel arbitration and to dismiss Patricko's counterclaims.

Patricko argued that Pla-Fit waived its right to compel arbitration by filing the motion for a preliminary injunction. The court disagreed and reasoned that, while a party may waive its contractual right to arbitrate, such waivers are not to be lightly inferred, and any doubts should always be resolved in favor of arbitration. It concluded Pla-Fit made its intentions to arbitrate known within three weeks after the resolution of the injunctive claims, which was less than two months after it had filed the motion for a preliminary injunction. To rise to the level of prejudice necessary to waive Pla-Fit's contractual right to arbitration, more was required. The delay was not prejudicial, discovery had not commenced, nor had the case advanced, and nothing in the record supported a conclusion that Pla-Fit had acted in bad faith or attempted to mislead Patricko about its intention to arbitrate the remaining claims. Accordingly, the court granted Pla-Fit's motion to compel arbitration.

STATE FRANCHISE LAWS

CALIFORNIA ADOPTS ELECTRONIC FRANCHISE FILINGS; CALEASI IS REPLACED

The California Department of Business Oversight has announced that "Beginning at noon on June 18, 2014... franchise applications and exemption notices filed under the Franchise Investment Law may be filed and paid for online using the DOCQNET self-service portal." All franchise filings may be completed online after that date.

Although CALEASI, the electronic database of franchise filings, is being phased out, information previously found there is being transferred to the DOCQNET website. Information about the DOCQNET system is available at www.dbo.ca.gov/DOCQNET.



NEW JERSEY APPELLATE COURT CONFIRMS TERMINATED INSURANCE AGENTS ARE NOT IN FRANCHISE RELATIONSHIP WITH INSURER

A New Jersey appellate court affirmed a state trial court's ruling that terminated insurance agents were not in a franchise relationship with Allstate Insurance Company and that the New Jersey Franchise Practices Act did not apply to their termination. *DeLuca v. Allstate N.J. Ins. Co.*, 2014 N.J. Super. Unpub. LEXIS 1090 (N.J. Super. Ct. App. Div. May 13, 2014). In this case, three terminated independent insurance agents sued Allstate for wrongful termination, seeking to apply the NJFPA to their relationship. The trial court issued an order dismissing the complaints, concluding that application of the franchise act would interfere with the regulatory framework between agents and insurers set out in New Jersey's insurance code and, thus, the relationship between Allstate and the agents did not constitute a franchise.

The appellate court affirmed and rejected the agents' contention that the NJFPA applied to their agreements with Allstate. The opinion noted insurance regulations protect agents by requiring a 90-day period for termination, with certain exceptions. The franchise statute, on the other hand, provides a 60-day termination period, but with different exceptions. Under the NJFPA a franchise agreement can be terminated only for good cause, while insurance regulations allow termination for any reason not excluded. The appellate court concluded that these and other conflicts pertain to "direct, unavoidable, patent, sharp and real differences between the Act and the heavily regulated insurance scheme" that result in the NJFPA being inapplicable to insurer-agent relationships. The appellate court also affirmed that even if there were no conflicts with insurance regulations, the agreements between the parties did not constitute a franchise under the Act because there was no "community of interest" and plaintiffs did not maintain a "place of business" in New Jersey as defined in the NJFPA.

CONTRACTS

NEW JERSEY COURT RULES CONTRACT AND STATUTE PRECLUDE CLAIMS

The United States District Court for the District of New Jersey recently granted a franchisor's motion to dismiss a franchisee's counterclaims for, among other things, fraud and a breach of the New Jersey Consumer Fraud Act ("NJCFA"). *Yogo Factory Franchising, Inc. v. Ying*, 2014 U.S. Dist. LEXIS 61968 (D.N.J. May 5, 2014). Ying's counterclaims were premised on allegations that he was induced into purchasing franchises by pre-contract misrepresentations of earnings potential, investment costs, and services to be provided by Yogo Factory.

In dismissing the fraud claim, the court concluded the franchisee had failed to plead with particularity, and, in any event, an integration clause in the franchise agreements



and a franchise questionnaire signed by Ying, through which he expressly denied receiving promises outside of the parties' agreements, foreclosed any claim that he reasonably relied on any representations. Further, relying on Third Circuit precedent, the district court ruled the NJCFA does not apply to the sale of franchises.

RICO

FRANCHISEES FAIL TO ESTABLISH ANY ELEMENT OF RICO CLAIM

In *Jennings v. Bonus Building Care, Inc.*, Bus. Franchise Guide (CCH) ¶ 15,284 (W.D. Mo. May, 7, 2014), a federal district court dismissed a lawsuit brought by four unit franchisees under the federal Racketeer Influenced and Corrupt Organizations Act ("RICO") because the franchisees could not meet any of the five elements required to sustain a RICO action. The franchisees alleged fraudulent and deceptive business practices against a total of 55 defendants associated with the Bonus Building Care franchise system, including corporate entities owned by the franchisor, multiple master franchisees, and various employees of the defendants. More specifically, the franchisees alleged that the defendants engaged in a scheme to defraud consumers by establishing a pyramid scheme, churning franchisees, charging erroneous or excessive fees, and disregarding their obligations under the unit franchise agreements.

The first RICO element required that the defendants be engaged in an "enterprise," consisting of an association of parties together for a common purpose over a sufficiently long period of time. Such an enterprise, however, must be distinct from the alleged pattern of racketeering, which in this case was the Bonus Building Care business itself. Because the franchisees argued that the entire Bonus Building Care system was created to perpetuate a fraudulent franchise scheme, they could not establish that the defendants were otherwise associated for any purpose sufficient to constitute an "enterprise" under the statute. Without the existence of an enterprise, it followed that the franchisees could not show the second RICO element that any of the 55 defendants operated or managed such an enterprise. The court also noted that the franchisees had failed to allege any action, much less participation, on behalf of at least 19 of the defendants. Although the franchisees did allege mail and wire fraud in their complaint, which could be sufficient to establish the third and fourth RICO element that each movant participated in predicate acts and a pattern of racketeering, the court noted that the fraud allegations did not satisfy the heightened pleading standards required for such allegations under the Rules of Civil Procedure. Similarly, the franchisees failed to establish the fifth element—that their injuries were proximately caused by the alleged predicate acts—because the complaint failed to identify any facts that moved it beyond a formulaic recitation of the elements.



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