The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

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

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CASE SUMMARIES

Below are summaries of recent case decisions of interest to franchisors.

STATE FRANCHISE LAWS

KENTUCKY FEDERAL COURT ALLOWS FRANCHISEE TO PROCEED WITH CLAIM THAT FINANCIAL PROJECTIONS VIOLATE MINNESOTA ACT

In *Long John Silver's Inc. v. Nickleson*, 2013 U.S. Dist. LEXIS 18391 (D. Ky. Feb. 12, 2013), a federal court in Kentucky granted in part and denied in part a franchisor's motion for summary judgment on a former franchisee's counterclaims. After Long John Silver's initiated a lawsuit against Nickleson in connection with multiple failed franchises in Minnesota, Nickleson brought various counterclaims, alleging violations of the Minnesota Franchise Act (MFA) and common law fraud, among other claims. Nickleson's counterclaims were based on Long John Silver's allegedly false and misleading statements concerning future profitability and the past performance of other franchisees.

The court denied Long John Silver's motion as to the violation of the MFA. It noted that, in order to succeed on this claim, Nickleson had to establish reasonable reliance on the statements. Long John Silver's argued that any reliance on representations about profitability was unreasonable because of the multiple disclaimers about costs and projected revenue in the franchising documents. While the court acknowledged that those disclaimers were relevant to a determination of reasonable reliance, it also noted that conflicting Minnesota case law on the subject could have led the franchisee to reasonably believe that such disclaimers would not be upheld in court. Therefore, the court held that there was a genuine issue of material fact regarding whether the franchisee reasonably relied on the alleged misrepresentations, and it denied summary judgment. Nickleson's claim of fraudulent misrepresentation survived summary judgment for the same reason. The court, however, did grant Long John Silver's motion with regard to Nickleson's claim of fraudulent non-disclosure. It held that a non-disclosure claim was only actionable when one party had a duty to disclose material facts, and the court found that the franchise agreement did not create any fiduciary relationship between the parties giving rise to such a duty.

SYSTEM CHANGE

NINTH CIRCUIT AFFIRMS $16 MILLION VERDICT IN FAVOR OF LICENSEE

The United States Court of Appeals for the Ninth Circuit last week affirmed a judgment won by an Avis licensee in Alaska who claimed that Avis steered business toward Budget® branded locations after the acquisition of that brand in 2002. *Alaska Rent-A-Car, Inc. v. Avis Budget Group, Inc.*, 2013 U.S. App. LEXIS 4566 (9th Cir. Mar. 6, 2013). The Alaska-based plaintiff claimed that Avis violated a prior settlement agreement, which promised licensees that any rental car companies acquired by Avis in the future would maintain separate sales, marketing, and reservation operations. An Alaska federal-court jury awarded $16 million to the plaintiff on its breach of contract claims. The appeal by Avis challenged the verdict on the grounds that the plaintiff was not covered by the prior settlement, and that errors occurred in the course of jury selection and the admission of expert testimony (particularly as to damages). The appeals court upheld the result on all grounds.

TERMINATIONS

PENNSYLVANIA FEDERAL COURT ENFORCES IMMEDIATE TERMINATION AND EVICTION FOR UNDERREPORTING OF SALES

A federal district court in the Eastern District of Pennsylvania this month issued a permanent injunction against a 7-Eleven franchisee and its employees who were found to have defrauded the franchisor by underreporting store sales. *7-Eleven, Inc. v. Upadhyaya*, 2013 U.S. Dist. LEXIS 29091 (E.D. Pa. Mar. 1, 2013). In this case, the franchisor had terminated the franchise without an opportunity to cure, which the court upheld on the grounds that fraud by the franchisee goes directly to the essence of

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the contract and cannot be cured. Finding that the defendants had failed to offer credible evidence to explain their misrecording of sales and their incorrect cash reports, the court upheld the termination. Building on that conclusion, the court entered an injunction under the federal Lanham Act against the defendants' continued operation of the business under the franchisor's name, and the court required them to turn the premises over to 7-Eleven.

SETTLEMENT

FEDERAL COURT ENFORCES SETTLEMENT TERMS SHEET

A federal court in the Northern District of Illinois ruled that a signed terms sheet between a settling franchisor and franchisee was an enforceable agreement under Illinois state law. *Pinnacle Performance, Inc. v. Garbis*, 2013 U.S. Dist. LEXIS 24433 (N.D. Ill. Feb. 21, 2013). This lawsuit began when the franchisor, Pinnacle Performance, filed suit against its former franchisees to enforce the covenant not to compete in the parties' franchise separation agreement. Months into the litigation, the parties negotiated and signed a settlement terms sheet in a settlement conference conducted by the court. A dispute later arose over the parties' obligations under the terms sheet.

On the former franchisees' motion, the court held that the terms sheet agreement was enforceable. Under Illinois law, a settlement agreement is enforceable if the parties expressed "an intent to be bound" and the agreement's terms are "sufficiently definite." The franchisor argued there was no intent to be bound by the terms sheet because the parties intended to memorialize the settlement terms with a formal agreement. Rejecting this argument, the court noted that the parties exchanged and negotiated multiple draft terms sheets and ultimately signed the final version without indicating that the deal was conditioned on future documentation. The court also observed that the agreement contained language suggesting its finality, for example the phrase "for 24 months from today." Finally, the court found that the terms were sufficiently definite to create a binding agreement because the parties' obligations were clear and any ambiguities could be resolved through ordinary contract construction.

BANKRUPTCY

DISTRICT COURT AFFIRMS BANKRUPTCY COURT DETERMINATION THAT OPTION HOLDER HAD STANDING UNDER TEXAS DECEPTIVE TRADE PRACTICES ACT

In *Carroll v. Farooqi,* 2013 U.S. Dist. LEXIS 22329 (N.D. Tex. Feb. 19, 2013), the United States District Court for the Northern District of Texas affirmed a U.S. Bankruptcy Court's holding that an individual had standing to pursue an action against a franchisor under the Texas Deceptive Trade Practices Act (DTPA). The case involved an unsuccessful sale of a Salad Bowl franchise. The CEO of the fast causal franchise company (who was also its president, chairman, and CFO) contacted a potential buyer of a franchise. The buyer signed a thirty-day option contract and paid $25,000 to the CEO for the franchise fee. Unfortunately, the buyer was unable to line up financing and demanded that the CEO refund his initial franchise fee. After the CEO filed an individual Chapter 13 bankruptcy case, the buyer initiated an adversary proceeding—a lawsuit in the bankruptcy case—against him. Among other things, the bankruptcy court held that the CEO had violated the DTPA, awarded the buyer a judgment for $88,000, and found that the debt was non-dischargeable in bankruptcy.

On appeal to the district court, the CEO did not challenge the bankruptcy court's decision that he violated the DTPA, but did appeal the finding that the buyer had standing to maintain an action under the statute. Specifically, the CEO argued that the buyer was not a "consumer" under the DTPA because he entered into an "option contract," which was neither a "good" nor a "service" under the Texas statute. The district court rejected that argument, holding that "a franchise may be a good or service under the DTPA." Moreover, in determining whether a party was a "consumer" for purposes of the DTPA, Texas law directed courts to examine a party's "central objective" in the transaction. Since the district court found that the buyer's "purpose in the entire transaction was to purchase a Salad Bowl franchise, not an Option Agreement," it concluded that the buyer had standing to bring a DTPA claim against the CEO.

CLASS ACTIONS

COURT REFUSES TO CERTIFY CUSTOMERS AS CLASS BECAUSE THEY FAILED TO DEMONSTRATE THEY SUFFERED THE SAME INJURY

In *Martin v. JTH Tax, Inc. d/b/a Liberty Tax Service,* 2013 U.S. Dist. LEXIS 15512 (D.S.C. Feb. 5, 2013), the United States District Court for the District of South Carolina refused to certify customers of Liberty Tax franchises as a class under Federal Rule of Civil Procedure 23. The plaintiffs alleged that Liberty Tax franchisees pressured them into paying additional fees to file unnecessary forms, and that they incurred additional tax liability as a result of the fraudulently filed forms. The court gave two reasons for refusing to certify the plaintiffs as a class. First, it found that the "commonality" requirement was not met because the plaintiffs failed to demonstrate that potential class members suffered the "same injury." The court found that each member of the potential class would have paid for different forms, incurred different tax liabilities, and potentially paid different fees depending on the franchised location they patronized. Moreover, the plaintiffs failed to demonstrate that the alleged wrongful acts were carried out at every office and by every tax preparer in the same manner, and that each potential class member was not complicit in the alleged tax fraud. Second, the court found that the "predominance" requirement of the class action rule was not met because the fact-specific inquiry required to establish each class member's claim and damages incurred would overshadow any class concerns. The court noted that the predominance requirement is far more stringent than the commonality requirement. As a result, the court denied class certification.

POST-TERMINATION INJUNCTIONS: TRADEMARK VIOLATIONS

FEDERAL DISTRICT COURT RULES THAT SIMILARITY OF A FORMER FRANCHISEE'S TRADEMARK TO THE FRANCHISOR'S WARRANTS AN INJUNCTION

In *You Fit, Inc. v. Pleasanton Fitness, LLC,* 2013 U.S. Dist. LEXIS 18106 (M.D. Fla. Feb. 8, 2013), a federal court in Florida granted the motion of You Fit, a franchisor, for a preliminary injunction under trademark law. The court found that the defendant former franchisee's operation of FIT U health clubs was confusingly similar to the franchisor's YOUFIT health clubs.

The court discussed the seven factors used to evaluate whether there was a likelihood of confusion, focusing primarily on the two most important—the strength of the plaintiff's mark and any actual confusion. The court determined YOUFIT to be a suggestive mark, requiring a customer to use his or her imagination to leap from the mark to the services of a health club. A suggestive mark is afforded a heightened level of protection, as compared to the protective given a merely descriptive term that had acquired secondary meaning. On the other hand, while suggestive, YOUFIT was deemed weak because of the common usage of the words "you" and "fit" in the fitness industry. Nevertheless, the court further determined that there were indications of actual confusion about the affiliation between the two businesses, based on reviews posted on the website yelp.com. Those postings, combined with the similarity in appearance, sound, and meaning between the marks YOUFIT and FIT U in the health club context—and by businesses competing for the same customers and having similar websites—led the court to conclude that there was a likelihood of confusion. Consequently, the franchisor was found likely to succeed on the merits of its trademark infringement, trademark dilution, and unfair competition claims, all warranting the issuance of a preliminary injunction.

INSURANCE

INSURER COVERAGE DENIAL FOR CONTRACTUAL EXCLUSION IN FRANCHISE DISPUTE IS UPHELD

A federal district court in Wisconsin granted partial summary judgment to a franchisor's directors and officers (D&O) insurance carrier following its denial of liability coverage based on key policy exclusions. In *Cousins Submarines, Inc. v. Federal Ins. Co.*, 2013 U.S. Dist. LEXIS 17306 (E.D. Wis. Feb. 8, 2013), citing the corporate liability coverage that supplemented its standard D&O liability coverage, a sandwich shop franchisor asked its insurer (Federal) to defend it in an underlying lawsuit. The underlying lawsuit alleged that Cousins and its representatives enticed a group of investors to open franchises in Indiana through arguably illegal means. Federal asserted policy exclusions, primarily an exclusion for liability under any written or oral agreement or contract (except to the extent that an insured organization would have been liable without the agreement), to deny coverage for the claims. Cousins unilaterally settled the underlying lawsuit using its own funds, then filed suit against Federal for breach of contract and bad faith denial of coverage.

In analyzing the contract liability exclusion, the court applied a two-pronged analysis. Under the first prong, it evaluated whether the liability arose from a franchise agreement, and then whether the claim arose from that liability. Federal took the position that a broad standard applied, excluding any claims for liability that would not lie "but for" the existence of a contract. Cousins argued for a more limited scope of the exclusion that would apply strictly to claims based on the contract itself. The court sided with Federal and determined that Cousins' liability stemmed from the existence of a franchise agreement. Under the second prong of the test for liability exclusion, the court considered the extent to which Cousins would have been liable in the absence of the agreement. The court determined that claims for breach of contract, rescission, and various statutory franchise violations were excluded, but that misrepresentation claims could have made Cousins liable in the absence of a franchise agreement. For that reason, the misrepresentation-related claims, including claims for violations of the Indiana Franchise Disclosure Act, were not dismissed. In most states, such claims could not exist in the absence of a contract between Cousins and investors, but the relevant Indiana laws provided for liability for any misrepresentation made in connection with the offer for sale of a franchise. Thus, Cousins could be liable for actions before the formation of the contract, even if a contract was never signed, and the contract liability exclusion did not apply for the pre-contract liability portion of the franchise claims.

CHOICE OF FORUM

NEW JERSEY FEDERAL COURT UPHOLDS FORUM SELECTION CLAUSE

In *Days Inns Worldwide, Inc. v. Royal Hospitality Group, LLC*, 2013 U.S. Dist. LEXIS 19464 (D.N.J. Feb. 11, 2013), the United States District Court for the District of New Jersey upheld the validity of a forum selection clause contained in the parties' franchise agreement. Days Inn terminated the franchise agreement after the franchisees, who were located in California, failed to pay outstanding fees. When Days Inn brought suit in New Jersey for breach of contract, the franchisees moved to dismiss the complaint on the grounds that the court lacked personal jurisdiction over them and that laying venue there would infringe upon their due process rights. The franchise agreement contained a forum selection clause in which the franchisees consented to the nonexclusive personal jurisdiction of New Jersey courts and waived any venue objection.

In denying the motion to dismiss, the court held that the franchisees could not overcome the plain language of the forum selection clause. The court first noted that forum selection clauses are presumptively valid and enforceable under federal law. The forum selection clause in this case constituted prima facie evidence that the court had personal jurisdiction over the franchisees because it (1) contained an express provision that conferred personal jurisdiction, (2) selected the district court of New Jersey as the venue in which disputes arising out of the franchise agreement would be adjudicated, and (3) designated New Jersey law as the governing authority. The court also rejected the franchisee's venue objections, concluding that they had endorsed Days Inn's venue selection by signing the franchise agreement, and that a substantial portion of the relevant events took place in New Jersey.

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