GRAY PLANT MOOTY

The GPMemorandum

TO: OUR FRANCHISE AND DISTRIBUTION CLIENTS AND FRIENDS

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

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ANNOUNCEMENT

GRAY PLANT MOOTY ADDS MARK KIRSCH AND JAN GILBERT

Mark Kirsch and Jan Gilbert joined Gray Plant Mooty's 32-member Franchise & Distribution Practice Group on February 1, 2013. Both will practice in the firm's Washington, D.C. office. These two high-profile attorneys bring more than 50 years of combined experience in the franchise industry, and both have strong backgrounds in domestic and international franchising.

Kirsch focuses his practice on domestic and international franchising and distribution matters, with an emphasis on transactional and regulatory work, mergers and acquisitions, and international franchising. He is the vice chair of the International Franchise Association Supplier Forum Advisory Board and will join the IFA Board in 2013. His accolades include being recognized in *Best Lawyers in America*, *International Who's Who of Business Lawyers*, *Franchise Times'* "Legal Eagles," and Washington, D.C. *Super Lawyers*. Before joining Gray Plant Mooty, Kirsch earlier practiced at DLA Piper, and most recently he was with Plave Koch PLC.

Gilbert has worked with both start-up and mature franchisors for more than 20 years and counsels them on all aspects of domestic and international franchising. He is currently the articles and topics editor for the American Bar Association's *Franchise Law Journal* and has consistently been named one of *The*

Best Lawyers in America, a "Legal Eagle" by *Franchise Times*, and a *Chambers USA Guide: America's Leading Lawyers* in franchising, among many other honors. Prior to joining our firm, Gilbert practiced in the Washington, DC, office of Haynes and Boone, LLP.

CASE SUMMARIES

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

TRADEMARKS AND TRADE ISSUES

UNITED STATES SUPREME COURT HOLDS BROAD COVENANT NOT TO SUE MOOTS TRADEMARK INFRINGEMENT ACTION

The Supreme Court's decision in *Already, LLC v. Nike, Inc.*, 568 U.S. ___, 184 L. Ed. 2d 553 (U.S. Jan. 9, 2013), is important for franchisors who may be considering bringing a trademark infringement action against a competitor (including a former franchisee) using a similar mark, as well as for recipients of such infringement claims. The unanimous court affirmed the lower courts' rulings that, once a trademark plaintiff has voluntarily dismissed its infringement suit and issued a covenant not to sue, the district court loses federal jurisdiction under Article III of the U.S. Constitution and is barred from considering a defendant's counterclaim that the mark is invalid.

Nike had filed an infringement action against a competitor shoe manufacturer, Already, LLC. Already counterclaimed, alleging that Nike's trademark was invalid and seeking to cancel the registration. Four months later, Nike delivered a comprehensive covenant not to sue to Already, in which Nike promised not to assert any claim against Already relating to the mark based on any of Already's current or previous shoe designs. Nike then moved to dismiss all claims and counterclaims for lack of subject matter jurisdiction. The district court dismissed the case as moot, and the United States Court of Appeals for the Second Circuit affirmed. In reviewing the case, the Supreme Court noted that the breadth of the covenant was adequate to meet the "formidable burden" of showing that Nike could not reasonably be expected to resume its enforcement efforts against Already. The high court rejected Already's policy argument that the case allowed Nike to bully a small innovator, noting that issuing covenants not to sue could be a risky long-term strategy for a trademark holder.

The Supreme Court's ruling confirms that franchisors and other trademark owners enjoy flexibility when issuing trademark cease and desist letters and in filing infringement suits. If the franchisor has a change of heart a properly drafted covenant not to sue can put an end to all aspects of the claim as well as potentially harmful counterclaims.

PIZZA FRANCHISOR'S TRADE DRESS INFRINGEMENT CLAIMS FAIL

A Michigan federal court recently denied a franchisor's motion for summary judgment on its trade dress infringement and unfair competition claims. *Happy's Pizza Franchise, LLC v. Papa's Pizza, Inc.*, 2013 U.S. Dist. LEXIS 10130 (E.D. Mich. Jan. 25, 2013), involved a lawsuit brought by Happy's Pizza Franchise, LLC, against Papa's Pizza, Inc. and Phil Almaki, who once was a passive investor in one Happy's Pizza location. Almaki later sold his interest in the Happy's Pizza store and opened several pizza restaurants under the mark Papa's Pizza. Happy's claimed that the Papa's Pizza restaurants copied its restaurant design and menu, in violation of the Lanham Act.

On Happy's motion for summary judgment on its trade dress and unfair competition claims, the court discussed the elements of trade dress infringement, distinctiveness, non-functionality, and customer confusion, and it rejected Happy's claim that its trade dress was inherently distinctive. Unlike the trade dress elements found to be inherently distinctive in other cases, such as a unique wine display system or a burnt orange and white color scheme with brick walls and a brown tile floor, Happy's granite countertops and tabletops, ceramic tiles and floors, back-lit pictures of menu items, and stainless steel shelving were found generic by the court and did not create an identifiable trade dress. Similarly, the menu offerings were not original and were labeled generically (*e.g.*, "Perch and Shrimp Combo"). Accordingly, the court denied Happy's motion for partial summary judgment on its claim of trade dress infringement and unfair competition.

CHOICE OF FORUM

COURT DENIES CHALLENGE TO VENUE IN FRANCHISOR'S HOME STATE

A Minnesota federal court has held that a franchisor's lawsuit was properly filed in its headquarters state because a substantial part of the events giving rise to the claims occurred there. *Great Clips, Inc. v. Ross*, 2013 U.S. Dist. LEXIS 12530 (D. Minn. Jan. 30, 2013). Great Clips filed the case in Minnesota seeking a declaratory judgment that it did not breach the confidentiality/non-slander clause of a settlement agreement it had signed with a franchisee. In response to the lawsuit, the franchisee moved to dismiss and transfer on the ground that venue was not proper in Minnesota, and alternatively on the ground that Texas was a more convenient venue. The settlement agreement did not contain a forum selection or venue clause, but selected Minnesota law to apply. (The underlying franchise agreements did contain Minnesota venue clauses.)

The court rejected the franchisee's motion and held that venue was proper, noting that the settlement agreement itself arose out of a lawsuit that originally was initiated in Minnesota by Great Clips. Through the settlement, the franchisee was releasing any claims it had relating to several franchise agreements, each of which required the claims to be brought in Minnesota. The court also noted that the franchisee had directed other activities into Minnesota, including written and oral communications. Finally, there was no evidence that the conduct at issue—the franchisor's alleged disclosure of confidential information—occurred anywhere but in Minnesota. The court held that even though there were connections to Texas, the court was not required to determine the "best" venue, but whether Minnesota was proper.

POST-TERMINATION INJUNCTIONS: NONCOMPETE COVENANTS

PRELIMINARY INJUNCTION ENFORCING POST-TERM NONCOMPETE APPLIED TO FORMER FRANCHISEES AND OTHERS ACTING IN CONCERT WITH THEM

A recent case from the Eastern District of Pennsylvania shows the lengths to which courts will go to enforce franchise agreements against personal guarantors and related parties. *Tantopia Franchising Co. v. West Coast Tans of PA, LLC*, 2013 U.S. Dist. LEXIS 8266 (E.D. Pa. Jan. 22, 2013). The relevant history began in 2002, when Tantopia Franchising Company entered into a franchise agreement with West Coast Tans (WCT) to operate a tanning salon in Philadelphia. Donald and Richard Weiss personally guaranteed WCT's obligations under that agreement. In 2009, WCT ceased operations. A new entity called CTG, which was owned 90 percent by Donald's wife, Rosalind Weiss, and 10 percent by Richard, entered into a lease for WCT's former space. CTG, in turn, sold its assets to TMA, whose sole shareholder was Christopher Connors, the son of Richard's deceased former fiancée. Tantopia obtained a preliminary injunction against WCT, Donald, Richard, and Rosalind Weiss, Christopher Connors, CTG, and TMA that enforced the post-term noncompete provisions of WCT's franchise agreement. The court held that it could enforce the franchise agreement against persons who were not parties to it under the "well-established [rule] that a non-covenantor who benefits from the covenantor's relationship with the competing business must abide by the same restrictive covenant agreed to by the covenantor." It concluded that "TMA and Connors are a mere continuation of, or straw man for, Donald and Richard Weiss, West Coast Tans and CTG."

The court also found that Tantopia demonstrated irreparable harm in several respects, including injury to reputation and goodwill, impediments to its ability to refranchise the area, and "irreparable harm in that permitting former franchisees to violate. . . the non-compete covenant will set a poor precedent for other franchisees." The court, however, denied the portion of Tantopia's motion to enforce its right of first refusal to purchase the former franchisee's tanning equipment, because Tantopia had not shown irreparable harm by the defendants' refusal to sell that equipment.

JURISDICTION AND PROCEDURE

FEDERAL COURT RULES DISPUTE RESOLUTION CLAUSE MUST BE FOLLOWED PRIOR TO LITIGATION AND STAYS PENDING PROCEEDINGS

The United States District Court for the Middle District of Tennessee last month ruled that dispute resolution procedures in the parties' franchise agreements survived termination of the agreements and must be followed prior to the initiation of litigation. *Shoney's N. Am., LLC v. Vidrine Rests., Inc.* (M.D. Tenn. Jan. 22, 2013). Shoney's commenced the action seeking liquidated damages arising from its termination of a number of franchise agreements with Vidrine. More than six months after Shoney's initiated the suit, Vidrine filed a motion to stay the action pursuant to the dispute resolution clauses in the parties' franchise agreements.

The dispute resolution clauses, which were the same under each franchise agreement, provided neither side could initiate a legal action "arising out of or relating to" the franchise agreements until the parties completed mediation. Shoney's argued the dispute resolution clauses no longer applied because they were extinguished with the termination of the franchise agreements. Shoney's further argued that Vidrine had waited too long to file its motion, and that, in any event, both parties had declined to exercise their right to mediate. Vidrine argued they were contractually entitled to mediate their disputes with Shoney's before any legal action could be brought. The court agreed with Vidrine on all counts. According to the court, the franchise agreements' dispute resolution clauses, by their terms, survived termination of the agreements and would continue to do so until "satisfied in full" or until they expired "by their nature." Accordingly, the court granted Vidrine's motion to stay the pending litigation until the parties satisfied the requirements of the dispute resolution clauses.

FRANCHISE SALES/TRANSACTIONS

FEDERAL COURT FINDS IT LACKS JURISDICTION OVER FTC ACT CLAIM

In *Palermo Gelato, LLC v. Pino Gelato, Inc.*, 2013 U.S. Dist. LEXIS 9931 (W.D. Pa. Jan. 24, 2013), the United States District Court for the Western District of Pennsylvania dismissed a licensee's action based on the FTC Rule for lack of subject matter jurisdiction. The parties had entered into a development and supply agreement that gave Palermo exclusive rights to sell Pino's gelato product in certain designated counties. The dispute arose when Palermo allegedly discovered that Pino had misrepresented its manufacturing method. Palermo filed suit seeking a declaratory judgment that the agreement was invalid on the grounds that the parties had entered into a franchise relationship and that Pino had violated the FTC Rule when it failed to provide a presale disclosure document. Palermo also raised state law claims of unjust enrichment and fraud in the inducement. Pino moved to dismiss the declaratory judgment cause of action, arguing that no franchise relationship existed and that Palermo could not invoke the FTC Rule to void their contract.

Without reaching Pino's argument, the court held that the claim that the FTC Rule voided the contract did not provide a basis for federal subject matter jurisdiction. The complaint needed to establish that Palermo's right to relief necessarily depended on resolution of a substantial question of federal law. The court determined that the complaint failed to meet this standard because the application of federal law did not arise in Palermo's original cause of action but by way of a defense to that action. The court also found that the case lacked an important federal interest given that the FTC Rule does not confer a private right of action and that no government actors were involved. In addition, no "substantial" federal question was presented, as numerous courts had determined that violation of FTC requirements cannot negate an agreement.

COURT UPHOLDS NARROW DEFINITION OF "CONSUMER" UNDER ILLINOIS CONSUMER FRAUD AND DECEPTIVE BUSINESS PRACTICES ACT

Chicago Male Medical Clinic (CMMC) brought suit against Ultimate Management, Inc. (UMI), a company that licenses and oversees a national affiliation of medical clinics, alleging, among many counts, that UMI had fraudulently induced CMMC's investment and had violated the Illinois Franchise Disclosure Act, the Illinois Consumer Fraud & Deceptive Business Practices Act, as well as common law fraud and breach of contract. In *Chicago Male Medical Clinic, LLC v. Ultimate Management, Inc.*, 2012 U.S. Dist. LEXIS 183257 (N.D. Ill. Dec. 28, 2012), the court addressed several motions, including UMI's request to dismiss all fraud claims (including under the franchise disclosure act).

The court granted UMI's motion to dismiss the fraud counts brought under common law and the IFDA, stating that the mere assertion that the business investment was obtained "through lies and deception" did not meet the heightened pleading requirement for fraud under Rule 9(b) of the Federal Rules of Civil Procedure. As for the claim that CMMC had violated the consumer fraud act, UMI argued that CMMC had failed to establish standing because a business only has standing to sue if it alleges that the misconduct was directed at the market in general. However, CMMC argued that it had standing as a "consumer." A consumer, as defined by the consumer fraud act, purchases merchandise (including intangible rights) for personal use. The court found that franchise services could not be used for personal use and held that CMMC's claim fell outside of the consumer fraud act.

ARBITRATION

IOWA FEDERAL COURT ENFORCES ARBITRATION PROVISION

A United States District Court in Iowa has granted a franchisor's motion to dismiss the complaint filed by its franchisee and enforced the applicable arbitration provisions. *Cahill v. Alternative Wines, Inc.*, 2013 LEXIS 14588 (N.D. Iowa Feb. 4, 2013). The franchisee sued the franchisor and its CEO for breach of a purchase agreement and services agreement between the franchisee and the franchisor, violation of Iowa business opportunity laws, and fraud. The defendants moved to stay or dismiss, seeking to enforce the services agreement's provision requiring arbitration in North Carolina.

The franchisee argued that the arbitration provisions contained in the agreements were unenforceable under Iowa Code section 537A.10(3), which voids any franchise agreement provision restricting jurisdiction in another state. The franchisee further argued that the statute applied to all franchise agreements and was not limited to arbitration agreements, so it did not preempt the Federal Arbitration Act. The court disagreed, holding that the Iowa statute's prohibition does not differentiate between forum selection clauses in contracts and forum selection clauses in agreements to arbitrate. Because the statute directly conflicts with the FAA and its broad policy for allowing arbitration of disputes when the parties have so agreed, it violates the Supremacy Clause of the U.S. Constitution. The court further held that the CEO, who was not individually a party to any of the agreements, could enforce the arbitration provisions because of his close relationship with the franchisor and because the claims against him were all derived from the same agreements. Finally, the court explained that dismissal was warranted as opposed to a stay because all of the matters at issue were subject to arbitration.

DISTRICT COURT UPHOLDS ARBITRATION FINDING OF CONSTRUCTIVE TERMINATION UNDER WISCONSIN STATUTE

The United States District Court for the Central District of California recently upheld an arbitrator's finding that a franchisor had constructively terminated a franchise agreement in violation of the Wisconsin Fair Dealership Law (WFDL), when, among other things, the franchisor cut off the franchisee's access to the franchise system's record-keeping and management web portal and its external website. In *Budget Blinds Inc. v. LeClair,* 2013 U.S. Dist. LEXIS 7463 (C.D. Cal. Jan. 16, 2013), two neighboring Budget Blinds franchisees became embroiled in a dispute regarding extraterritorial sales activity. One of the franchisees complained to the franchisor that the other franchisee (LeClair) was making sales into its territory. Budget Blinds confirmed the extraterritorial activity through its franchisee system portal, and then initiated arbitration against

LeClair. The arbitration demand sought a declaration that Budget Blinds was entitled to terminate LeClair's franchise agreement based on the extraterritorial sales activity. Budget Blinds allegedly filed the demand without contacting LeClair to discuss the dispute or to provide any notice of the claims. After the arbitration demand was filed, LeClair could only communicate with its franchisor by speaking with its lawyer. The arbitrator found that Budget Blinds, by cutting LeClair off from access to the portal and the external website, initiating arbitration, and referring internet and telephone leads to other franchisees, had constructively terminated LeClair's franchise agreement. In doing so, Budget Blinds violated the WFDL by failing to provide the required cure period.

Budget Blinds appealed the arbitrator's decision to the district court. Under the Federal Arbitration Act, the standard for a court's review of an arbitrator's decision is limited to determining if the arbitration award was procured by fraud or if the arbitrator has exceeded his or her power. An arbitrator exceeds his or her power when the award "is completely irrational, or exhibits a manifest disregard for the law." Under the facts of this case, the court declined to find that the arbitrator had manifestly disregarded the law or that her decision was completely irrational. Budget Blinds argued that its initiation of arbitration in order to seek a declaration that it was permitted to terminate the franchise agreement *by definition* meant that it had not terminated the franchise agreement, constructively or otherwise. The court disagreed, finding that a franchisor could constructively terminate a franchise agreement in violation of the WFDL without formally terminating it, and that the arbitrator's findings could be read as being consistent with an appropriate application of the law.

WASHINGTON COURT DECLINES TO VACATE ORDER COMPELLING ARBITRATION ABSENT SHOWING OF PREJUDICE

The Supreme Court of Washington recently upheld a trial court's order compelling arbitration in Washington, despite clauses in a franchise agreement providing disputes would be arbitrated in Connecticut, under Connecticut law (except for Connecticut franchise law). In *Saleemi v. Doctor's Associates, Inc.*, 292 P.3d 108 (Wash. Jan. 17, 2013), the plaintiffs sought to compel arbitration over DAI's termination of their Subway franchises in Washington. The trial court ruled that the forum selection and choice of law provisions of the franchise agreement were unenforceable, and entered an order compelling arbitration in Washington. DAI did not seek discretionary review of that order, and the plaintiffs prevailed at the ensuing arbitration.

On appeal, DAI asked the Supreme Court of Washington to vacate the original order compelling arbitration. The court noted that a party failing to seek discretionary review of an order compelling arbitration does not waive its right to challenge the order after arbitration. The court, however, held that the challenging party still must show prejudice in the ensuing arbitration before a court can vacate the original order to compel. The court noted that the "unusual" choice of law provision in the franchise agreement explicitly stated that Connecticut franchise law would not apply to disputes, and DAI conceded that the Washington franchise law applied by the arbitrator was the correct governing law in the case. Furthermore, the Washington arbitration was conducted by the same arbitration group and under the same arbitration rules as otherwise required by the parties' agreement. The court concluded that, because DAI had not demonstrated how the outcome of the arbitration might have been different had the trial court applied the franchise agreement's forum selection and choice of law provisions, any error in the trial court's order would have been harmless.

VICARIOUS LIABILITY

FRANCHISOR FOUND VICARIOUSLY LIABLE FOR FRANCHISEE ADVERTISING

A California state appellate court upheld a finding that a franchisor was vicariously liable for its franchisees' illegal advertising, determining that the franchisor had extensive controls over the advertising beyond that necessary to protect the franchisor's trademarks and goodwill. In *The People v. JTH Tax, Inc.*, 2013 Cal. App. LEXIS 37 (Cal. Ct. App. Jan. 17, 2013), the California Attorney General filed a complaint against Liberty Tax Service for several violations of consumer protection laws, including false advertising in relation to its refund-anticipation loans and electronic refund checks. The lawsuit alleged that Liberty was responsible for the misleading or deceptive statements its franchisees used in print and television advertising. Liberty appealed the trial court's ruling that it was liable for the franchisee's advertisements that were "likely to deceive."

Liberty argued that it was not liable for the franchisees' advertisements because the franchisor-franchisee relationship required a higher level of control, and it controlled the franchisee's advertising only to the extent necessary to protect its trademark and goodwill. The appellate court found that the Liberty operations manual demonstrated a level of control far in excess of what it needed to police its mark. The court emphasized Liberty's "particularly extensive" right of control over franchisee advertising, which Liberty used to not only protect its marks, "but also to dictate business strategy to franchisees." The appellate court acknowledged that a franchisor has a right to exercise control over the franchisee's operations and activities necessary to protect its marks and goodwill, but found that Liberty retained the right to "complete control" over franchisee advertising operations. The appellate court concluded that these facts were substantial evidence to support the trial court's decision that Liberty controlled franchisee advertising such that Liberty's franchisees were considered agents for purposes of advertising.

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