

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

Antitrust

Illinois Federal Court Excludes Plaintiffs' Expert Testimony on Certification Motion in Anti-Poaching Class Action

A federal court in Illinois granted Jimmy John's motion to exclude expert testimony of a putative class seeking certification, while denying the class's motion to exclude Jimmy John's expert testimony. *Conrad v. Jimmy John's Franchise, LLC*, 2021 WL 718320 (S.D. Ill. Feb. 24, 2021). The case against Jimmy John's is the most procedurally advanced of the class actions filed against various franchisors alleging that employee anti-poaching provisions formerly contained in many franchise agreements constitute an unlawful conspiracy in restraint of trade in violation of Section 1 of the Sherman Antitrust Act. After extensive discovery, the plaintiff franchisee employees and former employees filed for class certification, and both parties submitted expert testimony with respect to whether damages in the form of allegedly suppressed wages could be proven on a class-wide basis. In connection with the class certification motion, both sides sought to exclude the opposing side's expert testimony.

The plaintiffs' expert undertook a multivariate regression analysis that purported to show that wages were substantially suppressed class wide. In part, the expert relied upon a comparison of wage structures before and after the anti-poaching provision was removed from the franchise agreement in 2018. However, the court excluded this testimony, finding that the expert's methodology suffered from several flaws, including the fact that it treated all wages as hourly, even though many managers were compensated on a per-shift basis. Jimmy John's experts contended, and the court agreed, that this flaw caused inflated estimates of impact. In contrast, the court denied the plaintiffs' motion to exclude the testimony of Jimmy John's two expert witnesses, one of whom identified flaws in the analysis conducted by the plaintiffs' expert, while the other explained, from an economic perspective, the pro-competitive benefits of intra-brand vertical restraints in a franchise system. While the question of certification has not yet been decided, the exclusion of critical expert testimony creates a substantial impediment to the pursuit of the case on a class-wide basis. The plaintiffs recently moved for reconsideration of the court's decision to exclude their expert's testimony.

State Franchise Laws

“Four Strikes” Termination Provision in Franchise Agreement Satisfies Michigan Franchise Investment Law’s Good Cause Termination Requirement

A federal court in Michigan granted 7-Eleven’s motion for summary judgment and enforced the franchisor’s right to terminate a franchisee following repeated defaults. *7-Eleven, Inc. v. CJ-Grand, LLC*, 2021 WL 429332 (E.D. Mich. Feb. 8, 2021). The franchise agreement at issue permitted immediate termination if 7-Eleven issued four notices of default to its franchisee within a two-year period, regardless of whether any of the defaults were cured. 7-Eleven sought a declaratory judgment from the court vindicating 7-Eleven’s right to terminate its franchise agreement with CJ-Grand after the franchisee committed ten defaults under the agreement over a span of two years.

CJ-Grand argued that 7-Eleven lacked good cause to terminate under the Michigan Franchise Investment Law (MFIL) because CJ-Grand had cured its defaults. The MFIL prohibits a franchisor from unilaterally terminating a franchise agreement, except for “good cause,” which includes a franchisee’s failure to comply with any lawful provision of the franchise agreement and to cure such a breach after being given a reasonable opportunity to do so. The court held that 7-Eleven’s “four-strikes” provision, aimed at rooting out serial breachers, satisfied the MFIL’s good-cause requirement. In doing so, it noted that the statute’s language concerning the failure to cure after a reasonable opportunity identified a non-exclusive example of good cause. The court also had little trouble in rejecting CJ-Grand’s argument that the “four-strikes” provision was unconscionable.

Class Actions

Class Action Damages Cannot Quite Fill the Class Action Fairness Act’s Glass

A federal court in Nevada remanded a class action back to state court after Red Robin was unable to show that the putative damages exceeded the amount in controversy requirement under the Class Action Fairness Act (CAFA). *Bruun v. Red Robin Gourmet Burgers, Inc.*, 2021 WL 529784 (D. Nev. Feb. 12, 2021). A putative class of Red Robin customers alleged they had been denied 2 ounces of Stella Artois beer when they ordered 16-ounce beers that were actually served in chalicees that could only hold 14 ounces. Red Robin removed the case to federal court under CAFA. In response, plaintiffs argued the jurisdictional requirements under CAFA were not satisfied and requested the federal court remand the matter back to state court.

The court agreed to remand the matter, noting that CAFA gives federal courts jurisdiction over class actions if the putative class has at least 100 members, the parties have minimal diversity, and the amount in controversy exceeds \$5 million. When a defendant removes a case to federal court under CAFA, the court presumes the amount in controversy is satisfied unless challenged, and then the defendant must prove the amount in controversy. Red Robin argued that from 2016 to May 2020, its taps poured more than \$16 million in Stella Artois sales at their 454 corporate stores, and even more at their 102 franchised locations. In response, plaintiffs argued the amount in controversy should be limited to the amount of sales Red Robin received for the unrequited 2-ounces of beer, which was really only 12.5% of total sales or \$449,500. The court further discounted the amount in controversy because it was not reasonable to assume that every drop of Stella Artois ordered was for 16-ounce beer. Red Robin tried to fill their glass with attorneys’ fees and treble damages, but even those frothy damages could not satisfy the amount in controversy requirement. Thus, the federal court remanded the matter back to the (state) bar.

Choice of Law

Connecticut Federal Court Enforces Predecessor Franchisor Choice of Law Provision in Master Franchise Agreement

A federal court in Connecticut enforced the choice of law provision in a master franchise agreement entered into with the franchisor's predecessor. *Purugganan v. AFC Franchising, LLC*, 2021 WL 723916 (D. Conn. Feb. 24, 2021). Plaintiff Danilo Purugganan was a master franchisee of Doctors Express. He developed and managed Doctors Express Urgent Care franchises in New York and Connecticut. Defendant AFC Franchising later acquired Doctors Express, and Purugganan's Master Developer Agreement (MDA) was assigned to AFC. Years after this acquisition, AFC made plans to purchase four franchises in Purugganan's territory, and he sued AFC in Connecticut to stop the purchases. AFC sought to dismiss the lawsuit, arguing that the choice of forum clause required lawsuits to be brought in the same location as its principal place of business in Alabama. In an earlier decision, the court denied the motion, concluding that the choice of forum did not give Purugganan notice that it would "float" with a successor franchisor. AFC thereafter moved for judgment on the pleadings as to many of Purugganan's claims on the basis of the MDA's choice of law provision.

Unlike the choice of forum provision, the court did enforce the choice of law provision selecting the law of Maryland to govern the dispute. The court rejected Purugganan's argument that the choice of law provision was unenforceable because neither he nor AFC has any relationship to Maryland. The fact that Doctors Express was a Maryland resident when the MDA was formed supplied a sufficient relationship at the time of formation, and AFC stands in its predecessor's shoes for the purposes of the MDA. Having determined that Maryland law applied to Purugganan's contract-based claims, the court granted AFC judgment on the pleadings as to several of them. It found that the application of Maryland law precluded Purugganan's Connecticut Unfair Trade Practices Act claim; that Maryland law subsumed his bad faith, promissory estoppel, and UCC claims under his breach of contract claim; and that his claims for tortious interference with contract and prospective economic relations could not be maintained under Maryland law because AFC was a party to the relevant contracts and economic relationships. The court also granted AFC judgment on the pleadings as to Purugganan's claims for violation of the Sherman Act and Connecticut Franchise Act, and his claim for abuse of process.

Insurance

Illinois Federal Court Holds Franchisor's Insurance Coverage May Include Costs of Complying with an Injunction Requiring COVID-19 Safety Precaution

A federal court in Illinois has recently concluded that an insurer may have a duty to cover a franchisor's costs of defending a COVID-19-related injunction. In *McDonald's Corp. v. Austin Mutual Insurance Co.*, (N.D. Ill. Feb. 22, 2021), McDonald's claimed that Austin Mutual had a duty to defend McDonald's in an ancillary case brought by employees of a McDonald's franchisee alleging McDonald's was liable for public nuisance and negligence as the result of its decision to allow its franchisee to remain open during the COVID-19 pandemic without enhanced health and safety standards. Austin Mutual moved to dismiss McDonald's complaint.

The issue before the court was whether costs incurred by McDonald's to comply with a mandatory injunction sought by the employees to protect against COVID-19 infection would constitute "damage" "because of" "bodily injury," as those terms were used in the policy. In its motion to dismiss, Austin Mutual argued that the employees' claims were not covered because the policy was intended to cover damages paid to a third-party — not expenses incurred by the insured. The court found that "[a]n insurer can only refuse to defend if the allegations of the underlying complaint preclude any possibility of coverage." It then reasoned that if the employees were granted the sought-after injunction (resulting in necessary expenditures by McDonald's), it would only be because the employees had contracted or would be exposed to COVID-19, both of which would constitute "bodily injury." The court therefore determined that McDonald's complaint raised "a potential and legally defensible interpretation" of the policy, and denied Austin Mutual's motion to dismiss.

Preliminary Injunction

Court Enjoins Dallas Business from Using Trademarked Frosting Pattern

A Texas federal court has granted an injunction to a Bundt cake franchisor seeking to prevent a competitor from using its trademarked frosting pattern on her cake products. *Denbra IP Holdings, LLC v. Thornton*, 2021 WL 674238 (E.D. Tex. Feb. 22, 2021). Plaintiff Denbra IP Holdings, LLC d/b/a Nothing Bundt Cakes has over 300 franchises around the United States and Canada selling Bundt cakes topped with its trademarked frosting pattern. The frosting pattern consists of long strips of tubular ring-shaped frosting that expands outward from the center of the cake. Twenty-one of its franchises are located in the Dallas-Fort Worth area. In August 2020, some of the Dallas-Fort Worth-area franchisees reported to Nothing Bundt Cakes that Defendant Thornton was selling Bundt cakes using its trademarked frosting pattern and operating under the name "Anything Bundt Cakes." Nothing Bundt Cakes sent Thornton a demand letter and, in response, Thornton changed the name to "All About Bundt Cakes," but continued utilizing the frosting pattern. Nothing Bundt Cakes sent Thornton a second demand letter, but she continued using the frosting pattern. Nothing Bundt Cakes then brought a motion for a preliminary injunction.

Thornton failed to appear in the matter. Nonetheless, the court determined that all four factors considered in the preliminary-injunction analysis weighed in Nothing Bundt Cakes' favor and enjoined Thornton from using the frosting-pattern mark. First, the court determined that there was a substantial likelihood that Nothing Bundt Cakes would succeed on the merits because it has a protectable mark and Thornton's use of the mark was likely to confuse customers. Second, the court concluded that Nothing Bundt Cakes would suffer irreparable harm because it has established goodwill in the Dallas-Fort Worth area that may be lost due to Thornton's actions, and that it has lost control of its reputation. Third, the court found that the balance of equities weighs in Nothing Bundt Cakes' favor because any damage suffered by Thornton to replace advertising materials or stop using the frosting pattern is minimal compared to the harm to Nothing Bundt Cakes' reputation and its loss of goodwill. Lastly, the court concluded that enjoining Thornton will serve the public interest because the public interest "is always served" by enjoining the unauthorized use of a protected mark.

Jurisdiction and Procedure

Kentucky State Court Finds Franchisee Owner Lacks Standing to Sue, Holding that the Franchisee Entity was the Proper Plaintiff

The Court of Appeals of Kentucky affirmed the dismissal of a Jani-King franchisee owner's wage and hour, breach of contract, and fraud claims on the basis that the franchisee's individual owner lacked standing to sue. *Mouanda v. Jani-King*, 2021 WL 406317 (Ky. Ct. App. Feb. 5, 2021). The plaintiff, Constance Mouanda, was the sole owner of an entity, The Matsoumou's, LLC. That entity entered into a franchise agreement with Cardinal Franchising, Inc., a master franchisee for the Jani-King janitorial franchise system. In the instant suit, Mouanda alleged a variety of claims, including that she was fraudulently induced to enter into the franchise agreement, and that she was actually an employee of Jani-King and had been misclassified as a franchisee in violation of employment laws. The court held, however, that Mouanda was not the proper plaintiff because she was not the franchisee. On that basis, the court affirmed the lower court's dismissal of Mouanda's claims.

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