Franchising (& Distribution) Currents

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ANTITRUST

***Jacobs v. Tempur-Pedic Int'l Inc.*, 626 F.3d 1327, Bus. Franchise Guide (CCH) ¶ 14,499 (11th Cir. Dec. 2, 2010)**

This appeal of an antitrust case analyzed the sufficiency of plaintiffs' pleadings regarding an alleged vertical resale price maintenance claim and a claim of a horizontal price-fixing conspiracy based on a dual distribution system. Defendant Tempur-Pedic manufactures visco-elastic foam mattresses and sells them to customers through distributors and also through its own company website. Sales of Tempur-Pedic mattresses amounted to 80 percent to 90 percent of the visco-elastic foam mattresses sold in the United States during the complaint period. Plaintiffs purchased a Tempur-Pedic mattress from a distributor and then sued, claiming that Tempur-Pedic violated the Sherman Act by creating an unreasonable restraint of trade by enforcing vertical retail price maintenance agreements with its distributors and engaging with its distributors in horizontal price-fixing.

Tempur-Pedic moved to dismiss both claims, arguing that plaintiffs failed to meet the pleading standard set forth by the Supreme Court in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), because the allegations did not plausibly suggest illegal conduct. The trial court granted Tempur-Pedic's motion, and plaintiffs appealed. The Eleventh Circuit affirmed the dismissal.

The appellate court first explained that plaintiffs failed to allege a resale price maintenance violation under the rule of reason analysis because they failed to demonstrate harm adequately to competition in a relevant product market. Plaintiffs alleged that visco-elastic foam mattresses, such as those sold by Tempur-Pedic, constituted a distinct product submarket within the larger mattress market, and Tempur-Pedic's 80 percent to 90 percent market share in that alleged submarket made for a valid claim. The Eleventh Circuit, however, held that plaintiffs did not plead sufficient facts "plausibly" to suggest the existence of that alleged product submarket. Plaintiffs alleged that visco-elastic foam mattresses comprised a separate relevant product market, but they provided no specific evidence of traditional factors indicating the existence of such a separate product market, such as cross-elasticity of demand or other indications of price sensitivity that would indicate whether consumers treat visco-elastic foam mattresses differently than mattresses in general. Allegations that visco-elastic foam mattresses are more expensive than traditional mattresses and have "unique attributes" did nothing to indicate the degree to which consumers prefer such mattresses to traditional mattresses because of these differences, or whether consumers would consider a visco-elastic foam mattress as a substitute for a traditional mattress.

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The appellate court went on to hold that even assuming the complaint adequately pled a relevant product market, it failed adequately to allege actual or potential harm to competition. Plaintiffs alleged only that consumers lost hundreds of millions of dollars from Tempur-Pedic's alleged anticompetitive pricing scheme. This allegation, however, did not make "plausible" the existence of actual or potential anticompetitive effects such as reduction of output, increase in price over competitive market levels, or deterioration in quality. Even Tempur-Pedic's 80 percent to 90 percent market share was not enough; the court held that a showing of market power is necessary but not sufficient to establish harm to competition. The court explained that plaintiffs failed to allege how harm to competition resulted from Tempur-Pedic's alleged resale price maintenance agreements with its distributors.

Finally, the court affirmed the dismissal of plaintiffs' horizontal price-fixing claim based on Tempur-Pedic's dual distribution system. The court noted that two possible inferences might be drawn from the fact that Tempur-Pedic and its distributors charged the same price—one inference that there was tacit collusion that would support an unlawful price-fixing scheme, and a second inference that Tempur-Pedic and its distributor set prices independently and for their own business reasons. The court held that the inference of independent conduct was at least equally plausible, noting that distributors would have their own reasons for not raising prices above the minimum resale price set by Tempur-Pedic because, if they did, customers might buy exclusively

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from Tempur-Pedic's website. Tempur-Pedic, for its part, would not want to undercut minimum prices imposed on its distributors because doing so would drive the distributors out of business, resulting in the lost value from having an independent distribution system to reach and support more customers. The Eleventh Circuit held that plaintiffs had not met their pleading burden under *Twombly* because they did not show that the inference of illegal conduct was more plausible than the inference of independent, self-interested conduct.

One judge (interestingly, a district judge sitting by designation) filed a vigorous dissent, arguing that the majority had gone too far in applying *Twombly* by essentially requiring plaintiffs to prove their case in the complaint. The dissent relied on the dictionary definition of *plausible* as meaning "appearing worthy of belief" or "credible." The dissenting judge applied his "judicial experience and common sense" to conclude that under this definition, it was entirely plausible that Tempur-Pedic and its distributors had colluded to set prices. Nonetheless, at least in the Eleventh Circuit, it will be very difficult to allege a horizontal price-fixing conspiracy in a dual distribution system without more evidence suggesting collusion than just the fact that all sellers are abiding by the minimum retail price.

ARBITRATION

***MKJA Inc. v. 123 FIT Franchising, LLC,* 119 Cal. Rptr. 3d 634, Bus. Franchise Guide (CCH) ¶ 14,526 (Ct. App. 2011)**

The California Court of Appeal refused to allow a state trial court to lift a stay of franchisees' lawsuit against its franchisor based on their allegations that they could not afford to pursue their claims in a pending arbitration proceeding under the franchise agreement. Three sets of 123 Fit franchisees brought suit in California state court alleging that the franchisor fraudulently induced them to enter into their health club franchise agreements and that the franchisor breached those agreements by failing to provide operational support. The franchisees also brought claims for violation of the California Franchise Investment Law and the California Unfair Business Practices statute. The franchisor moved to stay the California action and filed a petition in a Colorado court to compel arbitration of plaintiffs' claims as required under the franchise agreement. The California court granted the motion to stay pending arbitration.

More than a year later, the franchisees filed a motion to lift the stay of the California action and for a declaration that the arbitration provisions in their agreements were unconscionable. The franchisees claimed that the cost of arbitration was prohibitive and prevented them from pursuing their claims. The court denied that motion, but a year later the franchisees filed a similar motion to lift the stay and to declare the arbitration provisions unconscionable. This time, the California trial court lifted the stay and declared the arbitration provisions unconscionable and unenforceable based on its finding that the cost of separate arbitrations was prohibitive to the franchisees, all of which allegedly were in severe financial distress. 123 Fit appealed.

The first question was whether the appellate court had jurisdiction over the appeal from the order to lift the stay. Interpreting California Code of Civil Procedure § 1294, the appellate court held that the appeal from the order lifting the stay was the functional equivalent of an appeal from an order dismissing or denying a petition to compel arbitration because the trial court's order effectively prevented the franchisor from enforcing the arbitration provisions in its agreements. The court explained that if the order were not appealable, the franchisor would be forced to proceed with the litigation to a final judgment and its right to arbitrate thus would be frustrated.

As to the merits, the appellate court had to interpret the general language of § 1281.4 regarding when a trial court can lift a stay of litigation pending arbitration. Determining that the purpose of the statutory stay is to protect the jurisdiction of the arbitrator by preserving the status quo until the arbitration is resolved, the appellate court held that a trial court does not have unfettered discretion to lift a stay but can only do so under circumstances in which lifting the stay would not frustrate the arbitrator's jurisdiction. The appellate court held that § 1281.4 does not permit a trial court to lift a stay on the ground that a party cannot afford to pay the costs associated with the arbitration because doing so would "materially impede the arbitrator's jurisdiction." The court also held that allowing a stay to be lifted for that reason would be fundamentally inconsistent with California's strong public policy favoring contractual arbitration.

The appellate court further held that the trial court lacked jurisdiction to declare the arbitration provisions unconscionable, unenforceable, or both. After a petition to compel arbitration has been granted and a lawsuit stayed, the trial court has only "vestigial jurisdiction" over the action that clearly does not extend to permit the court to declare an arbitration provision unenforceable, especially in a case such as this one where the arbitration provision had already been enforced by a court in another state.

BANKRUPTCY

***In re Shubh Hotels Pittsburgh, LLC,* Case No. 10-26337 JAD, 2010 Bankr. LEXIS 4017, Bus. Franchise Guide (CCH) ¶ 14,517 (W.D. Pa. Bankr. Nov. 23, 2010)**

Shubh Hotels Pittsburgh, LLC, a former franchisee of Hilton Hotels, filed a bankruptcy petition after Hilton terminated its franchise agreement and began operating as an independent hotel unassociated with any "prominent flag." After Shubh moved the bankruptcy court for permission to enter into a franchise agreement with Wyndham Hotels and Resorts, LLC, a secured creditor objected to the transaction on the basis that (1) the proposed franchise relationship with Wyndham was conceived in bad faith and constituted a delay tactic designed to prevent the lender's foreclosure efforts, and (2) the lender had veto power over the reflagging of the hotel. In support of its bad faith argument, the lender cited the past questionable conduct of certain Shubh principals in connection with various business matters.

Although the court cautioned the parties against committing further "shenanigans," it refused to hold that the proposed Wyndham transaction amounted to a bad faith litigation tactic. Rather, citing the benefits resulting from such transaction, including increased revenues, bookings, name recognition, and renewed marketing campaigns under the Wyndham flag, the court determined that Shubh exercised proper business judgment with respect to the proposed transaction. After noting that reflagging the hotel with another national brand was "key" to its long-term viability, the court further concluded that the proposed relationship between Shubh and Wyndham was made with due care, in good faith, and with the goal of furthering the interests of the bankruptcy estate. The court also rejected the lender's claim that the Wyndham transaction would violate the lender's loan documents, citing evidence that the proposed transaction would not harm the lender's collateralized position. Finally, the court rejected the lender's argument that the Wyndham franchise agreement would amount to a de facto plan of reorganization. In support of its position on this issue, the court noted that the Wyndham franchise agreement did not articulate a plan of reorganization. Similarly, the proposed transaction's impact on Shubh's reorganization was not any different than the other myriad transactions that can occur during the pendency of a bankruptcy, each of which can impact a debtor's reorganization in some fashion.

CHOICE OF FORUM

***Marpor Corp. v. DFO, LLC,* Case No. 10-1312, 2010 U.S. Dist. LEXIS 127616, Bus. Franchise Guide (CCH) ¶ 14,512 (D.P.R. Dec. 2, 2010)**

Marpor Corp., a developer and operator of multiple Denny's restaurants in Puerto Rico, sued DFO, LLC and Denny's, Inc. (collectively, DFO) in the Court of First Instance of Puerto Rico following DFO's alleged wrongful termination of Marpor's exclusive development rights. In the lawsuit, Marpor specifically alleged violations of Puerto Rico's Dealer Contracts Act of June 24, 1964 (Law 75) and requested an injunction to prevent DFO from depriving Marpor of its exclusivity in operating and developing Denny's restaurants in Puerto Rico. DFO removed the action to the federal court in Puerto Rico and subsequently moved to dismiss (or, in the alternative, transfer) the lawsuit because of the parties' contractual forum selection clause favoring South Carolina. The court ultimately granted DFO's motion to dismiss the action. Citing the mandatory nature of the parties' forum selection clause, which ordered all litigation to "be brought and maintained" in the state and federal courts of South Carolina, the court held that the forum selection clause would be enforced "absent exceptional circumstances that would make it unjust or unreasonable to do so." The court concluded that no such exceptional circumstances existed given that (1) Marpor chose to accept the contract terms without contesting the forum selection clause, (2) it was reasonably foreseeable at the time of contracting that disputes would be litigated in South Carolina, and (3) it would not be unduly burdensome for Marpor to present witness testimony in South Carolina. Finally, despite the "important public policy rubric" inherent in Law 75, the court noted that its decision to enforce the parties' contractual forum selection clause was consistent with federal standards on forum selection clauses generally.

CHOICE OF LAW

***1-800-GotJunk? LLC v. Superior Court*, 116 Cal. Rptr. 3d 923, Bus. Franchise Guide (CCH) ¶ 14,485 (Ct. App. 2010), *as modified* 2010 Cal. App. LEXIS 1972 (Nov. 19, 2010)**

This case presents the unusual situation of a franchisee arguing to enforce the choice of law provision in the franchise agreement against a franchisor that is trying to avoid the terms of its own contract. Even more unusual is that a California appellate court agreed to apply the franchise law of another state in a California lawsuit involving a California-based franchisee.

1-800-GotJunk? is a Delaware franchisor of junk-hauling businesses with its headquarters in Vancouver, British Columbia. The franchisee in this case operated in various geographic territories in the Los Angeles area. The franchise agreement contained a choice of law provision stating that the agreement shall be construed and interpreted according to the laws of the State of Washington. The UFOC provided to this franchisee contained a California-specific addendum stating that the franchise agreement required application of Washington law but that this provision "may not be enforceable under California law."

1-800-GotJunk? terminated the franchisee for failure to report revenue derived from certain jobs and failure to pay monies due the franchisor under the agreement. The franchisor terminated without giving the franchisee an opportunity to cure this default. The franchisee filed suit in Los Angeles County Superior Court claiming that the franchisor breached the franchise agreement by terminating it without cause and also violated the Washington Franchise Investment Protection Act.

The franchisee moved for summary judgment on its claim under the Washington statute on the grounds that the statute allows a franchisor to terminate without providing notice and an opportunity to cure only in four situations, none of which existed in this case. The trial court, employing an unusual procedural device, conducted a bifurcated trial on the choice of law issue to determine whether the Washington statute or the California Franchise Relations Act (CFRA) should apply.

The franchisee's attorney, a certified franchise law specialist, filed a declaration explaining that most franchise agreements include a choice of law provision, and this is typically done so that the franchisor's lawyer can become proficient in one state's law and avoid having to learn the law of numerous other states where their franchisees might operate. Choosing one state's law to apply in all franchise agreements also promotes consistency in franchise systems and helps to ensure that franchisees operate under consistent rules. The trial court also noted that the State of Washington was the closest U.S. jurisdiction to the franchisor's headquarters in Vancouver, Canada. The franchisor, on the other hand, submitted an affidavit from its chief executive disclaiming any knowledge of why the franchise agreement contained a choice of law provision.

The trial court found the franchisee's evidence to be reasonable and persuasive regarding the rationale for choice of law provisions generally and for the application of Washington law in this case. The franchisor then filed a petition for writ of mandate seeking to overturn the trial court's ruling.

The California Court of Appeal affirmed the trial court's decision, but it added an analysis of the CFRA and its impact on the decision. The court noted that under the Restatement (Second) of Conflict of Laws § 187, courts should enforce a contractual choice of law provision unless either (1) the chosen state has no substantial relationship to the parties or the transactions, and there is no other reasonable basis for the parties' choice; or (2) the application of the law of the chosen state would be contrary to a fundamental public policy of a state that has a materially greater interest in the determination of the particular issue. Here, the court noted that the chosen state, i.e., Washington, had no substantial relationship to the parties or the transaction. Nevertheless, it determined that the franchisee showed that a reasonable basis existed for the parties' choice. The appellate court went on to analyze whether application of Washington law would be contrary to a fundamental California policy. The court concluded that would not be the case because the Washington statute provided greater protection to the franchisee in this situation than did the CFRA. The court reasoned that giving the franchisee superior protection from summary termination pursuant to Washington law would not be a waiver of compliance with the CFRA and therefore would not offend California public policy. The moral of this case is "be careful what you ask for—you might get it."

***Sherman v. PremierGarage Sys., LLC*, Case No. CV10-0269-THX-MHM, 2010 U.S. Dist. LEXIS 77392, Bus. Franchise Guide (CCH) ¶ 14,461 (D. Ariz. July 30, 2010)**

This case is also discussed under the topic heading "Fraud."

The Florida franchisee plaintiffs asserted claims under the Florida Franchise Misrepresentation Act and the Florida Deceptive and Unfair Trade Practices Act. PremierGarage argued that these Florida statutory claims were precluded by the choice of law provision providing that the dealer agreements shall be interpreted and governed under Arizona law. The franchisees argued that the choice of law provisions should not apply because, under the analysis set forth in the Restatement (Second) of Conflict of Laws § 187, the application of Arizona law would be contrary to the fundamental public policy of Florida to protect franchisees within its boundaries. The court noted, however, that the Florida franchise statute did not contain an antiwaiver provision, and the court recognized the right of parties to agree by contract to apply the law of another state. The court also noted that although the franchisees alleged claims for fraud and negligent misrepresentation, they presented no evidence that the choice of law provision itself was procured by fraud. The court likewise refused to apply the Florida Little FTC statute in light of the Arizona choice of law provision. The court determined that the majority of the alleged misrepresentations took place in Arizona or Nevada and that the agreements were signed in Arizona. Moreover, the franchisees could bring suit for the same alleged misconduct under Arizona's Little FTC statute, so applying Arizona law would not be contrary to a fundamental public policy of Florida. The court therefore dismissed the franchisees' claims based on these Florida statutes.

Finally, the court dismissed entirely the claims of the Canadian franchisee plaintiffs based on the Ontario choice of law and choice of forum clause. The district court relied on the contractual language whereby the parties agreed "irrevocably to attorn to the jurisdiction of the courts of [Ontario]," as well as the unambiguous statement in the franchise disclosure document that "[a]ll lawsuits must be brought in the Province of Ontario."

CLASS ACTIONS

***Pelman v. McDonald's Corp.*, 452 F. Supp. 2d 320, Bus. Franchise Guide (CCH) ¶ 14,493 (S.D.N.Y. 2010)**

This is the latest decision in the putative class action filed against McDonald's alleging that a deceptive marketing scheme misled consumers into falsely believing that McDonald's food products could be consumed on a daily basis without incurring any adverse health effects. The case was originally filed in 2002, and in a series of several decisions of both the trial and appellate courts, plaintiffs' claims were narrowed to alleged unfair and deceptive acts and practices in violation of New York's General Business Law § 349. In their second amended complaint, plaintiffs alleged that McDonald's attempted to mislead them and the putative class from 1985 until 2002 by making misleading nutritional claims in advertising campaigns, promotions, brochures, and press releases that its foods were healthy, nutritious and/or were easily part of anyone's healthy daily diet. Plaintiffs claimed that they and the putative class members suffered injury in the form of (1) the financial costs of McDonald's products; (2) false beliefs as to the nutritional content and effects of McDonald's food products; and (3) obesity, elevated cholesterol levels, increased risk of coronary disease, and other adverse health effects caused by the prolonged use of McDonald's products. Plaintiffs moved for certification of a class consisting of New York residents, infants, and consumers who were exposed to McDonald's deceptive business practices and as a result purchased and consumed McDonald's products directly causing the alleged harm described above. Plaintiffs stated that the exact number of putative class members was not known, but they estimated the class size to number in the thousands.

Federal Rule of Civil Procedure 23(a) requires that for a class to be certified, the class representative must establish the four familiar elements of numerosity, commonality, typicality, and adequacy of representation. Plaintiffs sought certification under Rule 23(b)(3), which also requires the court to find that "questions of law or facts common to class members predominate over any questions affecting only individual members, and that a class action is superior over other methods for fairly and efficiently diffusing the controversy." McDonald's argued that plaintiffs failed to meet the predominance test because the issues subject to generalized proof applicable to the class as a whole did not predominate over those issues that are subject only to individualized proof.

The court noted that although a claim under New York General Business Law § 349 does not require proof of justifiable reliance on the alleged misrepresentations, a plaintiff must show that the defendant's deceptive act or practice caused the harm allegedly suffered. In this case, the court rejected plaintiffs' argument that a pecuniary loss for the purchase of McDonald's products and allegations of "false beliefs and understandings" stated claims for actual injury under the relevant statute. The only alleged injuries for which plaintiffs and the putative class might recover damages were those related to the development of certain adverse health effects and medical conditions. As to that alleged injury, however, the court determined that proof of a causal connection depended heavily on a range of factors unique to each individual, and class treatment therefore was not appropriate. The court credited McDonald's expert witness testimony that the causation question represented an inquiry specific to each class member that would depend on unique characteristics, such as family and medical background, preexisting medical conditions, age, lifestyle, quantity of product ingested, etc. Even plaintiffs' own expert acknowledged the lack of certainty as to a generalized causal connection between the consumption of McDonald's products and the alleged injuries or conditions that plaintiffs identified. The court also relied on the fact that the nutritional composition of food products consumed by each plaintiff from sources other than McDonald's, as well as the level of regular physical activity engaged in by each plaintiff, established that individualized proof would predominate as to the causation element. The district court therefore denied Rule 23(b)(3) certification.

Plaintiffs next argued that the court should certify an "issue class" under Rule 23(c)(4) for a determination solely of McDonald's liability for its deceptive conduct. Issue certification may be appropriate where a defendant's liability can be determined once, on a classwide basis, from common evidence. The requirements of Rule 23(a) and (b) must be satisfied only with respect to the common issues certified. The court noted that the issue of the material deceptiveness of McDonald's acts and omissions might be subject to common proof on a class basis, but it nonetheless denied certification because plaintiffs failed to meet the numerosity requirement of Rule 23(a). Plaintiffs did not present any specific evidence as to the actual number or range of persons meeting their proposed class definition who were exposed to McDonald's nutritional marketing scheme in New York during the years 1985 through 2002, who regularly ate at McDonald's at that time, and who subsequently developed the same medical conditions as plaintiffs. The court noted that this was not a situation where the defendant was in a unique position to have access to the identity and number of putative class members. The court therefore denied plaintiffs' motion for certification on all grounds.

CONTRACT ISSUES

***McKinnis v. Fitness Together Franchise Corp.*, Case No. 10-cv-02308-RPM, 2010 U.S. Dist LEXIS 133976, Bus. Franchise Guide (CCH) ¶ 14,510 (D. Colo. Dec. 6, 2010)**

This case involved the interpretation of a contractual right of first refusal provision in a master franchise agreement. Plaintiff franchisee entered into master franchise agreements for the District of Columbia and the State of Maryland. The agreements each contained a provision stating: "A right of first refusal for the sale of any Fitness Together Master Franchise State(s) that borders Washington, D.C. or Maryland is granted to Paul McKinnis. If any of these States as defined above are offered for sale, Paul McKinnis will have thirty days in which to have the sale finalized." Fitness Together had previously granted a master franchise for the State of Virginia to another franchisee, and in 2010 the franchisor purchased the Virginia territory back from that master franchisee. McKinnis claimed that his right of first refusal applied to this transfer; and when the franchisor refused his demand to purchase the Virginia territory, McKinnis sued for breach of contract.

The franchisor moved to dismiss or alternatively for summary judgment on the ground that the right of first refusal provision was unambiguous and did not apply in this situation. The court agreed and granted the franchisor's motion. The court based its decision on the nature of a right of first refusal provision in the abstract, and the court's opinion contains surprisingly little analysis of the actual language of the provision in this case. Citing several Colorado cases, the court explained that a right of first refusal provides the grantee with a contingent option to purchase an asset owned by the grantor if the grantor elects to sell. Based on that general principle of law, the court dismissed the franchisee's claim.

The actual language of this particular right of first refusal provision, however, arguably was not so clear. The provision was written in the passive voice, stating that a right of first refusal "is granted to" the franchisee and that if any of the neighboring territories "are offered for sale," the franchisee will have the right to purchase them. The use of the passive voice here arguably created an ambiguity as to whether another party's sale of a territory might trigger this franchisee's right of first refusal. In all events, a franchisor would be wise to avoid the passive voice in its agreements and to clearly articulate the scope of the right it intends to grant.

***Nat'l Franchise Ass'n v. Burger King Corp.*, Case No. 09-23435-CIV-Moore/Simonton, 2010 U.S. Dist. LEXIS 105953, Bus. Franchise Guide (CCH) ¶ 14,501 (S.D. Fla. Nov. 19, 2010)**

This important case explores the limits of the duty of good faith and fair dealing regarding a franchisor's exercise of discretion to set prices granted under its franchise agreements. The Burger King National Franchisee Association (NFA) sued for breach of contract based on Burger King's decision to set a $1 maximum price for certain products it designated for inclusion on its $1 value meal menu. Burger King's franchise agreements unambiguously gave it the right to require franchisees, without their consent, to offer designated items as part of its $1 value meal menu and therefore to set unilaterally maximum prices for those items. The franchise agreements also provided that Burger King could impose such standards and specifications that Burger King "in the good faith exercise of its judgment believes to be desirable and reasonably necessary." The NFA claimed that Burger King breached its express duty of good faith under the franchise agreements by requiring its franchisees to sell its Double Cheeseburger and then later its Buck Double burger for $1, a price that allegedly was below the franchisees' costs of these items. Burger King moved to dismiss the complaint, claiming that the NFA failed to allege sufficient facts to raise a claim that Burger King acted in bad faith in exercising its discretion to set the disputed prices.

Although this case involved an express contractual provision requiring the franchisor to exercise good faith in setting prices, the court relied on cases and analytical principles involving the implied covenant of good faith and fair dealing. The court held that the contractual good faith requirement meant that Burger King must exercise its judgment "with the honest belief that the measure it is adopting will help the company meet competition and succeed in the marketplace." The court explained that a plaintiff could raise a claim of bad faith in two ways. First, a plaintiff could allege facts identifying a franchisor's improper ulterior motive in taking the challenged action, such as a secret agenda by the franchisor to take over the franchise and its deliberate setting of prices to weaken the targeted franchisee. Alternatively, the plaintiff could allege facts indicating that the franchisor's stated purpose for its actions is merely a pretext for an actual impermissible purpose. In that situation, the court explained that a plaintiff generally must allege facts tending to show that no reasonable person could have thought that the steps taken by the franchisor were a reasonable means of carrying out the contract's purposes. In either case, the court explained that the magnitude of the injury claimed by the plaintiff is of central importance because no inference of bad faith arises simply because an exercise of discretion has some marginal economic impact on the plaintiff. An inference of bad faith arises when a franchisor exercises discretion in such a manner as to destroy effectively the benefits the plaintiff reasonably could have expected under the contract.

Applying these principles, the court held that the NFA's factual allegations were not sufficient to raise a plausible inference of bad faith. The NFA relied on four facts as the basis for its bad faith claim: (1) that Burger King's established price caused the franchisees to sell the products at a loss, (2) that Burger King adopted the prices despite the franchisees' disapproval, (3) that Burger King sent information to its franchisees to justify its decision that was allegedly inaccurate and deceptive, and (4) that Burger King imposed these prices even though its data showed that those prices would cause the franchisees to suffer losses. The court noted that even if the franchisees' allegations of below-cost pricing were true, there is nothing "inherently suspect" about such a pricing strategy for a business selling multiple products. There are many legitimate reasons why a business selling multiple products might choose to set the price of a single product below cost, such as building customer goodwill and loyalty, attempting to pull customers away from competitors, or serving as a loss leader to generate increased sales on other higher margin products. The decision to sell these particular items at a price allegedly below the franchisees' costs therefore did not raise an inference of bad faith.

Finally, the court held that the NFA's claim failed also because it did not allege the kind of serious injury necessary to support an inference of bad faith. The complaint alleged only that the franchisees had suffered losses on these two particular products, but it did not claim that the franchisees' overall businesses had been impaired or were no longer profitable. The court held that the NFA must allege that the damage to the franchisees' overall businesses was so severe as to deprive them of their reasonable expectations under the contract. The court thus refused to analyze the claim in the context of the particular products at issue and required the franchisees to show a substantial impact on their overall business.

Significantly, this case was decided on a motion to dismiss at the pleading stage. The court's willingness to evaluate critically and parse in such detail the NFA's allegations reflect the growing influence and importance of the Supreme Court's heightened pleading standards for complaints in *Twombly* and *Iqbal*.

DEFINITION OF FRANCHISE

***Gunn v. Farmers Ins. Exch.*, Case No. 09-454, 2010 Ark. LEXIS 247, Bus. Franchise Guide (CCH) ¶ 14,491 (Ark. May 6, 2010)**

Julia Gunn, a former Farmers insurance agent, sued Farmers Insurance Exchange and related entities in October 2007 for various claims arising out of Farmers' decision in 2004 to terminate her agent agreement. At issue was whether the termination provision in the parties' contract required good cause for termination or whether it permitted Farmers to terminate upon three months' notice. In analyzing the termination provision, the court concluded that the parties' contract contemplated three types of termination scenarios: termination without cause on thirty days' notice, termination for cause on thirty days' notice, and immediate termination for certain types of conduct. Thus, Farmers' decision to terminate its contract with Gunn on thirty days' notice was within its contractual rights.

Gunn next argued that to induce her to sign the contract, Farmers violated Arkansas common law by falsely representing that it would not terminate the contract unless it had good cause to do so. The court ultimately held that Gunn's fraud claims were time-barred because the three-year statute of limitations began to run on the date she received Farmers' written notice of termination, i.e., September 22, 2004, and not on the effective date of termination. Because Gunn filed suit after the three-year statute of limitations period, the court dismissed the fraud claims against Farmers.

The court also rejected Gunn's contention that she was a franchisee under the Arkansas Franchise Practices Act (AFPA). To qualify as a franchisee under Arkansas law, the alleged franchisee must have the unqualified right to sell or distribute the franchisor's products and services. The court cited numerous analogous cases where insurance agents were not deemed to be franchisees because each lacked the fundamental authority to engage clients and enter into agreements with them directly absent the insurer's approval. Indeed, although Gunn had limited authority to execute temporary insurance contracts with clients, the continuation of such policies was subject to Farmers' veto power. With respect to traditional insurance policies, Gunn had no power to bind Farmers, sell policies, or dictate or adjust prices. Concluding that the "unqualified authority to sell or distribute goods or services is an essential component of a franchise agreement" under Arkansas law, the court held that Gunn was not a franchisee under the AFPA, and, therefore, its protections were inapplicable to her business relationship with Farmers.

ENCROACHMENT

***In re Black Angus Holdings, LLC*, Bankr. Case No. 09-21349-11, 2010 U.S. Dist. LEXIS 91447, Bus. Franchise Guide (CCH) ¶ 14,464 (D. Kan. Sept. 2, 2010)**

This case involved the interpretation of protected territory language in a debtor franchisee's franchise agreement. The territory provision stated that the franchisor agreed not to sell or establish any other franchised or company-owned restaurant within "a one-mile exclusive radius" of the franchisee's restaurant site, except in limited situations that did not apply in this case. The agreement was later modified to extend the radius to two miles. The franchisor granted a franchise for a restaurant located 2.17 miles from the debtor franchisee's restaurant, and the new restaurant allegedly had a protected territory that extended in a one-mile radius around that location. Thus, the protected territories of the two restaurants overlapped, although neither restaurant was located within the protected radius distance of the other. The debtor franchisee alleged that the franchisor breached the territorial provision of its franchise agreement by granting the new franchise at a site that created an overlap of the two protected territories.

The franchisor moved to dismiss, arguing that the agreement was unambiguous and that its only obligation was not to establish a new restaurant within the two-mile protected radius. Because the new restaurant was more than two miles away from the debtor's restaurant, the franchisor argued there was no breach as a matter of law.

The bankruptcy court denied the franchisor's motion, ruling that the inclusion of the word *exclusive* before the word *radius* made the provision ambiguous enough to allow for the franchisee's interpretation that the clause should prohibit overlapping exclusive territories. The bankruptcy court agreed with the debtor franchisee that the phrase *exclusive radius* could reasonably be interpreted to bar the franchisor from establishing another restaurant with a territory radius overlapping the debtor franchisee's protected territory, thereby competing with the debtor franchisee in its specified territory.

The district court, however, reversed the bankruptcy court's decision and ordered that the encroachment claim be dismissed. The court agreed with the franchisor that the plain and unambiguous language of the territory provision only prohibited the franchisor from establishing a restaurant physically located within a two mile radius of the debtor's restaurant. The court disagreed that the word *exclusive* made the territory provision ambiguous; it concluded that the ordinary meaning of the word *exclusive* merely described the effect of the territorial provision that other restaurants were physically excluded from the defined territory. According to the district court, the language did not permit any interpretation that would give the debtor franchisee a right to exclusivity from any competition throughout the territory from another restaurant physically located outside that territory.

The conflicting decisions on this seemingly straightforward issue points out the importance of clear and careful drafting of franchise agreement provisions, especially protected territory provisions. From the franchisor's perspective, the word *exclusive* probably was not necessary here, and the use of that additional word almost cost the franchisor by leading to an interpretation that it never intended.

***Cottage Inn Carry & Delivery, Inc. v. True Freedom Invs. LLC,* Case No. 10-12833, 2010 U.S. Dist. LEXIS 113170, Bus. Franchise Guide (CCH) ¶ 14,482 (E.D. Mich. Oct. 20, 2010)**

In this encroachment case, the court rejected a franchisee's attempt to stretch the protected territory language to include a duty on the franchisor to prevent other franchisees from making sales in the plaintiff franchisee's protected trading area. Cottage Inn operated a franchise system of pizza delivery restaurants. It sued its franchisee, True Freedom, for breach of the franchise agreement for failure to meet financial obligations and for violation of a noncompetition clause. True Freedom counterclaimed that Cottage Inn breached the exclusive territory provision in its franchise agreement by allowing another Cottage Inn restaurant to deliver food within True Freedom's geographically protected area. Cottage Inn moved to dismiss the franchisee's counterclaim.

The relevant franchise agreement language stated that Cottage Inn "will not establish, or grant a franchise to another person to establish, another Cottage Inn store the physical premises of which are located within the area described in Exhibit B as the 'Protected Trading Area.'" The franchisee argued that this language implicitly included an affirmative duty to ensure that no other Cottage Inn restaurant infringed on the franchisee's protected trading area. The court rejected this interpretation of the contract because the plain language did not impose such a duty on the franchisor. True Freedom argued that the agreement was ambiguous, and therefore extrinsic evidence of alleged oral promises by Cottage Inn that it would police True Freedom's territory should be admissible. The court rejected this argument because it concluded that the agreement language was not ambiguous, and parol evidence could not be used to create an ambiguity where the plain language of the contract only permitted one interpretation. Applying Michigan law, the court held that when the parties include an integration clause in their written contract, it is conclusive and parol evidence is not admissible to show promises outside the agreement, except in cases of fraud or where the agreement is "obviously incomplete on its face" and parole evidence is necessary for the "filling of gaps." In this case, there was no evidence of fraud, and the court did not believe the franchise agreement provision was incomplete.

The court also rejected the franchisee's argument that the implied covenant of good faith and fair dealing should expand the scope of the protected territory restriction. The court dismissed this claim because Michigan law does not recognize a cause of action for breach of the implied covenant of good faith and fair dealing independent of a breach of an express contract provision. Although the court expressed sympathy for the franchisee's situation, it held that the franchisor could not be liable for the actions of another franchisee where the agreement did not impose the obligation that was the basis for plaintiff's claim.

FRAUD

***Rohm & Haas Elec. Materials, LLC v. Elec. Circuits Supplies, Inc.*, No. 10-10563-JLT, 2010 U.S. Dist. LEXIS 136080, Bus. Franchise Guide (CCH) ¶ 14,521 (D. Mass. Dec. 22, 2010)**

A manufacturer was not entitled to enforce a noncompetition clause in an amended and restated distributor agreement, a federal court in Massachusetts held, because the distributor had removed the clause from the agreement. After becoming dissatisfied with a distributor's performance, manufacturer Rohm and Haas sought to amend its agreement with the distributor by taking away a number of its customer accounts. Rohm and Haas sent the amended agreement to the distributor to sign and return. Before doing so, the distributor "inserted language in the document that removed the noncompetition provision." When Rohm and Haas received the signed document, it countersigned without noticing this change by the distributor. When Rohm and Haas later attempted to enforce the noncompete, it learned that the provision was no longer there.

Rohm and Haas sought a preliminary injunction to prevent the distributor from selling the same or competitive products to Rohm and Haas customers for one year. Rohm and Haas claimed that the distributor committed fraud and deceit and breach of contract by deleting one material provision while the parties were amending another material provision of their distributorship agreement. The court rejected each of these arguments, finding that Rohm and Haas was not likely to succeed on the merits, and denied the motion for an injunction.

Rohm and Haas argued that the distributor committed fraud and deceit by failing to notify it of the change made. By simply returning a signed amendment, Rohm and Haas asserted, the distributor was indicating that it had made no changes. The court rejected this argument, finding that Rohm and Haas had failed to show that the distributor had violated any duty to disclose or had made a false representation. Rohm and Haas should have expected further revisions after sending the distributor an amendment initiating a substantial reduction in its business, the court found. The distributor did not conceal or hide its changes. More importantly, the court stated, Rohm and Haas failed to show that the distributor was under a duty to disclose at all under Massachusetts law. Rohm and Haas is a large, sophisticated business with legal counsel, and nothing prevented it from acquiring information as to the change in the agreement, the court found. For the same reasons, the court rejected the breach of contract claim, which was tied to the claim for fraud and deceit.

***Sherman v. PremierGarage Sys., LLC*, Case No. CV10-0269-THX-MHM, 2010 U.S. Dist. LEXIS 77392, Bus. Franchise Guide (CCH) ¶ 14,461 (D. Ariz. July 30, 2010)**

This case is also discussed under the topic heading "Choice of Law."

An Arizona federal court applied the economic loss doctrine to bar claims by franchisees for fraud and negligent misrepresentation against their franchisor. Two groups of franchisees sued PremierGarage, a franchisor of products for residential garages such as floor coatings, cabinets, and organizers. The franchisees alleged that PremierGarage representatives made representations regarding the testing, installation, and performance of its garage products, as well as representations about the profitability of the franchises. The franchisees further alleged that the products did not perform as represented, and that due to those problems the franchisees did not achieve the profit projections and suffered severe operating losses. The franchisees brought claims for fraud and negligent misrepresentation, and they sought recession and restitution or, alternatively, compensatory damages.

PremierGarage argued that the franchisees' misrepresentation claims were barred by the economic loss doctrine because the claims were based on alleged misrepresentations regarding issues that were specifically addressed in the dealer agreements. The district court noted initially that the scope of the economic loss doctrine under Arizona law was "by no means settled." The leading Arizona case applied to economic loss doctrine in the context of a construction contract and defined the doctrine as "a common-law rule limiting a contracting party to contractual remedies for the recovery of economic losses unaccompanied by physical injury to person or other property." *See Flagstaff Affordable Housing Ltd. Partnership v. Design Alliance Inc.*, 223 P.3d 664, 667 (Ariz. 2010). The district court interpreted the *Flagstaff* decision to mean that the economic loss rule should apply where contracts negotiated between the parties have detailed provisions allocating risks of loss and specifying remedies for those identified losses. In this case, the franchisees signed dealer agreements that expressly allocated the risk of loss relating to the alleged misrepresentations about product performance and profitability, and the franchisees were seeking to recover economic losses in the form of costs of repair and lost profits. The court therefore held that the economic loss rule applied in this situation to uphold the expectations of the parties by limiting the franchisees to contractual remedies for the loss of the benefit of the bargain.

INJUNCTIVE RELIEF

***TES Franchising, LLC v. Dombach*, No. 10-0017, 2010 U.S. Dist LEXIS 107951, Bus. Franchise Guide (CCH) ¶ 14,480 (E.D. Pa. Oct. 7, 2010)**

A federal court in Pennsylvania refused to bench a business coach by enjoining him from competing with the business coaching franchise system that he quit to start his own new venture. A class action filed on behalf of 370 business coaching franchisees and four franchisors (all four owned by the same individual and collectively called FSBI) against executive strategist Eric Dombach sought a preliminary injunction based on claims of breach of a nondisclosure agreement, breach of a duty of loyalty, defamation, and breach of an alleged oral noncompete agreement. Other claims, including claims for misappropriation of trade secrets and unfair competition, were not a basis for injunctive relief.

Dombach had founded a telemarketing company, Coach Success Center (CSC), before joining FSBI. He executed a nondisclosure agreement with FSBI before his employment began in April 2008. FSBI agreed that he could continue servicing clients then in his private practice but could not acquire new clients. In May 2009, FSBI granted Dombach's request to become an independent contractor for FSBI on the condition that he continue to abide by the confidentiality provisions of the nondisclosure agreement and the employee handbook he received upon joining FSBI, as if he were an FSBI franchisee.

In November 2009, FSBI issued a warning notice to Dombach after learning that he was using company materials, had established a website, and was marketing his services. In December 2009, Dombach resigned from FSBI and sent a blast e-mail to numerous franchisees of FSBI announcing his resignation and stating that he had been expanding his private coaching practice during his tenure at FSBI.

Dombach and a partner established a website for My Coaches' Coach, offering services similar to those that FSBI provided to its franchisees. The website contained videos of Dombach talking about his work for FSBI and promoting an e-book entitled the *2010 Business Coaches Franchise Buyers Guide*. Plaintiffs asserted that the book contains confidential FSBI information and makes false statements about the FSBI franchise system.

FSBI filed a ten-count complaint against Dombach and moved for a preliminary injunction based on breach of the nondisclosure agreement, breach of a duty of loyalty, defamation, and breach of an alleged oral noncompete agreement. The court denied the motion for an injunction, concluding that FSBI did not show likelihood of success on the merits.

FSBI failed to show likelihood of success on the merits of its claim for breach of the nondisclosure agreement, the court concluded, because it did not show that the information Dombach used was not publicly available, previously known to him, or generally known within the business coaching industry before Dombach became affiliated with FSBI. On the other hand, the court found that FSBI likely could prove Dombach breached his duty of loyalty. But it found no threat of any immediate harm to FSBI from such a breach.

As for the defamation claim, the court concluded that any defamation or disparagement on Dombach's webpages or in his buyer's guide had been removed. Any past statements proven to be actionable can be remedied by money damages, and any future statements cannot be enjoined because to do so would constitute a prior restraint in violation of the First Amendment, the court concluded.

Regarding the noncompete agreement, the court concluded that FSBI was attempting to enforce "an oral contract, the terms of which are unknown and which appears to expire upon . . . Dombach's departure from FSBI." Thus, FSBI failed to establish that the restrictions in any agreement were "reasonably limited in duration and geographic context," and thus they were not enforceable.

Finally, the court held that the public interest in adherence to contractual obligations is not harmed by denying a preliminary injunction in this case, because FSBI failed to carry its burden of showing the need for a preliminary injunction on any of its claims.

JURISDICTION

The Cleaning Auth., Inc. v. Neubert,* 739 F. Supp. 2d 807, Bus. Franchise Guide (CCH) ¶ 14,465 (D. Md. 2010)

A federal court in Maryland refused a franchisor's request to exercise personal jurisdiction over the manager of a terminated home cleaning business franchisee because the manager's conduct likely did not meet the requirements of the Maryland long-arm statute and definitely did not satisfy constitutional due process requirements. The franchisor brought claims against its former franchisees and against the manager of the franchisees' business. The franchisor alleged that the franchisees improperly terminated their franchise agreements and were operating a competing business in violation of the noncompetition covenants in their franchise agreement. The manager defendant moved to dismiss for lack of personal jurisdiction, claiming she had no material contacts with the State of Maryland.

The manager had never visited Maryland, owned property in Maryland, entered into a contract in Maryland, or solicited any business in Maryland. The franchisor based its claims for jurisdiction on its allegations that the manager knew that the franchisees had an agreement with the franchisor, which the manager knew was a Maryland corporation, and that the manager regularly accessed the franchisor's website and regularly corresponded with the franchisor by phone and e-mail prior to the termination. The court held that even if those allegations, which the manager disputed in part, were true, they were not sufficient to establish jurisdiction in Maryland.

The court first analyzed whether long-arm jurisdiction existed based on the manager's alleged use of the franchisor's website. The franchisor argued that the manager had obtained proprietary information by going into its Maryland database in a way that was analogous to physically breaking into the franchisor's office in Maryland and stealing from a file cabinet. The court found the analogy to be inadequate. Both the tortious injury and the tortious act must have physically occurred in Maryland for the long-arm statute to apply. The court also rejected the argument that regular access to a Maryland website from another state constituted a "persistent course of conduct" in Maryland.

Even if long-arm jurisdiction existed, the court held that the alleged facts did not come close to meeting the constitutional due process standard. The court framed the question as whether a person who electronically received information via the Internet from Maryland is subject to personal jurisdiction in Maryland. The court looked to the Fourth Circuit's analysis of personal jurisdiction based on Internet activity and concluded that the manager's Internet usage in this case was more akin simply to posting or accessing posted information than to doing business.

The court also rejected the alternative arguments for jurisdiction advanced by the franchisor based on the so-called effects test created by *Calder v. Jones*, 465 U.S. 783 (1984), which holds that jurisdiction can exist where the "primary and most devastating effects" of a tort are intended and felt. The court concluded that there were not sufficient allegations that the manager committed an intentional tort and intended for that intentional tort to impact the franchisor in Maryland. The court also refused to find jurisdiction based on a conspiracy or agency theory with the franchisees because, under the intracorporate conspiracy doctrine, employees cannot conspire with the corporation that employs them. Finding no basis for jurisdiction under any of the franchisor's theories, the court dismissed all claims.

* Ms. Yatchak's firm, Faegre & Benson LLP, represented The Cleaning Authority in this action.

NONCOMPETE AGREEMENTS

***MarbleLife, Inc. v. Stone Resources, Inc.*, No. 10-2480, 2010 U.S. Dist. LEXIS 136041, Bus. Franchise Guide (CCH) ¶ 14,420 (E.D. Pa. Dec. 23, 2010)**

A federal court in Pennsylvania granted a preliminary injunction against a franchisee that chose not to renew its franchise agreement when its ten-year term expired but continued operating its stone repair and restoration business under the franchisor's mark. The court enjoined the former franchisee from operating in violation of the noncompetition clause of the agreement until a then-pending arbitration proceeding was resolved.

The franchisee initiated the arbitration in Texas less than a week after its franchise agreement expired. Six weeks later, after the franchisee ignored MarbleLife's demand that it cease using the MarbleLife mark and system, the franchisor filed a complaint for breach of contract, trademark infringement, and trademark dilution and moved for injunctive relief.

The franchisee argued that the franchise agreement, including its noncompetition covenant, is not enforceable under applicable Texas law because MarbleLife had fraudulently misrepresented its ownership of a patent for a surface coating designed to be applied to polished marble. The court rejected this argument, observing that there was not a single instance in ten years when the franchisee was unable to purchase or apply the coating in any way it chose. The franchisee also argued that MarbleLife breached the franchise agreement by improperly using the system's advertising fund. The court rejected this argument as well, noting that the franchise agreement required the franchisee to object in writing and provide an opportunity to cure any breach, which it never did. Finally, the court found that the franchisee had effectively conceded the agreement was enforceable by filing an arbitration demand against MarbleLife for breach of contract, which requires an enforceable contract as an element.

The court next considered the reasonableness of the noncompetition covenant, which barred the franchisee from competing for two years in ten specified counties and in any other county where MarbleLife has a franchise or a company office. These restrictions are not unduly burdensome or broad, the court concluded.

MarbleLife is likely to succeed on the merits of its claims, the court held. On the trademark infringement claim, the court found a likelihood of confusion based on the franchisee's continuing use of the MarbleLife mark as well as the franchisor's system, phone numbers, e-mail addresses, and advertising arrangements. The court also found a likelihood of success on MarbleLife's trademark dilution claim. The MarbleLife mark is "famous and distinctive," the court held, because it has been used extensively in MarbleLife's "unique advertising arrangements" for almost twenty years throughout the United States. The franchisee's continuing use of the mark "clearly serves to weaken [its] recognition," the court concluded.

***Sylvan Learning, Inc. v. Gulf Coast Educ., Inc.*, No. 1:10-CV-450-WKW, 2010 U.S. Dist. LEXIS 107160, Bus. Franchise Guide (CCH) ¶ 14,472 (M.D. Ala. Oct. 6, 2010)**

A federal district court in Alabama, applying Maryland law, granted a preliminary injunction against a terminated franchisee that barred it from competing with the franchisor, Sylvan Learning, for two years after termination within a twenty-mile radius of any Sylvan center then in operation.

Joseph Jezewski, who operated the only Sylvan franchise in Dothan, Alabama, for eighteen years, was terminated in

January 2010 for failing to attend at least two mandatory national conferences in any three consecutive years. After the termination, he continued operating as an independent learning center in the same location under the same sign with the same logos; and using the same telephone number, method of operation, materials, and client list as when he had operated a Sylvan Learning Center.

Sylvan sued Jezewski seeking a preliminary and permanent injunction and monetary damages based on claims of unfair competition, trademark infringement, breaches of the noncompete and post-termination clauses of his license agreement, and violations of the Alabama Trade Secrets Act.

The court in August 2010 entered an injunction against Jezewski on the basis of some of these claims and instructed the parties to brief the proper source of law for evaluating the noncompete clause in the franchise agreement, which specified Maryland law. A court in Alabama may apply another state's law regarding noncompete agreements as long as it is not "contrary to the fundamental public policies" of Alabama's law. Alabama courts have found noncompete provisions enforceable if the employer has a protectable interest and the restriction is reasonably related to that interest, is reasonable in time and place, and imposes no undue hardship. Maryland law is analogous, the court held, because it will sustain a noncompete agreement if the restraint "is confined within limits which are no wider as to area and duration than are reasonably necessary for the protection of the business of the employer and do not impose undue hardship on the employee or disregard the interests of the public."

Maryland common law recognizes a protectable interest in preventing an employee from using the contacts established during employment to pirate the employer's customers. The court noted that this protection has been extended to agreements between licensors and licensees of a franchise. A restraint against competition is justified if part of the compensated services of the former employee consisted of creating goodwill of customers and clients who are likely to follow the former employee, the court noted, but it is not justified if the harm caused consists merely in the former employee becoming a more efficient competitor.

Applying Maryland law, the court found a time restriction of two years and twenty miles "justifiable and reasonably necessary" to protect Sylvan's goodwill, business opportunities, and the franchise network. To permit a breakaway franchisee to violate its noncompete "would send a 'clear signal' to other disgruntled franchisees and might unravel the franchise system," the court stated. Enforcement of the noncompete does not hurt the public interest, the court concluded, "in view of other educational options available to children and parents."

The Cleaning Auth., Inc. v. Neubert*, 739 F. Supp. 2d 807, Bus. Franchise Guide (CCH) ¶ 14,465 (D. Md. 2010)

Franchisee defendants moved to dismiss the franchisor's complaint for breach of the noncompetition provision in the franchise agreement on the ground that the provision was overbroad as a matter of law. The district court concluded that there were open fact questions regarding the enforceability of the noncompetition covenant and therefore denied the franchisees' motion.

The covenant prohibited the franchisees from directly or indirectly owning or engaging in "any residential or commercial property cleaning business . . . within your Territory, plus the area formed by extending the boundaries of the Territory 100 miles in all directions," for two years after termination. Noting that under Maryland law the evaluation of noncompetition clauses is a fact-specific inquiry, the court held that it needed more information to determine whether this clause is enforceable. For example, the court wanted to know how far most cleaning professionals regularly traveled for appointments because the limits of such travel would be highly relevant to determine whether 100 miles is an appropriate radius restriction. The court also noted that the population density in the covered area is an important factor because a clause covering a wide radius would be more reasonable in a rural area than in an urban one. This case is a good example of the difference between state laws that mandate a fact-specific analysis versus state laws that analyze noncompetition restrictions from a more formalistic legal perspective, such as Georgia.

* Ms. Yatchak's firm, Faegre & Benson LLP, represented The Cleaning Authority in this action.

STATUTORY CLAIMS

***Awuah v. Coverall N. Am., Inc.*, 740 F. Supp. 2d 240, Bus. Franchise Guide (CCH) ¶ 14,473 (D. Mass. 2010)**

In a case that started when a terminated franchisee filed a claim with the state for unemployment compensation, the Massachusetts federal district court considered two key issues on summary judgment following the lower court's ruling that the franchisees indeed were employees of the franchisor, Coverall North America, Inc. These two key issues included an assessment as to whether (1) the Coverall franchise system was contrary to Massachusetts public policy, and (2) the franchisor violated the Massachusetts Wage Act with respect to payments made by the franchisees to Coverall under the franchise agreement.

As to the first issue, the franchisees argued that the Coverall system violated Massachusetts public policy because, as alleged employees of Coverall, they were required to pay Coverall for the opportunity to work. Such payments, the franchisees argued, were set forth in the Coverall franchise agreement and included franchise fees, royalty and management fees, insurance, supplies and equipment, and chargebacks (i.e., the fee charged by Coverall to its franchisees if a customer failed to pay for cleaning services). Citing the total absence of support for this argument in Massachusetts legislative history as well as the existence of Massachusetts laws that "condone a franchise distribution system," the court denied the franchisees' request for summary judgment on this issue.

Next, the court considered whether the franchisees' payment of fees to Coverall under the franchise agreement constituted recoverable damages under the Wage Act, which prevents an employer from shifting certain costs to an employee. Operating under the lower court's finding that the franchisees were covered employees under the Wage Act, the court held that Coverall did not violate the Act with respect to the franchisees' payments for franchise fees, royalty and management fees, supplies, and equipment because the parties were permitted to contract for the payment of such fees. The court concluded, however, that the franchisees' payments for insurance and chargebacks violated the Act, because (1) the Act itself prohibits an employer from shifting the cost burden for workers' compensation insurance to an employee; and (2) pursuant to the Act, the franchisees were entitled to be paid for cleaning jobs as they completed them, not only if the customer actually paid Coverall for the work.

***Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the USA, Inc.*, 700 F. Supp. 2d 1055, Bus. Franchise Guide (CCH) ¶ 14,466 (E.D. Wis. 2010)**

The Wisconsin Fair Dealership Law does not apply to prevent the national Girl Scouts organization (GSUSA) from implementing a realignment plan that would reduce the territory of the Manitou, Wisconsin, Girl Scouts council by more than half, a federal district court in Wisconsin ruled, granting summary judgment for the national organization and denying summary judgment for the local council. Applying the statute in this case would be "a direct affront to the Girl Scouts' reasoned efforts to organize and direct itself in a means that it judges most effective in proclaiming its expressive message," the court concluded.

Each Girl Scout council is an independent, nonprofit corporation with its own board of directors, property, and staff. The Girl Scouts' Blue Book, which sets procedures for changing a council's jurisdiction, states that "all actions taken must be consistent with state law." The Manitou council asserted that GSUSA's plan to cut its jurisdiction, as part of a "Core Business Strategy process to transform the Girl Scout Movement" by shrinking the number of councils nationwide by two-thirds, violated the Fair Dealership Law.

In February 2008, Manitou filed a thirteen-count complaint against GSUSA and sought a preliminary injunction to prevent the change in its jurisdiction. The district court in June 2008 denied Manitou's motion for an injunction, but the Seventh Circuit reversed and enjoined GSUSA from making any changes in Manitou's jurisdiction pending final resolution on the merits in the district court. The Seventh Circuit also found that the Manitou council is a dealer within the meaning of the Fair Dealership Law.

The Fair Dealership Law states that "no grantor . . . may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause." The Manitou council asserted that GSUSA's plan violated this provision.

On remand to the district court, GSUSA did not reargue the issue of whether the Fair Dealership Law applies; instead, it argued that its realignment effort did not run afoul of the statute. GSUSA moved for summary judgment on all counts of the complaint, and the Manitou council moved for summary judgment on its claim under the Fair Dealership Law. The district court concluded that, but for the injunction imposed by the Seventh Circuit, GSUSA's proposed reorganization would have resulted in a "constructive termination" and a substantial change in "the competitive circumstances of the dealership agreement" between GSUSA and the Manitou council.

GSUSA argued that it had "good cause" for cutting the Manitou council's jurisdiction in order to implement its national realignment strategy. To show good cause, a grantor must demonstrate an objectively ascertainable need for change, a proportionate response, and a nondiscriminatory action. The district court agreed with the Seventh Circuit's earlier conclusion that "fading brand image and waning program effectiveness," without a tangible effect on the bottom line, did not meet the standard of "good cause." The court stated that it had no basis for crafting a different standard simply because this case involved a not-for-profit entity. Thus, the court held, the Manitou council met its burden of showing, as a matter of law, that GSUSA's action violated the Fair Dealership Law.

GSUSA also argued, however, that even if good cause does not exist as a matter of law, applying the Fair Dealership Law to its actions in changing the Manitou council's jurisdiction would violate GSUSA's First Amendment rights to freedom of expressive association. The court agreed, concluding that applying the Fair Dealership Law to prevent GSUSA from implementing its realignment plan fully would constitute a burden on its "reasoned efforts to organize and direct itself in a means that it judges most effective in proclaiming its expressive message." Accordingly, the court denied the Manitou council's motion for partial summary judgment and granted summary judgment for GSUSA on all counts asserted against it.

***Hockey Enters., Inc. v. Total Hockey Worldwide, LLC*, No. 10-2943, 2011 U.S. Dist. LEXIS 2201, Bus. Franchise Guide (CCH) ¶ 14,531 (D. Minn. Jan. 10, 2011)**

A federal court in Minnesota ruled that a franchisee that opened a hockey training center franchise in Florida could not pursue claims under the Minnesota Franchise Act (MFA) against Minnesota franchisor Total Hockey. The court dismissed claims that defendants violated the Minnesota Franchise Act by making material misrepresentations and providing illegal earnings claims to induce plaintiffs to become Total Hockey franchisees and that they failed to register with the state before selling plaintiffs a franchise. These claims must be dismissed, the court held, because plaintiffs in their agreements chose Florida law to govern their relationship. Although Minnesota law does not allow for the waiver of rights secured by the MFA, the court noted that this provision applies only if the waiver purports to bind a Minnesota resident or corporation when that person or entity acquires a franchise or to bind a person residing anywhere who acquires a franchise that will operate in Minnesota. Given that these prerequisites do not apply, the court concluded, the parties' choice of law is not void, and the MFA does not apply to plaintiffs' claims.

The court did not dismiss plaintiffs' claims for fraud and negligent misrepresentation even though it cited "compelling evidence" that could refute the reasonableness of their reliance on defendants' alleged misrepresentations—including, for example, that "it was *not* imperative for the [plaintiffs' hockey training] facility to be located in or very near an ice rink." The court noted that issues of justifiable reliance, a necessary element of both fraud and negligent misrepresentation under Florida law, are inappropriate for resolution on a motion to dismiss and could be reconsidered in a motion for summary judgment.

The court dismissed two individual defendants from the lawsuit for failure to state a claim against them. But the court concluded that plaintiffs had alleged sufficient facts to maintain claims for fraud and misrepresentation and violations of Florida's Franchise Act against three other individual defendants, denying their motions to dismiss.

Plaintiffs' claims for breach of contract failed because they showed no affirmative contractual obligation for Total Hockey to provide them with ongoing suggestions and recommendations and assistance for unusual operating problems, the court concluded. The franchise agreements merely provided that if plaintiffs have a specific situation that requires assistance, they may request it from Total Hockey. If Total Hockey agreed to provide that assistance, certain charges would apply. Moreover, because plaintiffs did not state a claim for breach of contract, their claim for breach of the implied covenant of good faith and fair dealing also failed as Florida law recognizes no independent cause of action for such a breach.

Finally, the court held that the individual owner and guarantor of the franchises failed to state a plausible claim that he had suffered damages separate from those of the franchise itself and thus lacked standing to recover his alleged losses. His claims were dismissed without prejudice.

***R.N.R. Oils, Inc. v. BP W. Coast Prods. LLC,* No. BB219126, 2011 Cal. App. Unpub. LEXIS 108, Bus. Franchise Guide (CCH) ¶ 14,525 (Ct. App. Jan. 6, 2011)**

BP West Coast Products, a franchisor of ARCO branded gas stations and convenience stores, did not violate California's Business and Professions Code or Unfair Competition Law in the way it implemented an automated gasoline delivery system, retained fees generated by debit card transactions, or modified terms of franchise agreements, a California appellate court ruled. The court affirmed summary judgment in favor of the franchisor on all five claims asserted by a group of sixteen gasoline station franchisees.

The franchisees failed to show that BP's retention of debit card fees was an unfair business practice, the court affirmed, because the fees were paid by customers, not by the franchisees, and there was no evidence that the company's retention of the fees hurt competition; hurt the public interest; or was immoral, unethical, oppressive, or unscrupulous.

Likewise, the franchisees failed to show that BP committed unfair trade practices by forcing them to accept unnecessary fuel deliveries and bear the cost of fuel price changes, or by keeping vendor rebates and delaying payment or refunds and reimbursements. The court held that the franchise agreements expressly permitted these practices, there was no showing of anticompetitive impact or harm to the public interest, and the franchisees eventually were reimbursed for overcharges.

Finding that such disclosure was not required, the court rejected the franchisees' unfair trade practice claim against BP. A claim against BP for failing to disclose its full list of approved cigarette vendors also was rejected because the franchisees produced no evidence that BP required them to buy cigarettes only from approved vendors. Instead, the evidence showed they were free to buy from any vendor as long as the cigarettes were not counterfeit, required taxes were paid, and there was no "re-retailing."

Finally, the court affirmed that BP did not violate California's Business and Professions Code by giving the franchisees inadequate notice of a requirement to install updated computer sales equipment. The court concluded that this requirement was not a material modification of their agreements requiring such notice but instead was a right expressly reserved to BP in the agreement.

TAXATION

***KFC Corp. v. Iowa Dep't of Revenue,* 792 N.W.2d 308, Bus. Franchise Guide (CCH) ¶ 14,518 (Iowa 2010)**

Franchisor KFC Corp. is liable to the State of Iowa for corporate income taxes even though it has no physical presence in the state and all of its restaurants there are owned by independent franchisees, the Iowa Supreme Court held, affirming earlier decisions by the Iowa Department of Revenue (IDOR), an Iowa administrative law judge, and an Iowa district court. KFC argued that imposing such a tax would violate the U.S. Constitution's dormant Commerce Clause, as well as Iowa statutes, because it had no physical contact with the state and had no property located in the state.

KFC, a Delaware corporation based in Kentucky, licenses its system to a mix of independent restaurants and related entities. All KFC restaurants in Iowa are owned by independent franchisees. KFC has no employees in Iowa and owns no property there. Nonetheless, in 2001, IDOR assessed nearly $300,000 in unpaid corporate income taxes, penalties, and interest against KFC for the three years between 1997 and 1999. KFC protested the assessment.

IDOR asserted that a physical presence is not required under the Commerce Clause for the imposition of state income tax. The court affirmed this position, noting that its mandate was to determine how the U.S. Supreme Court would decide this case under case law and established dormant Commerce Clause doctrine. In support of this conclusion, the court noted that: KFC's royalty income from licensing its marks to independent franchisees is derived from Iowa customers and made possible by Iowa's infrastructure and Iowa's legal protection of the Iowa marketplace; KFC had the right to control the use of its marks by Iowa franchisees and the nature and quality of the goods that those franchisees sold under the marks; KFC had the right to control the Iowa franchisees' menu items, advertising, marketing, physical facilities, and sources for purchasing equipment, supplies, and other products; and KFC's franchisees in Iowa could deduct from their taxable income the royalty payments they made to KFC.

The court held that these facts supported the conclusion that IDOR's tax assessment did not violate the Commerce Clause or Iowa law. KFC had a sufficient nexus to Iowa to support the assessment because the franchise right is an intangible with a direct connection to the state. Imposition of the tax thus was not an undue burden on commerce, but a payment to the government that provided the economic climate that allowed the business to prosper.

The court also affirmed the holding that the tax assessment comports with Iowa Code § 422,23(1), which imposes an income tax on corporations deriving income from sources within the state, including income from real, tangible, or intangible property located or having a situs in the state. This tax "falls squarely within the intended scope" of this statute and within administrative rules promulgated to implement it, the court ruled.

TERMINATION AND NONRENEWAL

***Bella Co. v. Salonquest, LLC*, No. 2:09-cv-11517, 2010 U.S. Dist. LEXIS 129413, Bus. Franchise Guide (CCH) ¶ 14,509 (Dec. 7, 2010)**

Both a plaintiff distributor and a defendant manufacturer have reasonable interpretations of a distributorship agreement's termination provisions, a federal court in Michigan held, denying partial summary judgment to the distributor on the heels of an earlier decision denying judgment on the pleadings to the manufacturer. The termination provision is ambiguous, and the ambiguity "is not so slight as to be resolved by the principle of 'contra proferentem,'" the court held, referring to that principle as "a last resort." Instead, the court looked to extrinsic evidence of the parties' intent regarding termination and found that a material factual dispute precluded the grant of summary judgment.

The parties' dispute concerns two provisions of the agreement: Section 2 and Section 12. Section 2, the term provision, states that the term would end in four years. "However, unless terminated by either party in accordance with Section 12, the term of this Agreement shall be automatically renewed and extended for an additional one year term at the end of the initial term and each renewal term."

Section 12, the termination provision, permits the distributor to terminate by giving the manufacturer at least thirty days' notice of termination. It then adds that the manufacturer "may terminate the term of this Agreement for Cause by giving the Distributor written notice of termination at least ninety days prior to the effective date of termination specified in the notice." Section 12 enumerates nine definitions of "Cause."

Four months before the initial four-year term expired, the manufacturer gave the distributor notice that it would allow the agreement to expire. The distributor asserted that this notice violated the agreement because the agreement automatically renewed at the end of the initial four-year term and each year thereafter unless the distributor chose to terminate or unless the manufacturer had cause to terminate, as defined in Section 12. The manufacturer, on the other hand, asserted that Section 12 set forth the circumstances under which the parties may terminate the agreement during a term, rather than at the expiration of a term.

The court concluded that the parties' conflicting interpretations of the agreement were both reasonable. Thus, under Ohio law, which governed the agreement, the court looked to extrinsic evidence and the agreement as a whole to determine the parties' intentions regarding termination. Finding a material factual dispute regarding those intentions, the court denied summary judgment.

***Dunkin' Donuts Franchised Rests. LLC v. Strategic Venture Group*, Inc., No. 07-1923, 2010 U.S. Dist LEXIS 119417, Bus. Franchise Guide (CCH) ¶ 14,494 (D.N.J. Nov. 10, 2010)**

A federal court in New Jersey ruled that evading payroll tax obligations and filing false tax returns constitute material and noncurable breaches of franchise agreements and constitute good cause under the New Jersey Franchise Practices Act for termination.

Following a bench trial, the court found that three franchisees operating in New Jersey had paid thousands of dollars for employees' apartment rental fees, car lease fees, and airfares, among other personal expenses, without withholding payroll tax from these amounts, treating them instead as business expenses. The franchisees did not log the payments as employee wages in corporate records and did not report them as wages in tax documents, the court found.

The court rejected the franchisees' argument in rebuttal that under the "obey all laws" clause of their contracts, the failure to comply with the law must relate to the "maintenance and operation" of the franchise. The court also rejected their argument that the franchisor had failed to establish damages, as required for a breach of contract claim. Finally, the court rejected the franchisees' argument that the franchisor acted with unclean hands by citing under reporting and failure to maintain adequate records as grounds for their termination but choosing not to pursue those claims at trial. The court concluded that Dunkin' Donuts' strategic decision to abandon these claims does not indicate misconduct.