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Joint Employer Exposure in Class Actions by Employees of Franchisees:

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Joint Employment in the Class Action Context

Calendar year 2016, and 2017 to date, have seen a number of key decisions in the class action context in lawsuits alleging that a franchisor should be held to be a joint employer with franchisees. As in the prior year, agency decisions, such as the *Browning Ferris* decision by the National Labor Relations Board, were not cited in judicial opinions. Instead, the courts generally relied on formulations of tests considering the economic realities of franchisor/franchisee relationships and/or the extent to which the franchisor exercised control relative to franchisee employees to assess whether the franchisor could be held liable as a joint employer.

As a general matter, well pleaded complaints plausibly alleging facts sufficient to find that a franchisor exercised sufficient control over its franchisees' employees to be held an employer are surviving motions to dismiss. On the other hand, franchisors saw some significant victories on summary judgment motions on joint employment theories, under the economic realities/control tests and on the ostensible agency theory. Courts also worked through special issues that arise in franchise joint employment class actions around conditional and collective certification and managing discovery and notice.

A. Franchisor Motions to Dismiss in Joint Employment Class Actions.

1. *Ocampo v. 455 Hospitality LLC* Case No. 14-CV-9614, 2016 WL 4926204 (S.D.N.Y. Sept. 14, 2016)

Employees of a franchisee filed a putative class action asserting FLSA and New York Labor Law claims against Doubletree Franchise LLC and Doubletree Hotel Systems, Inc. (together, "Doubletree Defendants"). The Doubletree Defendants filed a motion to dismiss asserting that plaintiffs did not plausibly allege that the Doubletree Defendants were their employer. The Doubletree Defendants relied on provisions of the franchise agreement to contend that the franchisee solely employed its employees and was merely an independent contractor of the Doubletree Defendants.

The court held that "economic realities, not contractual labels, determine employment status for the remedial purposes of the FLSA." In order to assess the economic reality, the court articulated two tests applied by the Second Circuit to determine whether an employment relationship exists for purposes of the FLSA.

One test, the "formal control test," asks "whether the alleged employer: (1) had the power to hire and fire the employees; (2) supervised and controlled employee work schedules or conditions of employment; (3) determined the rate and method of payment; and (4) maintained employment records." The second test identifies a number of factors pertinent to determining whether a person or entity exercised "functional control" over an employee, even if formal control is lacking. Under the second test, the "functional control test," courts look to a number of nonexclusive, relevant factors, including: (1) whether the alleged employer's premises and equipment were used for the plaintiffs' work; (2) whether the subcontractors had a business that could or did shift as a unit from one putative joint employer to another; (3) the extent to which plaintiffs performed a discrete line job that was integral to the alleged employers' process of production; (4) whether responsibility under the contracts could pass from one subcontractor to another without material changes; (5) the degree to which the alleged employers or their agents supervised plaintiffs' work; and (6) whether plaintiffs worked exclusively or predominately for the alleged employers.

The court noted that neither test provides a "rigid rule" but rather the tests provide "a nonexclusive and overlapping set of factors to ensure that the economic realities test … is sufficiently comprehensive and flexible to give proper effect to the broad language of the FLSA." The court held that the Complaint pled facts to at least satisfy the functional control test and state a plausible joint employment claim against the Doubletree Defendant because it alleged that the Doubletree Defendants:

(1) imposed mandatory training programs for hotel employees;
(2) maintained the right to inspect at any time;
(3) imposed mandatory recordkeeping requirements;
(4) established standards, specifications, and policies related to construction, appearance and operations;
(5) required that the franchisee use a particular business software system to track revenue and operations;
(6) retained the unlimited right to make changes to the manner in which the hotel was operated;
(7) regularly performed both scheduled and unannounced audits and inspections compliance with financial recordkeeping requirements and quality assurance standards, which incentivized good performance by franchisee employees and punished poor performance;
(8) had the right to terminate the franchise agreement in the event that standard requirements are not met, would result in the termination of employment of franchisee employees; and
(9) were aware that plaintiffs were not paid gratuities owed to them, but failed to stop the unlawful wage practices and policies that were perpetrated.

Accordingly, the court denied the franchisor's motion to dismiss.

2. *Attai v. Delivery Dudes, LLC,* Case No. 15-CIV-62522, 2016 WL 828816 (S.D. Fla. Mar. 2, 2016)

In contrast, a federal court in Florida granted a motion to dismiss a putative FLSA collective action against a franchisor where it found the complaint "utterly lacking" in factual allegations plausibly alleging a basis for joint employment. Plaintiff was a delivery driver who filed a lawsuit alleging FLSA violations by Delivery Dudes, LLC, Delivery Dudes Franchise Systems, LLC, and Dude Holdings, LLC ("Delivery Dude Defendants"). The Delivery Dude Defendants filed a motion to dismiss asserting that the Complaint failed to allege that they jointly employed the Plaintiff. The court granted the motion to dismiss because there were allegations regarding the relationship between the various defendants and the complaint merely grouped all defendants together without allegations regarding any particular defendant's conduct in relationship with other defendants. However, the Court did give plaintiff leave to amend. On

April 7, 2017, Plaintiffs amended their complaint to add a number of specific allegations about each defendant and the controls imposed by the franchise agreement. As of this writing, no motion to dismiss or answer had been filed.

B. Joint Employment and Motions for Summary Judgment.

Courts handed down a number of important summary judgment decisions in joint employment class and collective actions in the last year. Generally speaking, these decisions favored franchisors.

1. ***Salazar v. McDonald's Corp.*** **Case No. 14-CV-02096, 2016 WL 4394165 (N.D. Cal. Aug. 16, 2016) & 2017 WL 950986 (N.D. Cal. Mar. 10, 2017)**

McDonald's had two significant summary judgment victories in a putative class action alleging claims under the California Labor Code, as well as for negligence violation of California's Private Attorney General Act and California's Unfair Competition Law.

Employees of a franchisee filed a class action lawsuit asserting state wage and hour claims against McDonald's Corp., McDonald's USA, LLC, and McDonald's Restaurants of California (together, "McDonald's") and a single multi-unit franchisee. Plaintiffs argued that McDonald's was liable to them as their joint employer and/or under an ostensible agency theory. McDonald's filed a motion for summary judgment arguing that it was not a joint employer of plaintiffs and did not have an ostensible agency relationship with its franchisee.

The court concluded that the three-prong test articulated by the California Supreme Court in *Martinez v. Combs*, 49 Cal. 4th 35 (2010) informed by the California Supreme Court's subsequent opinion in *Patterson v. Dominoes Pizza, LLC*, 60 Cal. 4th 474 (2014), should control. Under the *Martinez* test, the term "employer" has three alternative definitions: "(a) to exercise control over the wages, hours or working conditions, *or* (b) to suffer or permit to work, or (c) to engage, thereby creating a common employment relationship."

Under the first prong of the *Martinez* test, the plaintiffs argued that McDonald's retained a contractual right of control and also indirectly controlled working conditions by promulgating operational standards and conducting graded inspections. The court found that McDonald's did not exercise direct or indirect control over the plaintiffs' working conditions because: (1) it did not directly or indirectly retain the right to control personnel or employment matters at the franchisee's restaurant; (2) it was not involved in hiring, firing, disciplining, setting the work schedules or pay for employees; (3) McDonald's did not pay the employees; (4) employees of the franchisee oversaw training and orientation; (5) the franchisee was free to reject (and did reject) the business advice it received from McDonald's; (6) employees went to the franchisee with questions or concerns about their jobs; and (7) the franchisee purchased workers' compensation insurance. The court also rejected as insufficient to create control the franchisee's use of a McDonald's job screening website and optional point of sale software. These undisputed facts demonstrated that McDonalds did not exercise direct or indirect control over plaintiffs' wages, hours or working conditions. The court likewise found that McDonald's was not the employees' employer under the second and third prongs of *Martinez*, finding dispositive the undisputed fact that the franchisee alone controlled the hiring, firing, wages, hours and everyday aspects of the work place environment.

However, the court found a triable issue of fact existed on whether McDonald's was liable to plaintiffs under an ostensible agency theory. Ostensible agency exists where: (1) the person dealing with the agent does so with reasonable belief in the agent's authority; (2) that belief is generated by some act or neglect of the principal sought to be charged; and (3) the relying party is not negligent. McDonald's argued that plaintiffs could not reasonably believe they worked for McDonald's because the online employment applications told plaintiffs they "were applying for employment with an independently owned and operated McDonald's franchisee, a separate company and employer from McDonald's Corporation and any of its subsidiaries." The court found that such a statement did not automatically defeat the reasonableness of plaintiffs' belief. The court found there was "considerable evidence, albeit subject to dispute, that McDonalds caused plaintiffs to reasonable believe that the franchisee was acting as its agent." Specifically:

- Plaintiffs believed they worked for McDonald's and referenced themselves as working for McDonald's;
- Plaintiffs were required to wear McDonald's uniforms and prepared and served food in McDonald's packaging;
- Plaintiffs greeted customers by saying "Welcome to McDonald's";
- Plaintiffs were subject to training by McDonald's and interacted regularly with McDonald's consultants;
- Plaintiffs applied through a McDonald's website, which said they were seeking "a job opportunity with McDonald's," and the written employment application was also emblazoned with the McDonald's logo;
- McDonald's was responsible for some of the content contained in plaintiff's orientation materials;
- Plaintiff's received documents styled as "McDonald's Store Policies"; and
- Plaintiff's testified they sought employment at McDonald's because it "is a large corporation with many stores around the world," "would involve a steady job in a safe environment," and "would make sure they were paid and treated correctly because it is a large corporation with standardized systems."

This decision, along with a similar case against McDonald's in the *Ochoa* case, discussed below, caused considerable consternation amongst franchisors. But in March 2017, the judge revisited ostensible agency, on McDonald's second motion for summary judgment on ostensible agency, which the court granted on March 10, 2017. The court noted that, in its first motion, McDonald's did not raise the question of whether ostensible agency is a valid predicate for claims brought under the California Labor Code. In its second motion for summary judgment, McDonald's focused on that question and argued that it could not be held liable for violations of the California Labor Code because it does not fall within the statutory definition of an "employer." This time, the court agreed.

The court noted that wage orders issued by the Industrial Welfare Commission ("IWC") define the employment relationship and, thus, who may be held liable. IWC Wage Order 5-2001 provides that to "employ" is to "engage, suffer or permit to work" and defines an employer as one whom "directly or indirectly, or through an agent or any other person, employs or exercises control over the wages, hours or working conditions of any person." The court further observed that its prior order considered these tests and concluded that McDonald's was not liable under any of them.

Plaintiffs contended that the Wage Order permitted a finding of liability for violations under an ostensible agency theory, because the order contained the words "through an agent." Plaintiffs also advanced a variety of public policy arguments, unsuccessfully. The court held, however, that the phrase is limited when read in context, because the wage order restricted the definition of one who employs, through an agent to one who "employs or exercises control" over the workplace environment. Thus, the court concluded that the plain language of the Wage Order did not permit a finding of liability via ostensible agency and granted McDonald's motion for summary judgment.

2. *Pope v. Espeseth, Inc.* No. 15-CV-486, 2017 WL 108081 (W.D. Wis. Jan. 11, 2017)

Plaintiffs filed a proposed collective and class action alleging that their former direct employer, a franchised window cleaning company, compensated them using a commission-based compensation method that failed to pay them minimum wage and overtime pay, in violation of the Fair Labor Standards Act ("FLSA") and Wisconsin state wage and hour laws. Plaintiffs originally filed suit against the franchisee and its owner, and later added the franchisor Fish Window Cleaning Services, Inc. ("Fish Window Cleaning"), claiming that Fish Window Cleaning and the franchisee jointly employed plaintiffs, as well as employees of franchisees around the country. Plaintiffs sought to conditionally certify a nationwide collective action of window cleaners allegedly jointly employed by Fish Window Cleaning and all of its franchisees for purposes of their FLSA claims. Briefing on the franchisor's motion for summary judgment on joint employment and the plaintiffs' motion for conditional certification of the nationwide class of window cleaners employed by any Fish Window Cleaning franchisee proceeded simultaneously.

The franchise agreement contained a number of provisions establishing the independence of the franchisee in matters of hiring, discharge and employee discipline and stating that no franchisee employee would be deemed an employee of the franchisor. Plaintiffs contended that Fish Window Cleaning supervised and controlled the franchisee's employees sufficient to be deemed a joint employer primarily through two means: (1) a template policy and procedure manual that Fish Window Cleaning provided to its franchisees; and (2) by making recommendations to franchisees for methods of compensating window cleaners.

Under the FLSA, an employer is defined as "any person acting directly or indirectly in the interest of an employer in relation to an employee." 29 U.S.C. §203(d). The court applied the test articulated in *Moldenhauer v. Tazewell-Pekin Consol. Commc'ns Ctr.*, 536 F.3d 640 (7^{th} Cir. 2008), to assess whether Fish Window Cleaning exercised control over the employees' working conditions. The court considered whether Fish Window Cleaning: (1) had the power to hire and fire employees; (2) supervised and controlled employee work schedules or conditions of payment; (3) determined the rate and method of payment; and (4) maintained employment records.

Plaintiffs conceded that the franchisor did not have the power to hire and fire franchisee's employees and did not maintain employment records for the franchisee's employees, thereby eliminating the first and fourth factors from consideration. The court then turned to plaintiffs' contention that Fish Window Cleaning exercised control over work schedules through a policy and procedure manual provided to franchisees. While there was evidence that the franchisee believed that he was required to provide his employees with a copy of the manual and have them sign off on it, the undisputed evidence also demonstrated that the franchisee was not required to follow the manual as drafted by Fish Window Cleaning and, in fact, modified the manual as he wished. For example, the court noted that the franchisee modified the report time recommended by the manual, eliminated a requirement in the manual that employees pay for items in their work uniforms, and did not follow a recommendation that franchisees not schedule weekend work. Thus, the court found that plaintiffs had failed to adduce evidence that Fish Window Cleaning controlled franchisee employee work schedules.

Plaintiffs next contended that Fish Window Cleaning determined rates and methods of pay through recommendations to franchisees for commission-based compensation programs for their employees. The court held that, although the franchisee had implemented a commission-based compensation method, it did so with modifications from the franchisor's recommendation, demonstrating that the compensation method was not required. The court held that a "recommendation regarding the method of employee compensation does not, on its own, amount to control over employees' working conditions" and granted the franchisor's motion for summary judgment on the FLSA claims.

Plaintiffs also alleged that Fish Window Cleaning was their employer under Wisconsin law. To prevail on the state law minimum wage claims, plaintiffs were required to show that Fish Window Cleaning has "control or direction of any person employed at any labor or [is] responsible directly or indirectly for the wages of another." Wis. Stat. § 104.01(3)(a). The court noted the similarity of the definitions to the FLSA's definition, and found that the same evidence that doomed plaintiffs' FLSA claim likewise precluded a finding that Fish Window Cleaning was an employer under state law. The court further declined plaintiffs' invitation to import the test for respondeat superior liability of a franchisor, or the test for independent contractor status from Wisconsin case law, to override the statutory definitions of employers, and dismissed on summary judgment plaintiffs' claims against Fish Window Cleaning.

It is worth noting that plaintiffs failed to plead an ostensible agency or apparent authority claim, and the court denied plaintiffs' eleventh hour motion to amend their complaint to include the theory. Thus, the court did not take up apparent authority on the merits, though it was briefed by the parties. In late March 2017, plaintiffs reached a settlement with the franchisee and its owner. Plaintiffs dropped their Wisconsin claims and settled the FLSA claims against the franchisee. In the motion for preliminary approval of the settlement, plaintiffs indicated that they intend to appeal the grant of summary judgment to the franchisor.

3. ***Gessele v. Jack in the Box, Inc.*** **No. 3:14-CV-1092, 2016 U.S. Dist. LEXIS 172061 (D. Or. Dec. 13, 2016)**

Jack in the Box, Inc. ("Jack in the Box") employed plaintiffs at company-owned stores until March 29, 2010, when the company-owned stores converted to franchised stores. Plaintiffs filed a lawsuit against Jack in the Box and three of its franchisees alleging violations of the FLSA and state wage and hour laws for a period that included work after March 29, 2010. Jack in the Box filed a partial motion for summary judgment arguing that it was not Plaintiffs' employer after March 29, 2010.

Jack in the Box's franchise agreement provided that:

- franchisee was "an independent contractor and shall not be deemed an agent, partner, joint venture or employee" of the franchisor,
- Jack in the Box was to have no control over the terms and conditions of employment of the franchisee's employees; and
- "The franchisee determines who to hire into what position at the restaurant. The franchisee decides which employees to schedule to work, what days and times to schedule them, when the employees will take breaks, and the total number of hours the employees will be scheduled to work each week. Jack in the Box has no input, control or direction over schedules, hours, or hiring decisions."

The court applied the Ninth Circuit's four-part test for determining joint employment: "whether the alleged employer (1) had the power to hire and fire the employees; (2) supervised and controlled employee work schedules or conditions of employment; (3) determined the rate and method of payment; and (4) maintained employment records."

The court found that Jack in the Box did not have the power to hire or fire franchisee employees and was not responsible for or involved in setting work schedules, hours of employment, salaries, insurance or benefits. The court likewise was not persuaded by the fact that franchisor employees trained franchisee management personnel, or that it required its franchisees to use its payroll system. Finally, the fact that Jack in the Box provided nonmandatory advisory materials on human resources and training subjects were not sufficient to establish control. Thus, the court granted summary judgment in Jack in the Box's favor.

C. The Challenges of Conditional Certification and Class Certification in Franchisor Joint Employer Cases

Courts also issued some significant opinions related to class certification in 2016 and in 2017 year to date. These decisions presented a decidedly mixed bag and point up some of the practical problems to class actions in the joint employment contract.

1. *Ochoa v. McDonald's Corp.* Case No. 3:14-cv-02098, 2016 WL 3648550 (N.D. Cal. July 7, 2016)

While McDonald's had success in defeating the joint employer theory on the merits in the

Salazar case, it did not fare as well in front of a different judge in the *Ochoa* case. There, as in *Salazar*, plaintiffs allege a variety of labor violations by the owner of five franchised locations and also sued McDonald's on direct and vicarious liability grounds. The court granted McDonald's motion for summary judgment on plaintiffs' direct liability theories but denied it on the issue of whether McDonald's may be liable on an ostensible agency theory. Plaintiffs settled with the franchisee, leaving McDonald's as the last entity standing.

Plaintiffs moved for certification of a class under Rule 23 of the Federal Rules of Civil Procedure prior to the court's summary judgment order as to the direct liability theories. The court ordered supplemental briefing on how the ostensible agency theory might impact the class certification question. In its supplemental brief, McDonald's argued that allegations of ostensible agency were incapable of being resolved on a class basis, because it necessarily involves individualized questions of personal belief and the reasonableness of reliance on the perceived agency relationship. The court rejected McDonald's argument, which it characterized as an *a priori* bar to class certification in cases involving ostensible agency.

The court then engaged in a traditional analysis of the evidence to determine whether class-wide adjudication was appropriate under Rule 23 and found that plaintiffs had tendered "substantial and largely undisputed evidence that the putative class was exposed to conduct in common that would make proof of ostensible agency practical and fair on a class basis." The court cited evidence that plaintiffs: (i) were required to wear McDonald's uniforms; (ii) packaged food in McDonald's boxes; (iii) received paystubs, orientation materials, shift schedules and time punch reports all marked with McDonald's name and logo; and (iv) in most cases, applied for a job through the McDonald's website. The court also noted that employees "spent every work day in a restaurant heavily branded with McDonald's trademarks and names." And plaintiffs also submitted declarations stating that they believed that they were employed by McDonald's, while McDonald's submitted no evidence showing that any named plaintiff or putative class member did not believe McDonald's was their employer or that they were unjustified or unreasonable in relying on that belief.

The court held that plaintiffs' claims for miscalculated wages, unpaid overtime, and uncompensated time for maintenance of their crew uniforms were appropriate for certification. The court denied class certification on plaintiffs' meal period and rest break claims, because there was no evidence of a standard policy or practice of denying crew members of meal and rest breaks. Rather, because the evidence was that individual managers had discretion regarding breaks, plaintiffs had failed to satisfy the commonality requirement under Rule 23(a)(2) and predominance under Rule 23(b)(3).

In late October, with trial set for December 2016, McDonald's settled this case for $3.75 million. The settlement was preliminarily approved in January 2017.

D. Denials of Conditional Certification in Joint Employer Cases

Federal courts in New York and Florida handed franchisors significant victories on motions by franchisees seeking conditional certification of collective actions alleging that the franchisor should be held jointly liable under the FLSA with multiple franchisees.

1. *Aguiar v. Subway 39077* Civ. Action No. 6-23399 (slip op. S.D. Fla. Nov. 18, 2016)

Late in 2016, a federal court in Florida declined to certify a collective action under the FLSA where the plaintiffs sought to create a class of individuals employed by 38 separate, non-party franchisees located across south Florida. The Eleventh Circuit recommends, but does not require, a two-tiered approach to certification of a collective action under the FLSA. The first stage involves a "fairly lenient standard" to determine whether the proposed plaintiffs are similarly situated. The court may consider a number of factors in determining whether plaintiffs are similarly situated, including (1) whether plaintiffs share a job title; (2) whether they worked in the same geographical location; (3) whether the alleged violations occurred in the same time period; (4) whether the plaintiffs were subjected to the same policies and practices and whether they were established by the same decision maker in the same manner; and (5) the extent to which the violations claimed by plaintiffs are similar.

The court found that there were two fatal hurdles to conditional certification. First, the named plaintiffs had no employment relationship with the franchises other the ones at which they were employed. The court noted that plaintiffs offered no precedent that permitted the employees to file suit against franchises with which they had no employment relationship. Second, plaintiffs had failed to show the existence of any employees other than those who were already named plaintiffs who wished to opt in. Even leaving these issues to one side, the court concluded that certification of a collective action was not appropriate under the factors outline above, because the franchises were spread through a large geographic area and there was no evidence of common practices, policies or supervision.

2. *Durling v. Papa John's Int'l, Inc.* 16 Civ. 3592, (S.D.N.Y. Mar. 29, 2017)[1]

A court in the Southern District of New York reached a similar conclusion in late March, in an FLSA collective action against Papa John's, in which the plaintiffs sought conditional certification of a nationwide class of pizza delivery drivers employed by Papa John's in corporate locations and employed by franchisees, the vast majority of whom are nonparties to the case. Plaintiffs alleged that Papa John's systematically under-reimbursed its drivers for driving-relate expenses, resulting in drivers being paid effectively well below minimum wage. Plaintiffs claimed that Papa John's not only operated corporate-owned stores, but also jointly employed all franchisees' delivery drivers and that it devised and disseminated the policies and practices that caused employees to be uniformly under reimbursed.

Courts in the Second Circuit follow a two-step process to determine whether to certify a collective action under the FLSA. At the first stage, the plaintiff must make a "modest factual showing" that the plaintiff and other plaintiffs together were victims of a common policy or plan that violated the law. If the plaintiff satisfies the modest burden, the court then permits the plaintiff to send notices to potential plaintiffs to opt in to the class. The FLSA does not define the term

[1] Available at https://dlbjbjzgnk95t.cloudfront.net/0908000/908750/decision.pdf.

similarly situated, but courts require that there be a factual nexus between the claims of the named plaintiff and those who may opt in to the action. At the second stage, the court determines on a full record whether the collective action may go forward by determining whether those who have opted in at the notice stage are, in fact, similarly situated to the named plaintiff.

The court found that there was no evidence that Papa John's dictated the payment policy for delivery drivers at all Papa John's restaurants including franchise locations, because Papa John's provided evidence showing that it was not involved in how franchisees compensate employees. The court held that the fact that Papa John's and its franchisees used the same point of sale system did not show how or how much franchisees paid drivers, and the fact that Papa John's had access to the data in no way indicated that it was dictating compensation policies.

Similarly, the court found that there was no evidence of a common practice violating the law to bind the class together. The fact that there were common policies, such as similar uniforms, the use of the Papa John's logo or general use of personal vehicles for deliveries was inadequate to show a common practice. And the court was unwilling to infer that there was a common practice at all 780-some franchise locations from the evidence that showed the practices of the corporate locations plus two franchised locations.

Finally, it is worth noting that the court considered two other cases, *Ochoa* and *Jimmy John's* (discussed below), and found neither helpful to the plaintiffs before the court. The court distinguished *Ochoa* because all of the plaintiffs in that case worked for the same franchisee—thus, there was no need for a showing of common policy or practice across separately owned entities. The court found *Jimmy John's* unhelpful to plaintiffs because, at the conditional certification stage in that case, the plaintiffs supported their motion for conditional certification with declarations containing first-hand knowledge from employees at eleven locations in seven states, and also relied on corporate materials that demonstrated that the franchisor dictated aspects of the assistant managers jobs.

3. ***In re: Jimmy John's Overtime Litig.*** **Case No. 14 C 5509 (Consolidated)**

The Jimmy John's case, which is ongoing in the United States District Court for the Northern District of Illinois, illustrates one of the key difficulties of class and collective treatment of joint employment cases: because franchisees hire and pay their employees, they typically maintain the records containing the contact information necessary to notify putative class and collective members. If the franchisee is not a party to a case, as is the case in the Jimmy John's overtime litigation, contact information for putative class members must be obtained through franchisees voluntarily or through compelled discovery.

In December 2015, the court conditionally certified a class that included the current and former employees of nonparty franchisees. Thereafter, plaintiffs served subpoenas on some 280 franchisees, seeking contact information for current and former assistant managers employed by the franchisees during the relevant time period. At least three of the franchisees objected by letter to the subpoenas. Other franchisees apparently ignored the subpoenas. The court then assisted the parties in negotiating a letter to be sent by Jimmy John's to its franchisees requesting contact information for additional putative plaintiffs who worked for the franchisees, the so-called "ask nicely" letter. The "ask nicely" letter went to franchisees in February 2016. Meanwhile, notice of the collective was sent to more than 4,000 putative collective members who were employed at Jimmy John's corporate locations and for those franchisee employees whose information was reasonably available and accessible to Jimmy John's.

The "ask nicely" letter to franchisees was not effective in securing contact information. Ultimately, plaintiffs filed motions to compel the three franchisees who had objected by letter to the subpoenas to respond. The court granted the motion as to one, but denied it as to the other two on procedural grounds. But the delay in getting information from franchisees necessitated a second round of notice to putative collective members in late 2016. Meanwhile, the parties completed contentious discovery on the joint employment liability that closed in late March 2017. Dispositive motions are likely to follow.

Franchisor is Potential "Employer" of Franchisees:

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Franchisor as Potential "Employer" of Franchisees in Janitorial Franchises

Within the janitorial franchising segment, franchisors for many years have been pursued by class action attorneys hoping to establish unit franchisees as their franchisor's employees. Since most cleaning franchises use a subfranchise model, attempts also are made to find that the unit franchisees are the direct employees of the ultimate franchisor, bypassing the subfranchisor altogether. And seeing an opportunity to increase state revenues, a small number of states began to pursue this type of claim as well, hoping to collect unemployment premiums and, in some cases workers compensation. Finally, under the previous administration, the Federal Department of Labor also began to pursue this type of claim against janitorial franchisors. During the previous year, all three types of cases have made the headlines.

A. *Williams v. Jani-King of Philadelphia Inc.* No. 15-2049, 2016 WL 5111920 (3d Cir. Sept. 21, 2016)

Procedural History

Plaintiffs' class action employment lawyer Shannon Liss-Riordan began pursuing misclassification claims against janitorial franchisors more than a decade ago. This particular installment of her pursuit was originally filed against Jani-King of Philadelphia ("JKP") in state court in Pennsylvania on March 20, 2009. JKP immediately removed the case to federal court in Pennsylvania. The first 3.5 years of the case were spent on JKP's Motion to Dismiss or Transfer and Plaintiff's Motion to Remand back to state court. In the end, in December 2012, the Court declined to send the case back to state court or to transfer the case to Texas, where the Jani-King brand is based. The Court did dismiss the plaintiffs' claims for breach of good faith and fair dealing as this cause of action is not recognized under either Texas or Pennsylvania law.

In August 2013, the plaintiffs moved to have the case certified as a class action, which JKP timely opposed. In March 2015, the Court granted the Motion to Certify and JKP appealed this decision to the U.S. Court of Appeals for the Third Circuit.

Analysis

On September 21, 2016, the Court of Appeals affirmed the class certification. In so doing, the Court reviewed the four conditions that must be satisfied under Federal Rule 23(a) and noted that at least one of the conditions of Rule 23(b) also must be met. The four conditions of Rule 23(a) include numerosity, commonality, typicality, and adequacy[2]. The standard of review applied

[2] Rule 23(a) provides:

> PREREQUISITES. One or more members of a class may sue or be sued as representative parties on behalf of all members only if:
>
> (1) the class is so numerous that joinder of all members is impracticable;
>
> (2) there are questions of law or fact common to the class;
>
> (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class; and
>
> (4) the representative parties will fairly and adequately protect the interests of the class.

is abuse of discretion. On appeal, JKP had not disputed the requirements of numerosity, typicality and adequacy, but rather focused on Rule 23(a)'s commonality and Rule 23(b)(3)'s predominance[3] requirements. Commonality requires that there be common issues of law or fact, and predominance requires that these common issues must predominate over issues affecting individual class members.

To reaching its decision, the Court noted that it must consider the evidence that would prove plaintiffs' misclassification claim. Since the Pennsylvania statute at issue did not actually define "employee," the Court looked to common law to identify the standard used to determine employment status. The test in Pennsylvania is a form of the common law "right to control" test. The plaintiffs argued that the documentary evidence (the franchise agreements, policies manual and training manual) was substantially the same for all franchisees, and that this evidence alone was sufficient to establish that the plaintiffs were employees and to meet the commonality and predominance requirements. JKP argued that actual control was the appropriate standard, rather than a mere right to control, and therefore the individual experiences of each franchisee were more relevant than the documents, thereby precluding commonality and predominance. JKP also argued that a written agreement alone was never sufficient to establish an employment relationship. Finally, JKP argued that the controls necessary to protect and maintain its interest in its trademark, trade name and goodwill should be excluded from the right to control analysis, as has been recognized by other states' courts.

The Court rejected JKP's arguments, and noted that the right to control, rather than actual control, was the relevant standard, and that the common documentary evidence was sufficient to evaluate JKP's right to control and to meet the commonality and predominance requirements. The Court also noted that Pennsylvania law does not currently recognize a distinction between controls necessary to protect the brand and other controls. One judge wrote an extensive dissent, and noted his belief that the Pennsylvania Supreme Court would likely recognize that controls necessary to protect a franchisor's trademark, trade name, and goodwill are insufficient by themselves to establish an employment relationship, and that the plaintiffs' evidence consisted primarily of these types of controls.

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[3] Rule 23(b)(3) provides:

> TYPES OF CLASS ACTIONS. A class action may be maintained if Rule 23(a) is satisfied and if:
>
> * * *
>
> (3) the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy. The matters pertinent to these findings include:
>
> (A) the class members' interests in individually controlling the prosecution or defense of separate actions;
>
> (B) the extent and nature of any litigation concerning the controversy already begun by or against class members;
>
> (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and
>
> (D) the likely difficulties in managing a class action.

The case then went back to the District Court, and the notices to class members were mailed March 17, 2017, with opt-outs required by April 24, 2017.

B. *Washington Department of Labor and Industries v. Lyons Enterprises, Inc.* 185 Wash.2d 721, 374 P.3d 109 (2016)

Procedural History

Lyons Enterprises, Inc. ("LEI") had been a master franchisee in the Jan-Pro commercial cleaning system since 2000. LEI was audited by the Washington Department of Labor and Industries ("WDLI") in 2005 and this audit concluded that LEI had no obligation to pay workers compensation premiums on behalf of its unit franchisees.

The WDLI again audited LEI in July 2010, and this time determined that LEI must pay workers compensation premiums on behalf of all its unit franchisees. Under Washington law, a company must pay workers compensation premiums on behalf of its employees, but also must pay on behalf of its independent contractors, if the essence of the independent contracts is the personal labor of the contractors. WDLI determined that the unit franchisees were independent contractors, but that the essence of their contracts was the provision of their personal labor.

LEI appealed this determination to the Washington Board of Insurance Appeals, which ruled in December 2011 that LEI was not obligated to pay any workers compensation premiums on behalf of its franchisees. The WDLI appealed this decision to a three member panel of the Washington Board of Insurance Appeals. This panel ruled that LEI would have to pay workers compensation premiums for all of its franchisees that did not have employees, but would not have to pay premiums for franchisees that had their own employees.

Both LEI and WDLI appealed this decision to the Pierce County Supreme Court, which, in May 2013 ruled that LEI had to pay premiums for all of its unit franchisees. LEI then appealed to the Washington Court of Appeals, which ruled in February 2015 that LEI would have to pay workers compensation premiums for all of its franchisees that did not have employees, but would not have to pay premiums for franchisees that had their own employees.

LEI then appealed to the Washington Supreme Court.

Analysis

In May 2016, the Washington Supreme Court affirmed the Court of Appeal's decision. With the varying decisions at each level of this dispute, one can see how franchises in Washington State live in a state of uncertainty on their obligations under the state's employment laws.

The Washington Industrial Insurance Act covers all employees, and also all independent contractors, if <u>the essence of the work provided by an independent contractor is the contractor's personal labor</u>. Therefore, the Washington definition of "worker" is far broader than any other state's definition of "employee."

The WDLI always conceded that the unit franchisees were not LEI employees. They contended that the unit franchisees were independent contractors, and that the essence of the contract was the provision of personal labor.

The Court determined, by considering the "realities of the situation," and given the nature of the franchise agreements and the relationship of the parties, that the "essence" of the franchise agreements is the provision of labor, i.e., cleaning services. The Court then had to determine whether the labor provided was "personal" labor, meaning the direct labor of the independent contractors (franchisees). In determining whether the labor provided was personal, Washington courts have identified three types of independent contractors that do not provide personal labor. The Court found that the third of these types of contractors, one who "of necessity <u>or choice</u> employs others to do all or part of the work he has contracted to perform," would apply to those franchisees that had actually chosen to employ others to do some of the work. The Court therefore found that those franchisees that had actually hired employees or assistants would not be considered LEI's workers.

However, for those franchisees that did not choose to employ others to do any part of the work, the Court found that their provision of cleaning services was personal labor and those franchisees were therefore workers. The Court found that whether the franchisee had <u>actually</u> hired employees or assistants, rather than merely having the right to hire, was the determining factor.

Even for those franchisees that were considered workers, they would be excluded if they met all 6 factors required for an exemption. These 6 factors are:

(1) The individual has been and will continue to be free from control or direction over the performance of the service, both under the contract of service and in fact; and
(2) The service is either outside the usual course of business for which the service is performed, or the service is performed outside all of the places of business of the enterprise for which the service is performed, or the individual is responsible, both under the contract and in fact, for the costs of the principal place of business from which the service is performed; and
(3) The individual is customarily engaged in an independently established trade, occupation, profession, or business, of the same nature as that involved in the contract of service, or the individual has a principal place of business for the business the individual is conducting that is eligible for a business deduction for federal income tax purposes; and
(4) On the effective date of the contract of service, the individual is responsible for filing at the next applicable filing period, both under the contract of service and in fact, a schedule of expenses with the Internal Revenue Service for the type of business the individual is conducting; and
(5) On the effective date of the contract of service, or within a reasonable period after the effective date of the contract, the individual has established an account with the Washington Department of Revenue, and other state agencies as required by the particular case, for the business the individual is conducting for the payment of all state taxes normally paid by employers and businesses and has registered for and received a unified business identifier number from the state of Washington; and

(6) On the effective date of the contract of service, the individual is maintaining a separate set of books or records that reflect all items of income and expenses of the business which the individual is conducting.

The Court found that the franchisees that were considered workers did not meet the requirements of Section (3), in that the franchisees were not engaged in independently established businesses. The Court based its decision on the fact that most franchisees were not in the commercial cleaning business before they bought their franchises, and the franchise agreement contained a one year post-termination non-compete, which meant that the franchisees actually had to terminate their businesses on the termination of the franchise agreements. The Court found these factors sufficient to hold that the franchisees were not in independently established businesses and therefore remained workers.

Having determined that whether each franchisee had actually hired others was the dispositive factor, the Court sent the case back to the Board of Industrial Insurance Appeals to determine which franchisees had actually hired others to help with the cleaning services.

C. *United States Department of Labor v. Jani-King of Oklahoma Inc.* Case number 5:16-cv-1133-W, U.S. District Court for the Western District of Oklahoma

The Federal Department of Labor ("DOL") had been conducting audits of janitorial franchise companies for several years. The previous Administrator of DOL's Wage and Hour Division, David Weil, is well known for his belief that franchising is one example of a fissured workplace, and that janitorial franchise companies (along with hotels and restaurants) are prone to the wage and hour law violations that plague fissured workplaces. So it came as no surprise when DOL began pursuing a janitorial franchise company. But Jani-King was not the first janitorial franchisor that DOL pursued. In 2015, DOL filed suit against a master franchisee in the Heits Building Services franchised system. *Perez v. Grammatico Enterprises, Inc.*, U.S. District Court of New Jersey, case no. 2:15-cv-07054. In this case, the DOL alleged that all unit franchisees were actually employees. This master franchisee lacked the resources necessary to defend, and so in May 2016, quickly settled the case by seemingly acquiescing to all DOL demands. Grammatico now uses subcontractors instead of franchisees.

On the heels of this "win," on September 29, 2016, DOL filed suit against a Jani-King subsidiary, Jani-King of Oklahoma, Inc. ("JKOK") alleging that JKOK failed to maintain records of employees, including payroll records, hours worked, and wages paid. Notably, the DOL did not allege that minimum wage or overtime violations had occurred. JKOK filed a Motion to Dismiss, arguing that the Complaint failed to state a claim on which relief can be granted (insufficient factual allegations such as claiming corporations and limited liability companies were employees), and that the Complaint did not include indispensable parties (the unit franchisees).

On March 20, 2017, the Court granted JKOK's Motion to Dismiss on the insufficient factual allegations argument, leaving the door open for DOL to file an amended Complaint. The Court noted that the FLSA defines "employee" to mean any <u>individual</u> employed by an employer. 29 U.S.C. § 203(e)(1). In agreeing with JKOK, the Court noted that, based on the plain words of the statute, corporate and limited liability company franchisees could not be employees. The DOL had alleged that all of JKOK's franchisees were employees, making no distinction between individual franchisees and entity franchisees. The Court found this allegation was conclusory, and nothing more than a "naked assertion" devoid of further factual enhancement. The Court then held that the allegations in the Complaint were not sufficient to support the reasonable inference that JKOK had violated the FLSA in connection with each and every franchisee. The Court left open the option of DOL filing an amended complaint.

DOL did file an Amended Complaint on April 10, 2017. In this Complaint, the DOL has changed its reference to the franchisees from "persons" to "individuals" and has included allegations that the franchisee's business entities were formed as a requirement from the franchisor to purchase the franchise. The DOL is apparently still contending that even the business entity franchisees should be converted to employees. JKOK is expected to file another Motion to Dismiss.

FPR Guidelines (NASAA Commentary):

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New FPR Commentary

A. Background

The Federal Trade Commission's Amended Franchise Rule permits a franchisor to disclose financial results in Item 19 of a franchise disclosure document (FDD), provided the franchisor has a "reasonable basis" for the representation. Item 19 is seen as a valuable tool for sharing financial performance information with prospective franchisees. It is noteworthy that Item 19 is voluntary, and the only truly voluntary component of disclosure in the FDD.

"A franchisor electing to make a Financial Performance Representation must, among other things, have a reasonable basis and written substantiation for the representation at the time it is made and disclose the bases and assumptions underlying the representation in Item 19." 16 CFR Parts 436 and 437.

The FTC Rule does not specifically define what constitutes a "reasonable basis." Reasonable basis has been generally defined in other contexts, but in the contexts reviewed, reliance on the specific facts of the case and the underlying supportive information is fundamental to any determination that a reasonable basis does or does not exist.

In the securities context, the reasonable basis standard can act as a safe harbor where a statement, made with a reasonable basis, is not fraudulent, but a statement made without a reasonable basis can be characterized as an "untrue statement" if done knowingly or recklessly. *U.S. Sec. & Exch. Comm'n v. Ustian*, 2017 WL 365572, No. 16C33885 (N.D. Ill. Jan. 24, 2017).

In the tax context, the reasonable basis standard is used in understatement cases. When describing whether an understatement under 26 U.S.C. §6662(B) is unreasonable, the statute refers to underlying facts that are adequately disclosed creating a reasonable basis for the understatement. However, a reduction does not occur if the understatement is attributable to a tax treatment that does not accurately reflect the income of the corporation. Therefore, if the underlying facts to an understatement are inaccurate, there is no reasonable basis.

The New FPR Commentary reflects an attempt to respond to questions raised by franchisors, their representatives and state franchise examiners about FPRs. *See* North American Securities Administrators Association, Inc. (NASAA), NASAA Legal Department, Notice of Request for Comments Regarding A Proposed Franchise Commentary on Financial Performance Representation, p. 1, (proposed Sept. 14, 2016), *available at* https://goo.gl/So6exk (last visited Apr. 14, 2017). The primary rationale for the New FPR Commentary appears to be to clarify what constitutes a "reasonable basis" by establishing a set of guidelines and standards to govern the disclosure of financial results in Item 19, the support or factual basis which franchisors will be required to provide when making certain types of FPRs, including use of data sets and implementing defined terms, as well as prohibiting or restricting certain disclosures. Theresa Leets, ET AL., Regulatory Update, American Bar Association 39th Forum on Franchising, p. 27-29 (2016).

Theoretically, the rationale of the New FPR Commentary seems consistent with the approach taken by experienced practitioners in advising and assisting their franchisor clients in the preparation of FPRs for years. It has been understood that what constitutes a reasonable basis for an FPR is fact-specific and will vary from FPR to FPR. But the basis and assumptions for the FPR must be clearly stated and defined in the FPR, and written factual information must be possessed by the franchisor that reasonably supports the representations in the FPR, as it would be reasonably understood by a reasonable prospective franchisee – like a prudent businessperson making an investment decision. FED. TRADE COMM’N, FTC RULE COMPLIANCE GUIDE 85-94, available at, https://goo.gl/TDWTPZ (last visited Apr. 20, 2017).

Both the rationale and the practitioners’ approach would seem only positively enhanced by requiring definitions of the key terms as noted below, inclusion of the median and averages, when either is used, and describing the material differences between information presented about company-owned outlets and operational franchise outlets.

The sections below address the following key topics of the New FPR Commentary: (1) defined terms; (2) averages and medians; (3) high and low data; (4) gross sales data for company-owned outlets; (5) gross profit and net profit data for company-owned outlets; (6) data for managed outlets; (7) merging data for company-owned outlets and operational franchised outlets; (8) preparing subsets; (9) using cost and expense data alone; (10) applying historical data to forecasts (and projections); and (11) using disclaimers and waivers. Finally, the update concludes with an analysis of recent Item 19 litigation.

NASAA is expected to adopt the New FPR Commentary, without significant revisions in late 2017 to become effective in early 2018. The effective date is set forth as the later of 180 days after the date of NASAA’s adoption or 120 days after the franchisor’s next fiscal year end, if it has an effective FDD as of NASAA’s adoption date. The effectiveness of the New FPR Commentary will apply to updates made after the effective date.

There have been several articles urging compliance with the New FPR Commentary prior to its effectiveness, as certain state examiners have indicated that they plan to refer to the New FPR Commentary when reviewing FPRs especially during the 2017 renewal periods. Given the purported rationale for the New FPR Commentary to clarify “reasonable basis,” state examiners now have increased bandwidth to provide comments regarding “reasonable basis~~”~~.”

Any franchisor that elects not to follow the New FPR Commentary should consider the FTC Rule FAQ #38 which addresses the following point - if a franchisor is required by a state to modify a FPR, can the unaltered FPR be delivered to prospective franchisees in other states? The FAQ indicates that a failure to make the changes to the FPR in all of the other states will raise concerns as to whether the FPR meets the FTC Rule’s requirements. FED. TRADE COMM’N, FTC RULE FAQ’S, QUESTION AND ANSWER 38, *available at* https://goo.gl/28A133 (last visited Apr. 14, 2017).

This provides additional incentive to a franchisor who receives comments to its FPR from a state to absorb the time and cost associated with amending registrations in all of the states in which the franchisor is registered based on the FPR comments and changes.

B. Summary of Changes

1. Using Defined Terms:

Disclosures must include defined terms describing the data and identifying the sources of the data. The following defined terms are included in a definition section of the New FPR Commentary as follows:

- *Average*, also known as the "mean," means the sum of all data points in a set, divided by the number of data points in that set.

- *Company-owned outlet* means an outlet owned either directly or indirectly by a franchisor, by an affiliate of the franchisor, or by any person required to be identified in Item 2 of the franchisor's FDD, which operates a substantially similar business under the same brand as the business the franchisor offers to franchisees. It also includes any such outlet that: (i) is operated as a joint venture owned in part by a franchisor, by an affiliate of the franchisor, or by a person required to be identified in Item 2; and (ii) is managed by the franchisor, an affiliate of the franchisor, or by a person required to be identified in Item 2.

- *Operational franchise outlet* means an outlet operated under a franchise agreement that: (i) is not a Company-owned outlet; and (ii) has been fully operational for one full year or, in the case of franchise systems that operate seasonally, for at least one full season. It also includes any such outlet that: (i) is owned by a franchisee; and (ii) is managed by the franchisor, an affiliate of the franchisor, or a person required to be identified in Item 2.

- *Gross profit* means gross sales minus cost of goods sold, or minus the cost of providing services for a franchise system that offers services.

- *Gross sales* means the total revenue derived from the sale of goods or services less sales tax, discounts, allowances, and returns.

- *Managed outlet* means any outlet that: (i) is owned by a person that is not a franchisee, the franchisor, an affiliate of the franchisor, or a person required to be identified in Item 2; and (ii) is managed by the franchisor, an affiliate of the franchisor, or by a person required to be identified in Item 2.

- *Median* means the data point that is in the center of all data points used. That number is found by examining the total number of data points and finding the middle number in that set. In the event the number of data points is an odd number, the median will be the center number. If the data set contains an even number of data points, the median is reached by taking the two numbers in the middle, adding them together, and dividing by two.

- *Net profit* means gross profit minus all ordinary and recurring operating expenses, interest, income taxes, depreciation, and amortization.

2. Averages and Medians:

Averages can be used in an FPR if the franchisor also discloses the Median of those numbers, because the existence of any outliers may skew the average and thereby make the disclosure misleading—even if the calculation is accurate. Similarly, a disclosure of Medians must also include the Average of those numbers even if the calculation is accurate.

Averages and Medians may exclude data from Company-owned outlets and Operational franchise outlets closed during the time period covered by the FPR, if it also discloses: (i) the number of Company-owned outlets that closed during the time period, if the FPR includes Company-owned outlets; (ii) the number of franchise outlets that closed during the time period, if the FPR includes Operational franchise outlets; and (iii) the number of excluded outlets that closed during the same time period after being open less than 12 months. This disclosure should cover each year or other period of time covered in the FPR.

3. High and low data:

Whenever disclosing Averages of Gross sales or using Medians, the FPR must also include the highest and lowest number in a range (e.g., if an Average monthly Gross sales number is presented in the FPR, the franchisor must also present the highest and lowest monthly Gross sales from the sample used).

4. Gross sales data for Company-owned outlets:

A franchisor with any Operational franchise outlets cannot make an FPR based on Gross sales. A franchisor without any Operational franchise outlets may base an FPR on Gross sales, if doing so would be reasonable, and if the representation describes any material financial and operational differences between Company-owned and Operational franchise outlets. Note: It is unclear why the New FPR Commentary does not permit a franchisor with Operational franchise outlets to make an FPR on Gross sales of Company –owned outlets as long as it also includes data on the Operational franchise outlets.

5. Gross profit and Net profit based on Company-owned outlets:

A franchisor may make an FPR based on Gross profit or Net profit based on Company–owned outlet data, as long as the franchisor accounts for material financial and operational differences between Company-owned outlets and Operational franchise outlets in the FPR. Wherever franchisees would likely incur additional or higher costs, these costs must be presented in the Company-owned outlet P & L. These would include (in a pro forma or imputed fashion) royalties, advertising fund contributions or any other fees paid by franchisees if these fees are not paid by the Company-owned outlets or are paid by the Company-owned outlets at a different rate than franchisees, and other costs which franchisees incur which are not incurred in a Company-owned outlet. The information must be presented in the same manner as the rest of the FPR. However, this excludes use of footnotes and if a tabular format is used, the additional data would be included or added to the table. Any adjustments or supplemental disclosure must be in the same format as the rest of the FPR.

6. Data for Managed outlets:

A franchisor may provide an FPR containing Managed outlet data as long as the results of Managed outlets are not materially different from the results of other outlets presented. A franchisor may characterize a Managed outlet as any of the following categories of data in a FPR: (i) a Company-owned outlet category; (ii) an Operational franchise outlet category; or (iii) a separate Managed outlet category. If the results of Managed outlets are materially different from the results of other outlets included in the FPR, the franchisor may not include results of Managed outlets in the FPR.

7. Merging data on Company-owned outlets and Operational franchise outlets:

Generally, franchisors may not merge data on Company-owned and Operational franchise outlets with two exceptions. First, the franchisor may present the data in a combined format after separately presenting data for Company-owned outlets and Operational franchise outlets. Second, the franchisor may merge the data if there are too few franchisees (determined to be less than 10)—making the franchisee data discernible—and the Operational franchise and Company-owned outlets each has Gross sales that are not materially different.

8. Preparing subsets:

There must be at least 10 outlets to base an FPR on a subset. If presenting a subset of best performers (e.g., top 10%), the franchisor must also present a corresponding subset on lowest performers (e.g., bottom 10%). Note: Subsets can be and seem intended to be covered most effectively by the use of supplemental FPRs.

9. Cost and expense data alone:

Presenting cost or expense data alone is not an FPR; however, a franchisor that makes an FPR disclosing Gross sales alone may not separately provide cost or expense data outside of the FPR from which a prospective franchisee could readily calculate average Net profits.

10. Applying historical data to forecasts (projections):

The New FPR Commentary combines the concept of forecasts and projections. Forecasts (projections) must be based on historical data and a reasonable sample size—and cannot be based on hypothetical situations or expectations. Historical results may be adjusted or supplemented based on market changes (e.g., when the current rents are higher/lower than historic rents). Forecasts (projections) must be based on historical data from outlets substantially similar to the type of outlet offered in the FDD. Bottom line, projections must be based on the brand being offered and the use of forecasts/projections appear to have been eliminated and replaced with using historical data.

11. Prohibiting disclaimers and waivers:

A clear and conspicuous admonition means it is disclosed as a separate paragraph in bold type without any additional formatting (e.g., no capital letters, small caps, underlining or larger type). The admonition may not vary from the prescribed language in the New FPR Commentary. If the FPR is not based on Gross sales (e.g., hotel occupancy rates), modification to the admonition is permitted. The admonition under the New FPR Commentary must be presented in a separate paragraph from the rest of the FPR and in bold, like this for example:

"Some outlets have earned this amount. Your individual results may differ. There is no assurance that you'll earn as much."

See FPR Commentary 19.22.

C. Recent Item 19 cases:

The guidelines established in the New FPR Commentary arrive while a few interesting Item 19 cases are playing out in court and in the press. In a case recently filed by Pie Five franchisees, the complaint against the franchisor asserts several claims under state and federal law for deceptive trade practices and fraud, and it includes claims against the franchisor for violations of Items 8 and 19. Generally, the franchisees allege that the franchisor disclosed misleading information about the chain's sales and profitability in Item 19. *See* Complaint, *Carl A. Dissette et al. v. Pie Five Pizzo Co., Inc., et al*., No. 1:16-vc-11389 (N.D. Ill. Dec. 15, 2016); *see also* Jonathan Maze, *Pie Five closes 9 restaurants amid lawsuit*, NATION'S RESTAURANT NEWS, Mar. 22, 2017, available at https://goo.gl/SMiVpW. In their complaint, the franchisees touch on a few items addressed by the New FPR Commentary, including the following (non-exhaustive) allegations:

- **Misleading profitability**: Use of misleading Company-owned outlet data by (1) disclosing select subsets of Company-owned outlets, and (2) not including any data on Operating franchise outlets to falsely represent profitability.

- **Failing to define and describe sources of data:** Failure to identify sources of data, including neglecting to differentiate material financial and operational differences between Operational franchise outlets and Company-owned outlets, pointing to the royalty fees paid by franchisees as a key difference the franchisor should have disclosed.

- **Misleading geographical subsets:** Failure to explain differences in geographic markets by concealing data related to the difficulty of achieving sales in new markets.

- **Misleading high and low data:** Use of tiers to group performance into categories intended to disguise weak performance.

Currently, based on the court docket as of April 19, 2017, this case is in its early pretrial stages, with Pie Five having filed a motion to dismiss.

Another example involves a case in which Papa Murphy's franchisees allege that the franchisor misrepresented financial information by presenting "heavily skewed" data. Mike Francis, *Second set of franchisees sue Papa Murphy's charging it misled them*, THE OREGON LIVE, June 19, 2014, available at https://goo.gl/aSMhF2 (last visited Apr. 20, 2017); *see also* Fourth Amended Complaint, *LMP Enter. LLC et al. v. Papa Murphy's Int'l LLC, et al.*, No. 14-2-00904-0 (Super. Ct. Wash. Nov. 14, 2016). Papa Murphy's franchisees' claims relate to the following (non-exhaustive) items addressed the New FPR Commentary:

- **Misleading methodology:** Alleges that the franchisor grouped performance of outlets into tiers made up of data having materially different characteristics, and that the tier system concealed poor performance based on the location of an outlet and/or the newness of the outlet.

- **Fraudulent use of geographical data**: Alleges that the franchisor knew that the success of a store depended on where it was located in the U.S., and thus fraudulently failed to disclose material differences in data based on geography. For example, franchisees allege that outlets in certain regions had to incur two or three times the amount in marketing costs compared to outlets in other regions, and outlets in certain regions achieved 30% less in sales compared to outlets in the rest of the system.

- **Failing to describe sources of data**: Alleges that the franchisor neglected to disclose the sources and integrity of data, particularly claiming the franchisor omitted information that would inform them that struggling outlets had failed to submit P & L statements, and were not represented in the performance data disclosed.

According to the court docket as of April 19, 2017, the case is currently in the discovery phase.

D. Conclusion:

Most of the changes described in the New FPR Commentary appear reasonably suited to the purpose of enhancing a prospective franchisee's understanding of the data presented, particularly with respect to highlighting performance that is aligned with or materially different than the prospect's anticipated performance. Two changes in the Commentary that do not seem consistent with this purpose are: 1) the prohibition on the use of Gross sales data of Company-owned outlets when the franchisor has both Company-owned outlets and Operational franchise outlets; and 2) the combining of, or perhaps more accurately, the non-existent use of forecasts and projections. With respect to the Gross sales issue, permitting Gross sales data when both Company-owned outlet and Operational franchise outlet information is used would be a preferable approach. With respect to the treatment of forecasts and projections, the requirement that historical information be used mitigates against the practical use of forecasts or projections as typically understood in business, financial and accounting circles.

When the UFOC guidelines, and then later the FTC Rule and amendment adopted the reasonable basis standard, the burden for compliance shifted from legislated dictates to the marketplace, and to the franchisors who were required to maintain, analyze and present data that is clear, defined and properly sourced and identified. FED. TRADE COMM'N, STAFF REPORT TO

THE FED. TRADE COMMISSION & PROPOSED REVISED TRADE REGULATION RULE 159-160 (2004), *available a*t https://goo.gl/RReojb (last visited April 24, 2017).

Because Reasonable Basis is a standard that is fact specific and does not lend itself to formulaic or rigid requirements, an increasingly inflexible approach to FPRs would seem to take FPRs back to a time when the FTC Rule's requirements were viewed as too onerous to satisfy and the UFOC Guidelines had an Item 19 and an Alternate Item 19 (Item 19A), both of which were viewed by practitioners as generally undesirable and impractical formats. RUPERT BARKOFF ET AL., FINANCIAL PERFORMANCE REPRESENTATIONS: THE NEW AND UPDATED EARNINGS CLAIMS 3-6 (Stuart Hershman & Joyce Mazero eds., 2008). For example, start-up franchisors without company-owned outlets were prohibited from making any earnings claim because the earnings claim had to be based on the specific system's experience. *Id*. at 4. The previous stringent approaches to Item 19 were a significant reason contributing to the low percentage of franchisors making FPRs.

While there has not been any report as of the date of this paper describing a significant number of cases concerning the preparation of FPRs under current Item 19, and assuming there is compelling anecdotal and other evidence supporting the changes in the New FPR Commentary, some consideration should be given to whether franchisors and franchisees instead would both benefit from increased training and education. The training and education should focus on best practices applicable to methodologies for obtaining, analyzing and presenting data in an FPR, as well as on the due diligence required to demonstrate whether a potential investment is worthy of pursuit.

Cybersecurity Exposure:

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Recent activity in the field of data protection, privacy, and cybersecurity continues to directly impact franchise companies. Judicially driven developments in the past year signal an ongoing (if not increasing) need for franchise companies to pay careful attention to this subject. A few of the highlights include:

I. Allegations of Fair and Accurate Credit Transactions Act ("FACTA") violations.

FACTA, passed in 2003, prohibits retailers from issuing an electronically-printed credit card (or debit card) receipt that includes: (1) the card's expiration date; and/or (2) more than the last five digits of the customer's credit card number. 15 U.S.C. § 1681c(g)(1). Similar requirements are found in the private agreements that vendors sign with card issuers, that is, the PCI-DSS standards that are established by the PCI Security Standards Council (a joint effort of credit card issuers, such as American Express, Discover, JCB, MasterCard, and Visa to set security standard for payment account security). Under those standards:

> Businesses must physically secure or restrict access to printouts of cardholder data, to media where it is stored, and devices used for accessing or storing cardholder data. It's important to understand that PCI is about protecting both electronic data and paper receipts as well.4

Some of the cases that addressed FACTA in the last year are summarized below:

A. *Flaum v. Doctor's Associates, Inc.* 204 F.Supp.3d 1337 (S.D. Fla. 2016)

This case involved a consumer's class-action suit against Doctor's Associates, Inc. ("DAI"), the franchisor of the "Subway" system. Here, Flaum, the plaintiff, alleged that DAI violated FACTA because he received a transaction receipt containing his full credit card expiration date after he made a purchase at a franchisee-owned "Subway" shop in Pompano Beach, Florida. A related case, *Alan v. Doctor's Associates, Inc.*, was filed in California on July 6, 2016 and subsequently consolidated with the consent of the parties into the *Flaum* case in Florida. *Alan v. Doctor's Associates, Inc.*, No. 2:16-CV-04945 (C.D. Cal. July 6, 2016).

Flaum sought statutory damages for the class in the amount of $100 to $1,000 per receipt. DAI moved to dismiss, arguing that the plaintiff lacked standing and that the court had no subject matter jurisdiction to hear the case because, *inter alia*, Flaum failed to allege injury in fact.

The court's discussion of whether DAI – as the franchisor – was responsible for a franchisee's alleged statutory violation consisted of a single sentence summarizing the plaintiff's allegation:

[4] PCI Security Standards Council, "PCI DSS Quick Reference Guide," May 2016 (https://www.pcisecuritystandards.org/documents/PCIDSS_QRGv3_2.pdf?agreement=true&time=1492975933410).

> Doctor's Associates operates under the brand name "Subway" and exercises control over its individually-owned franchise restaurants; Doctor's Associates' control over Subway includes dictating the point of sale ("POS") terminal used at its franchise locations.

204 F.Supp.3d at 1338. DAI argued that even if the alleged facts were true, it was still entitled to dismissal. *Id*. at 1339. However, the Court denied DAI's motion.

In *Flaum*, DAI argued that its franchisee's failure to provide a proper receipt was merely a "bare procedural violation" of FACTA and that, therefore, there was insufficient injury to establish subject matter jurisdiction. The court reviewed the standard and, in relevant part, whether it was necessary for the plaintiff to prove that it had suffered actual injury where there was an allegation of a statutory violation.

The *Flaum* decision – issued in August 2016 – cited a May 2016 Supreme Court decision involving an allegation of statutory violations of the Fair Credit Reporting Act. *Spokeo, Inc. v. Robins*, 136 S. Ct. 1540 (2016). In *Spokeo*, the Court wrote that: "[t]he violation of a procedural right granted by statute can be sufficient in some circumstances to constitute injury in fact; in such a case, a plaintiff need not allege any *additional* harm beyond the one identified by Congress." *Id*. at 1544 (emphasis supplied). Thus, the Supreme Court in *Spokeo* did not completely open or close the door, but, rather, indicated that further review was needed to establish whether an alleged violation of a statutory procedural right was – of its own accord – enough to show the "concrete harm" needed to provide standing.[5]

Citing *Spokeo*, the *Flaum* court concluded that Congress, when enacting FACTA, had intended to create a substantive privacy right for consumers.[6] Thus, the court concluded that the

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[5] A contrast to the *Spokeo* and *Flaum* treatment of a statutory violation may be found in a recent case with significant implications for franchisors: the Third Circuit decision in Wyndham's challenge to the FTC's administrative case involving an alleged data breach at certain Wyndham-branded hotels. In *FTC v. Wyndham Worldwide Corp.*, 799 F.3d 236, 255–56 (3d Cir. 2015), the Third Circuit threw cold water on the FTC's contention that an alleged unfair and deceptive practice led to injury, e.g., due to possible identity theft, without having to prove that subsequent injury (e.g., identity theft) actually occurred. The court wrote that relevant inquiry under the FTC Act "asks whether 'the act or practice <u>causes or is likely to cause substantial injury</u> to consumers which is <u>not reasonably avoidable</u> by consumers themselves and not outweighed by countervailing benefits to consumers or to competition.' While far from precise, this standard informs parties that <u>the relevant inquiry here</u> is a cost-benefit analysis, that considers a number of relevant factors, including the probability and expected size of <u>reasonably unavoidable harms</u> to consumers given a certain level of cybersecurity <u>and the costs to consumers that would arise from investment in stronger cybersecurity</u>." *Id*. at 255–56 (citations omitted; emphasis added). Shortly after that decision was handed down, the FTC and the company resolved the case in a settlement that did not impose obligations on the franchisor with respect to franchisee-operated hotels.

[6] The court's conclusion in *Flaum* is essentially the same as that reached by other courts examining alleged FACTA violations of a similar nature before and after *Spokeo*. *See, e.g., Church v.*

plaintiffs had suffered "concrete harm" and denied the defendant's motion to dismiss. Within several months, the parties resolved the dispute with the court's approval of a $31 million dollar settlement, reported to be one of the largest in a FACTA case.[7]

B. *Strubel v. Comenity Bank* **842 F.3d 181 (2d Cir. 2016)**

Spokeo led to a different line of reasoning in the Second Circuit, where in a November 2016 decision, the Court of Appeals concluded that an alleged violation of the Truth in Lending Act was not sufficient on its own to establish standing where the plaintiff could not show an effect from the alleged violation. Rather, the Second Circuit concluded in *Strubel* that:

> [W]e understand *Spokeo*, and the cases cited therein, to instruct that an alleged procedural violation can by itself manifest concrete injury where Congress conferred the procedural right to protect a plaintiff's concrete interests <u>and</u> where the procedural violation presents a "risk of real harm" to that concrete interest. But even where Congress has accorded procedural rights to protect a concrete interest, a plaintiff may fail to demonstrate concrete injury where violation of the procedure at issue <u>presents no material risk of harm</u> to that underlying interest.

Id. at 190. The *Strubel* court concluded that the plaintiffs did not show sufficient risk of harm to a concrete statutory interest, affirmed the award of summary judgment to the defendant bank, and also affirmed dismissal of the class certification. *Id*. at 200-01.

Another FACTA case, decided earlier this year, cited *Strubel*. In *Cruper-Weinmann v. Paris Baguette Am., Inc.*, 2017 WL 398657, at *2 (S.D.N.Y. Jan. 30, 2017), the court granted a motion to dismiss in a FACTA case where the plaintiff "does not allege that she suffered identity theft as a result of the printing of the receipt, or that anyone else ever saw or accessed the receipt."

Accretive Health, Inc., 654 F. App'x 990, 993 (11th Cir. 2016) ("An injury-in-fact, as required by Article III, 'may exist solely by virtue of statutes creating legal rights, the invasion of which creates standing....'"); *Hammer v. Sam's E., Inc.*, 754 F.3d 492, 498–99 (8th Cir. 2014) ("Congress gave consumers the legal right to obtain a receipt at the point of sale showing no more than the last five digits of the consumer's credit or debit card number. Appellants contend that Sam's Club invaded this right. ... Thus, we conclude that appellants have alleged an injury-in-fact sufficient to confer Article III standing."); *Wood v. J Choo USA, Inc.*, 201 F.Supp.3d 1332, 1338 (S.D. Fla. 2016) (customer suffered harm as soon as the improper receipt is printed, and need not prove subsequent identity theft); *Guarisma v. Microsoft Corp.*, 209 F.Supp.3d 1261, 1264 (S.D. Fla. 2016) (violation of FACTA sufficient to create concrete-injury without more); *Korman v. Walking Co.*, 503 F.Supp.2d 755, 759 (E.D. Pa. 2007) (no need for proof of actual harm, such as identity theft; Congress provided for statutory damages even if some consumers could not prove "actual damages"); and *Ehrheart v. Lifetime Brands, Inc.*, 498 F.Supp.2d 753, 755 (E.D. Pa. 2007) ("FACTA, however, created a right to electronically printed receipts that truncate the consumer's credit card number and which do not print the expiration date of the consumer's credit card.").

[7] Steven Trader, "Judge OKs Subway's Record $31M FACTA Settlement," <u>LAW360</u>, Mar. 23, 2017 (https://www.law360.com/articles/905386).

This line of cases demonstrates that there is a substantive split in the circuits, and that another trip to the Supreme Court is possible, if not likely, in the near future.

II. Claims Flowing from Data Breaches.

Data breaches continue to be one of the most prevalent, and newsworthy, topics in the cybersecurity field. The potentially destructive consequences of a serious data breach are widespread, particularly with respect to a company's brand name and business reputation. Paradoxically, that impact may be mitigated by the sheer magnitude and scope of data breaches that occur and are reported with seemingly routine frequency. However, frequency typically doesn't resolve claims of injury, and some companies that have sustained a data breach may find that additional headaches if and when the breach issue is litigated.

A. *Irwin v. Jimmy John's Franchise, LLC* 175 F.Supp.3d 1064 (2016)

In *Irwin*, the plaintiff brought a class-action suit against the defendants claiming that she suffered injury (namely, fraudulent use of her credit card) as a result of a data breach at "Jimmy John's" restaurants that allegedly exposed customers' personal and financial information. Defendant filed a motion to dismiss. The court granted the motion in part and denied the motion in part.

The case stemmed from a data breach that allegedly occurred in early 2014. At that time, Barbara Irwin visited a franchisee-owned "Jimmy John's" restaurant in Arizona. She used her debit and credit cards to complete transactions. In July 2014, the company learned it was the victim of a data breach; however, the company did not announce the data breach until September 24, 2014. Ms. Irwin alleged that her credit card was fraudulently used at least five times in the intervening period, and that those fraudulent uses of her credit card were directly related to the "Jimmy John's" breach. Subsequently, Ms. Irwin filed a nine-count complaint alleging violations of common law, as well as violations of Illinois and Arizona state law. The Jimmy John's defendants filed a motion to dismiss all of the claims.[8]

Of the nine complaints, the court dismissed all but two. The court allowed a claim under Illinois law for breach of implied contract and a claim under the Arizona Consumer Fraud Act. Of the two claims, the court's decision to let the breach of implied contact claim stand likely has the furthest reaching impact. There, the court concluded that:

> Under the circumstances, and under Illinois law, Irwin has stated a claim for breach of implied contract. There was an offer, acceptance, consideration, and a meeting of the minds. When the customer uses a credit card for a commercial transaction, he intends to provide the data to the merchant, and not to an unauthorized third party. There is an implicit agreement to safeguard the customer's information to

[8] The decision includes no discussion of why the franchisor was alleged to be responsible for the data breach at a franchised location.

> effectuate the contract. Irwin has alleged the existence of an implied contract obligating Jimmy John's to take reasonable measures to protect Irwin's information and to timely notify her of a security breach.

Id. at 1070-71. Thus, the court was willing to entertain the notion that the mere act of completing a commercial transaction is enough to create an affirmative duty for a franchisee (and likely the franchisor), and due to that factual question, the court would not grant the companies' motion to dismiss.[9]

In another case, a different federal trial court in Illinois addressed the issue while also contrasting the relationship of a consumer (and the retailer) with that of a credit-card issuing bank (and the retailer). There, the court concluded that while the consumer may have a plausible argument that it had an implied contract with the retailer, the bank did not:

> The relationship between a cardholder and a merchant is unique from that between the Plaintiffs (issuing financial institutions) and Schnucks (a supermarket). It is easier to see how a contract might be implied between a cardholder and a merchant where the cardholder provides payment and walks away with tangible goods such as groceries, and in exchange the merchant receives electronic payment thus giving them value for the goods. This elementary transaction much more clearly contains the basic principles of a contract than the relationship between financial institutions and merchants.

Community Bank of Trenton v. Schnuck Markets, Inc., 210 F.Supp.3d 1022 (S.D. Ill. 2016).

B. *Torres v. Wendy's Co.* 195 F.Supp.3d 1278 (M.D. Fla. 2016)

This case arose from well-publicized hacks into the computer systems at various "Wendy's" restaurants in the U.S. These hacks, which allegedly originated with the installation of

[9] The *Irwin* court cited a First Circuit case upholding denial of summary judgment in a similar fact pattern. *Anderson v. Hannaford Bros. Co.*, 659 F.3d 151, 159 (1st Cir. 2011) ("a jury could reasonably find an implied contract between Hannaford and its customers that Hannaford would not use the credit card data for other people's purchases, would not sell the data to others, and would take reasonable measures to protect the information."). *See also In re Target Corp. Data Sec. Breach Litig.*, 66 F.Supp.3d 1154, 1177 (D. Minn. 2014) (The consumer plaintiffs "plausibly alleged the existence of an implied contract as well as its terms, and this allegation is sufficient to allow the claim to go forward."); *In re Michaels Stores Pin Pad Litig.*, 830 F.Supp.2d 518, 531–32 (N.D. Ill. 2011) (citing *Hannaford Bros.*, above). *Cf. Enslin v. Coca-Cola Co.*, No. 2:14-CV-06476, 2017 WL 1190979, at *14 (E.D. Pa. Mar. 31, 2017) (where employer spelled out its policy on collecting and using employee data, and there was a data breach, court declined to imply additional contract terms, and did not certify class action).

malware on certain "Wendy's" POS systems, led to the theft of customers' payment card data (e.g., credit and debit card information, expiration dates, card verification numerals, and PIN data for debit cards). Here, the plaintiff, Jonathan Torres, visited a "Wendy's" restaurant on January 3, 2016 and used his debit card to complete a transaction. Not long after that, Mr. Torres' credit union contacted him to inform him that his debit card was used to make sizeable purchases at two other retailers. Mr. Torres informed his credit union that the charges were fraudulent and he filed a police report.

The plaintiff brought a consumer class action alleging that the franchisor failed to adequately safeguard customer information against a breach. The defendant franchisor filed a motion to dismiss, which the court granted, although without prejudice.

Mr. Torres filed a three-count complaint, alleging breach of implied contract, negligence, and violations of Florida's Deceptive and Unfair Trade Practices Act. The defendants filed a motion to dismiss, arguing that Mr. Torres lacked standing to bring the case. To have establish standing, the Plaintiff must show that (1) the plaintiff suffered or will imminently suffer an injury-in-fact; (2) a causal connection exists between this injury and the defendant's conduct; and (3) the plaintiff's injury is likely to be redressed by a favorable decision.

Here, the court noted that the plaintiff did not allege any out-of-pocket loss, but instead claimed that by having his information stolen, he faced the "imminent, immediate, and continuing risk of harm from identity theft and identity fraud."

The court's analysis focused on whether the plaintiff had suffered an "injury-in-fact." The court stated that to establish injury-in-fact, the plaintiff must demonstrate "a legally cognizable interest that has been or is imminently at risk of being invaded." Generally, "allegations of possible future injury are not sufficient." *Id*. at 1281.

The *Torres* court noted that the plaintiff did not suffer any actual monetary loss as the result of the breach, as Mr. Torres' credit union refunded the fraudulent charges on his card. The court also agreed with Wendy's that injury sufficient to establish standing did not arise from the speculative concept that there might be future unreimbursed harm to the class members stemming from the data breach ("[t]he majority of courts … have rejected the threat of future harm in data breach cases as insufficient to confer standing absent allegations that harm is "certainly impending."). *Id*. at 1283.

Usefully, the *Torres* court contrasted cases where the plaintiffs did show sufficient harm to get past a motion for dismissal and the instant case, where the customers' did not prove that they suffered losses. Among other things, the court noted that the possibility that the plaintiffs might later be unable to access their own accounts was neither clear nor imminent and therefore, they lacked standing to raise their claim against Wendy's.

C. *Lewert v. P.F. Chang's China Bistro, Inc.*
819 F.3d 963 (7th Cir. 2016)

Here, the Court of Appeals issued a decision in 2016 stemming from a 2014 data breach. While the plaintiffs in *Lewert* did not pay for any fraudulent charges, they did spend time and money (and in one case, purchased additional credit monitoring services) to keep track of any future identity theft. They brought a class action claim against the company. In contrast to *Torres*, Chief Judge Wood, writing for the Seventh Circuit, reversed the lower court in *Lewert* and concluded that there was sufficient injury, and therefore that standing had been established. The *Lewert* court held that:

> We identified two future injuries that were sufficiently imminent: the increased risk of fraudulent credit- or debit-card charges, and the increased risk of identity theft. These, we found, were not mere "allegations of possible future injury," but instead were the type of "certainly impending" future harm that the Supreme Court requires to establish standing.

Id. at 966. Quoting a California court (which in turn, was quoting from a Supreme Court decision), the *Lewert* court also wrote that:

> The plaintiffs "should not have to wait until hackers commit identity theft or credit-card fraud in order to give the class standing, because there is an 'objectively reasonable likelihood' that such injury will occur."

Id. (citations omitted).[10]

III. TCPA Cases

Fans of cases involving "junk faxes" will remember with a certain fondness the Telephone Consumer Protection Act (TCPA). Several recent cases illustrate that the TCPA, which bans the use of automated telephone equipment to place most commercial calls (47 U.S.C. § 227(b)(1)) lives on in the spaces created by new technology. In 2009, the U.S. Court of Appeals for the Ninth Circuit confirmed that "a text message is a 'call' within the meaning of the TCPA." *Satterfield v. Simon & Schuster, Inc.*, 569 F.3d 946, 952 (9th Cir. 2009).

A. *Keim v. ADF MidAtlantic LLC* *199 F.Supp.3d 1362 (S.D. Fla. 2016)*

The Plaintiff, Brian Keim, filed a class-action in May 2012, alleging that certain franchised "Pizza Hut" operators violated the TCPA by sending him and other consumers thousands of unwanted spam SMS messages. The four franchise operators that Keim sued own "Pizza Hut"

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10 The *Lewert* court also cited (*id*. at 966-67) the Seventh Circuit's 2015 decision of the Seventh Circuit in *Remijas* also found injuries "sufficient for standing in the time and money the class members predictably spent resolving fraudulent charges (even if the bank ultimately repaid those charges), as well as in the identity theft that had already occurred and in the time and money customers spent protecting against future identity theft or fraudulent charges." 819 F.3d at 966-67 (citing *Remijas v. Nieman Marcus Group, LLC*, 794 F.3d 688, 694 (2015)).

stores in a dozen states and jurisdictions.[11] Indeed, in this ruling the issue at hand was whether the defendants could be subject to jurisdiction in Florida on the basis of text messages sent to the plaintiff's phone number that has a Florida area code ("305"). The court concluded that the answer was "yes," finding that the "Defendants should have reasonably anticipated that sending the allegedly TCPA-violating text messages to a Florida resident's cell phone would cause harm in Florida." *Id*. at 1369.

B. *Van Patten v. Vertical Fitness Group LLC* 847 F.3d 1037 (9th Cir. 2017)

In *Van Patten*, the court affirmed the district court's grant of summary judgment in favor of the defendant gym operator. Here, the plaintiff had visited a "Gold's Gym" location in Wisconsin seeking information about becoming a member, and at that time, consented to receiving text messages. Later, the plaintiff cancelled his gym membership and moved to California. He continued to receive text messages from the gym operator (which had since left the "Gold's Gym" system and rebranded under the "Xperience Fitness" brand). In 2012, the plaintiff received two text messages to alert him to the fact of the rebranding and offering a discount if he were to rejoin. Within a short while, he filed a complaint and class action alleging TCPA violations.

On appeal, the Ninth Circuit concluded that although a consumer could revoke their prior express consent to receive a text message, here, the mere fact that Van Patten's cancelled his gym membership was not enough to revoke his consent to receive text messages. *Id*. at 1047. The Court of Appeals affirmed the lower court's grant of summary judgment.

C. *Lennartson v. Papa Murphy's Holdings, Inc. and Papa Murphy's Int'l LLC* 2016 WL 51747 (No. C15-5307 RBI) (W.D. Wash. 2016)

In this pre-*Spokeo* case, the court addressed a class action claim alleging TCPA violations from a text-message marketing campaign. Here, the plaintiff signed up to receive promotional messages and did not reply "STOP" to opt out when he received SMS text messages. Due to a change in FCC regulation, an issue arose as to whether the consent given to receive promotion messages was broad enough to constitute "required express consent" to satisfy the TCPA requirements given the re-interpretation of the FCC consent standard. A portion of this decision concerned interpretation of the law regarding deference to administrative agencies (here, the FCC).

Even though the court stayed its proceedings pending the Supreme Court's resolution of the then-pending *Spokeo* case (as to the question of whether there is automatic standard conferred without more from violation of a statutory right), the court also noted that the outcome of *Spokeo* was somewhat moot because the plaintiff had standing in that he "articulated actual harm" because they of the need to pay to receive SMS text messages. *Id*. at *4.

This case should be of interest to franchisors on the issue of consent. Franchisors and their

[11] *See also Agne v. Papa John's Int'l, Inc.*, 286 F.R.D. 559, 572 (W.D. Wash. 2012) (granting class certification to a group of plaintiffs complaining of TCPA violations involving a text marketing campaign involving certain "Papa John's" franchised restaurants.

ad agencies should consider whether they are justified in relying upon an understanding that their past practices were sufficient to have obtained the requisite degree of “required express consent” to send text messages to a consumer.

<u>Arbitration Enforcement Trend Increases</u>:

Craig Tractenberg, Partner
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ARBITRATION TRENDS TOWARDS ENFORCEMENT

I. Electronic assent to arbitration provisions gathering steam in franchise and other contexts.

In *Geselle v. Jack in the Box, Inc*. 3:14-CV-1092-BR (D. Or. Dec. 13, 2016), the district court was called upon to resolve tricky issues regarding arbitration in wage and hour disputes and joint employment six years after the case had first been filed. In 2010, employees of Jack-in-the Box in Oregon filed a class action for the violation of the minimum wage and overtime provisions under the Fair Labor Standards Act (FSLA), as well as various violations of Oregon law. Before the case came to trial, Jack in the Box sold selected company owned stores to franchisees. Among the several holdings on summary judgment was that an employee of the franchisee is not jointly employed by the franchisor. In addition, the decision provides some interesting holdings with respect to arbitration.

A. The Employee was required to arbitrate this case.

When Plaintiff Jason Diaz was 16 years old, he applied for a position at a Jack in the Box corporate location in 2008. Although he never wrote his signature with a pen, Diaz electronically signed the arbitration agreement as part of the new-hire process at Jack in the Box. Diaz affirmatively accepted the arbitration agreement by logging onto a CBT terminal, reviewing the agreement, clicking "yes" that he agreed to the terms, and entering his confidential password to record his agreement. Under Oregon law, that electronic signature is binding.

Although Mr. Diaz signed before he reached the age of majority, he had the opportunity to disaffirm the contract when he reached the age of majority, which in Oregon is the age of 18. The Court found that he had not timely disaffirmed the arbitration agreement when he reached the age of majority. The Court further held that he ratified this voidable contract by continuing to work in the restaurant; accordingly, the arbitration contract was valid and enforceable.

B. Unenforceable provisions of the arbitration clause were severable.

Mr. Diaz attacked the arbitration clause as illegal because the clause stated: "[n]either Employee nor Company shall be entitled to join or consolidate in arbitration claims . . . or arbitrate a representative action or a claim as a representative or member of a class." The Court held that this portion of the clause violates the mutual aid and protection clause of the NLRA, 29 U.S.C. § 157, and the collective action provision of the FLSA, 29 U.S.C. § 216, citing *Morris v. Ernst & Young, LLP*, 834 F.3d 975 (9th Cir, 2016), to support his assertion.

The *Morris* case, applied to Jack in the Box's contract, particularly § 7 and § 8 [of the NLRA] renders the terms of the concerted action waiver unenforceable. The "separate proceedings" clause prevents concerted activity by employees in arbitration proceedings, and the requirement that employees only use arbitration prevents the initiation of concerted legal action anywhere else. The result is interference with a protected § 7 right in violation of § 8. Thus, the "separate proceedings" terms in the [defendant's] contracts could not be enforced under federal labor policy or under the Federal Arbitration Act.

In its Reply, Jack in the Box asserted that the arbitration agreement does not violate the NLRA because it contains a severability clause permitting the Court to sever the concerted-action prohibition of the agreement. The Court applied existing case law to save the enforceable portion of an arbitration agreement. The Court severed the illegal provisions, and the labor claims continued as part of the class action for trial. The remaining matters, such as unpaid wages and other Oregon law state law issues were arbitrable under the modified arbitration agreement.

II. Arbitration clauses continue to be enforced to arbitrate claims regardless of the parties.

In *Doctor's Associates v. Burr*-CCH . ¶15,891 (D. Conn., Dec. 28, 2016)-the Subway® franchisor petitioned to compel arbitration of claims asserted in California state court by the Burrs, unsuccessful franchisee applicants for a casino location. The Burrs claimed that the development agents eventually awarded the franchise interfered with their candidacy. The federal district court in Connecticut held that:

1. The development agent defendants in the state court case were not required parties on the franchisor's s petition to compel arbitration;
2. Comity and respect for the state court would not preclude federal court from compelling arbitration;
3. The arbitration agreement in the Burrs' franchise application required arbitration of state court claims against the development agents, even though the agents were not parties to the arbitration agreement.

The Burrs alleged that, in 2013, the Morongo Tribal Council approved them to be the new Subway® franchisee located inside the Morongo Casino and Hotel Spa. The Burrs then applied to the Subway® franchisor in early 2014. The scope of the arbitration clause provided:

> I agree that I will settle any and all previously unasserted claims, disputes or controversies arising out of or relating to my application or candidacy for the grant of a SUBWAY ® franchise from Franchisor, pursuant to the laws of Connecticut, USA and by binding arbitration only. …

The Burrs alleged that, after considering their application, the franchisor eventually awarded the franchise to the development agents, the Marwahas. The Burrs filed suit in California state court claiming that the Marwahas allegedly caused the franchisor to withdraw its acceptance of the Burrs so the Marwahas "could steal the franchise for themselves." The Burrs asserted claims against the Marwahas for intentional misrepresentation, interference with contractual relations and prospective economic relations and unfair business practices. The Subway® franchisor then filed an arbitration against the Burrs for declaratory relief relating to the facts of the underlying California state court lawsuit in addition to filing its petition to compel arbitration.

A. The Court did not require the Marwahas to be parties to the petition to compel arbitration even though they were named defendants in the California state

court lawsuit.

The Burrs' first defense to the motion to compel arbitration was lack of jurisdiction. The Burrs claimed that the Marwahas were required to be parties to the motion to compel filed in federal court and could not be joined as it would destroy diversity. Both the Burrs and the Marwahas were citizens of California. The Court had previously decided similar issues in two other Subway® cases under Fed. R. Civ. P. 19(a). The question was whether the Marwahas were indispensable parties, such that the case should be dismissed without them or should continue in their absence. The Court applied the threshold tests (a) whether complete relief could be granted among the existing parties, and (b) whether going forward would impede the interests of the absent parties or expose the absent parties to more exposure or inconsistent obligations. The Court concluded that the Marwahas were not parties to the underlying arbitration agreement and therefore were not indispensable parties. The Court thus confirmed its diversity jurisdiction and continued with its analysis.

B. Principles of comity did not require deference to the California state court.

The Burrs' next defense to the motion to compel was the request to defer to the California state court to decide arbitrability. The Burrs argued that the Marwahas should assert the arbitrability argument in the California state law case. The Court rejected that argument because the Marwahas were not parties to the arbitration clause and could not assert such a right.

As a supplemental argument, the Burrs asserted the "first-filed rule" to argue that the first filed state court case had priority. The Court rejected that argument because the rule only applies between competing federal courts and not between parallel state and federal proceedings, holding "federal courts have a virtually unflagging obligation to exercise the jurisdiction given to them…."

C. Absence of third parties from the arbitration agreement does not prevent arbitration among the parties.

The Burrs argued that the California lawsuit was outside of the scope of the arbitration clause because the Marwahas were not parties to the arbitration agreement, were not acting in their capacity of development agents when they committed the business torts and the Burrs never agreed to arbitrate with the Marwahas.

The Court determined that the scope of the clause included the intentional torts alleged because all arose out of the Burrs' candidacy for a franchise. Similarly, the Court found the absence of the Marwahas from the arbitration contract to be unavailing. The arbitration provision contained a broad reference to claims, which could encompass claims against non-parties to the agreement. The clause did not limit the Burrs to arbitration only against parties to the agreement. Furthermore, the Burrs tried to distance the Marwahas from Subway® claiming that they were sued in their individual capacities rather than their conduct as Subway® development agents. The Court cited precedent which "repeatedly held that a 'court will not permit plaintiffs to avoid arbitration simply by naming individual agents of the party to the arbitration clause and suing them in their individual capacities … [t]o do so would be to subvert the federal policy favoring arbitration and the specific arbitration clause in the instant case.' "

In summary, the Court concluded that even though the Burrs did not agree to arbitrate against persons who were not parties to the arbitration arbitration, they did agree to arbitrate all claims, which could include related parties within the scope of the arbitrable claims. The Court noted that the Subway® franchisor "did not seek to compel the Burrs to arbitrate with the Marwahas…[r]ather, DAI [Subway] seeks to compel the 'Burrs to arbitrate with DAI their claims against' the Marwahas."

III. Equitable estoppel is applied to compel arbitration of case against non-signatories, even after discovery was taken.

In *Hyung Wook Kim v. Bruce Kim*, CCH ¶15,867 (Ill. App., Nov. 30, 2016) the franchisee was equitably estopped from denying application of an arbitration clause to the fraud claim against the agents of the franchisor.

Franchisee filed a lawsuit for fraudulent inducement against individuals who sold him the franchise in violation of the Illinois Franchise Disclosure Act, the Illinois Consumer Fraud and Deceptive Business Practices Act and common law causes of action. Defendants filed a motion to dismiss or stay pending arbitration. The motion was initially denied because the individual defendants were not parties to the arbitration clause and an issue of fact existed whether the defendants, as non-signatories to the Franchise Agreement, could compel arbitration in their representative capacity.

After deposition, defendants filed a renewed motion to compel arbitration or dismiss, claiming that the plaintiff's claims were so intertwined with the Franchise Agreement, and that they were obviously acting as agents for the franchisor, that it was immaterial that they were not signatories. In support of this renewed motion, defendants attached the transcript where the franchisee testified that he knew he was buying the franchise from the franchisor, not signing a franchise agreement with the defendants personally, and that franchisee knew defendant was always working for the franchisor. In addition, defendants submitted an affidavit that all contacts with the franchisee were in the capacity of Director of Franchise Development and that all emails contained that representative title.

The trial court dismissed the complaint. The appellate court commented that the renewed motion was untimely filed in the trial court, but not raised on appeal and no prejudice occurred, so any objection as to timeliness was waived and the entire case was subject to de novo appellate review of the dismissal.

A. No waiver of right to compel arbitration by filing an answer and taking discovery.

The first issue on appeal was whether defendants waived their right to compel arbitration by filing an answer and conducting discovery. This Court held that waiver requires acting inconsistent with a known right, and that the answer and discovery was focused on vindicating that right to arbitrate. The Court also rejected as untimely plaintiff's claim, first raised on appeal, that it was too expensive to arbitrate. Similarly, the Court rejected plaintiff's argument that the existing case was not within the scope of the arbitration clause, as the argument was not properly developed in the trial court or on appeal.

B. Equitable estoppel is exception to general rule and allows a non-party to compel arbitration.

The Court applied the contract choice of law of the State of Delaware to determine the general rule that only a party to an arbitration agreement may compel arbitration. Delaware law also allows two exceptions that might have been applicable, equitable estoppel and agency.

Equitable estoppel will allow a non-signatory to compel arbitration in three instances: (1) where a signatory must rely on the agreement containing the arbitration clause to make its claims against the non-signatory, (2) where the signatory raises allegations of "substantially interdependent and concerted misconduct by both the signatory and one or more signatories," or (3) "where there is a close relationship between the alleged wrong and the non-signatory's obligations and duties under the contract and where the claims are intimately founded in and intertwined with the contractual requirements."

The Court decided that the franchisee's claim of inducement could not occur without the existence of the franchise agreement and held the franchisee was estopped from avoiding arbitration under the agreement.

IV. Arbitration clauses in franchise agreements are not generally unconscionable or unenforceable.

In *John Han v. Synergy HomeCare*, CCH ¶15,900 (N.D. Ca., Feb. 2, 2017), franchisor filed a motion to compel arbitration and plaintiff franchisee defended on the basis that the dispute was not within the scope of the arbitration clause or was unenforceable due to unconscionability. The Court examined the issues under the recent case of *Mohamed v. Uber Techs, Inc.*, 836 F.3d 1102 (9th Cir. 2016), addressing whether these decisions were for the arbitrator or for the courts.

Whether a dispute is subject to arbitration requires the court to decide two gateway issues, (1) whether an arbitration clause exists and (2) whether the agreement encompasses the dispute in issue. The court's role is limited to determining arbitrability and enforcing it, with the merits left to the arbitrators. These gateway issues, however, can be delegated to the arbitrators by clear and unmistakable language. Citing Ninth Circuit precedent, the court recognized that incorporating the AAA rules constitutes clear and unmistakable evidence that the contracting parties agreed to arbitrate. The Court then undertook the analysis whether the delegation to the arbitrators was effective.

Effective delegation requires clear and unmistakable language, and "the delegation must not be revocable under state contract defenses such as fraud, duress, or unconscionability." The Court then applying the reasoning of *Mohamed* found that it was not clear whether the delegation of arbitrability to the arbitrators was clear. The Court then examined the language of the delegation clause and concluded that the drafting was unclear whether the parties decided to have the arbitrators decide arbitrability. The Court therefore concluded that it must determine whether the matter is arbitrable.

A. The Court was to decide whether a valid arbitration agreement exists.

Some of the disputes were carved out of the arbitration clause, but several of the counts of the complaint were within the scope of arbitration, so the issue became whether the arbitration agreement was unenforceable due to state law contract defenses. Applying California law, the issue was whether the agreement was both procedurally and substantively unconscionable.
Procedural unconscionability measures the level of surprise and oppression. The Court acknowledged prior precedent that franchise agreements have some characteristics of contracts of adhesion because of the franchisor's superior bargaining strength. Nevertheless, franchise agreements are not unconscionable merely because of superior bargaining strength. Plaintiff claimed surprise at the arbitration clause because she was the assignee of the franchise agreement and claimed she did not know of its existence. The Court, however, noted that the arbitration clause was conspicuous in the franchise agreement. In addition, a separate addendum which was signed repeated that disputes required arbitration, and recommended that he seek legal counsel before purchasing. The Court did acknowledge that the franchisor had superior bargaining power and found that the franchise agreement "is, at most, minimally procedurally unconscionable."

The Court next examined whether the arbitration provision was overly harsh or generates one-sided results. Plaintiff claimed that lack of mutuality and an onerous forum selection clause unfairly favored the franchisor. As to mutuality, the Court noted that a one-sided contract is not necessarily unconscionable where the party with superior bargaining strength legitimately needs extra protection. The Court found that the confidential information and intellectual property of the franchisor required extra protection sufficient to justify the one-sidedness of the contract. Similarly, the forum selection clause requiring arbitration in Arizona rather than in California is not unreasonable given that the franchisor's headquarters is located in Arizona and because notice of arbitration in Arizona was well disclosed before signing the franchise agreement. The Court held that plaintiff did not meet the heavy burden of defeating the enforceability of the franchise agreement.

Plaintiff argued additionally argued that the arbitration and delegation provisions are not enforceable because she was the assignee of the franchise agreement and did not have all of the procedural protections as if she was an original signer. The Court stated that it was "unconvinced" that plaintiff was surprised by the presence of an arbitration clause. The Court added that Lai-Biker, the plaintiff, specifically and affirmatively agreed to assume all obligations of her predecessor, including the paragraph referenced in the addendum which contained the arbitration clause. The Court granted the motion in part to stay the claims within the scope of the arbitration.

<u>Other Cases of Importance</u>:

Les Wharton, Chief Legal Officer

Coverall North America

This portion of the IFA Legal Symposium Judicial update for 2017 is intended to cover certain cases beyond those addressed in the earlier sections of the paper. It is not intended to be exhaustive as to other franchise related cases in the past year. Rather, it looks only at cases that the author believes might be of interest.

I. Noncompetition

A. *Organo Gold Int'l, Inc. v. Ventura* 2016 WL 1756636 (W.D. Wash. May 3, 2016)

Organo involved a multi-level marketing ("MLM") company that distributes a ganoderma-based coffee products in the U.S., Mexico and more than 30 other countries. Ganoderma is a mushroom of some sort, but is apparently important to the system, as it forms part of the limitations on the non-compete in this case. This case provides interesting analysis of a number of issues.

First, they eliminated an argument by the defendants that because the agreement called for mediation as a condition to litigation, the court should throw the matter back for mediation. The court said that there was a carve-out for injunctive relief in the agreement, so a complaint seeking an injunction to enforce the non-compete was appropriate. The court made short work of citation to a case where the purported violator of a non-compete had sued for a declaratory judgment.

Washington requires additional consideration for a non-compete in the employment that is entered into in the middle of the term of employment, so the defendants were trying to argue that additional consideration was needed here each time the successive 1 year agreement terms were renewed. The court said that this was not "mid-term", as each renewal of the agreement was a separate event and renewal constituted consideration. This was a distributorship case, more analogous to a franchise in that it was two independent businesses, but the court nevertheless used an employment agreement context as the baseline for review. Blue penciling is permitted in Washington, but the court did not need it.

The court asked whether the non-compete clauses were necessary to protect Organo's business or goodwill. The defendant said that it would—the clause protected the business, the network of distributors, from departing employees (the court refers here to the distributors as employees) unfairly leveraging personal contacts or confidential information acquired during their tenure—which would give the defendant unfair advantage in recruiting for a competing MLM.

The court also found the scope of the provision reasonable. A nationwide non-compete was reasonable because of the nature of an MLM business—the Organo distributors were not limited to selling in a particular geography. And, the court said that the scope of the prohibition was reasonable in that it was limited to businesses selling only ganoderma-based products, not any MLM business, or even a coffee selling business. The court arrived at the limitation by looking closely at the language in the provision in question.

The defendant argued that the non-solicitation provision was overly broad since it was not limited to customers beyond the ganoderma business. But the court said that a prohibition against solicitation need not be so limited, if it was related to customers solicited during an "employee's" term of service. Here the prohibition related to "existing" customers.

The court considered the balance of harm to the public if the agreement was enforced and determined that the public would not be deprived of ganoderma-based products if the non-compete were enforced.

The court then considered the tortious interference claim. In Washington (and other jurisdictions) the standard for tortious interference is: (1) existence of valid contractual relationship or business expectancy; (2) defendants had knowledge of the relationship; (3) intentional interference inducing or causing the breach or termination of the relationship or expectancy; (4) defendants interfered for an improper purpose; and (5) resultant damage. Here the question was whether defendant's interference was "wrongful". It would be wrongful in Washington if done for an improper purpose or with improper means. Here the court said the purpose was to seek additional compensation. That, the court said, was not wrongful or improper. Hence, no tortious interference.

The court also considered the issue of irreparable harm and determined that the nature of the business makes it vulnerable to losing customers after a relationship ends—so there is more here than an injury that can be quantified.

In balancing the equities, the court determined that the requested restrictions did not impinge on the defendant's "chosen field", finding they cover only their ability to sell ganoderma-based products, a narrow area.

The court found an injunction in the public interest finding that enforcement was reasonable and necessary. The court noted that the public can still buy ganoderma-based products, just not from the defendants for the period of the non-compete.

B. *ReBath LLC v. New England Bath Inc.* Bus. Franchise Guide (CCH) ¶ 15,801 (D. Ariz. July 15, 2016)

ReBath involves a franchisee in the bathroom remodeling business whose franchises expired. The franchisee continued in the business at the same location under a new name, but still used the ReBath names and marks, failed to turn over the manuals and customer contracts, and continued to use websites with the ReBath names and marks. The websites included customer testimonials resulting from the installation of ReBath products.

The defendants quickly acquiesced on cessation of use of the names and marks, and apparently agreed to cease using and return proprietary information. That left the court to consider whether the non-compete was enforceable and whether the defendants could leave the testimonials on their website.

Arizona law does not look favorably on restrictive covenants, so the court said the restraint could not be greater than needed to protect the "employer's" (here again the court looked to the employment context notwithstanding the independent business relationship in a franchise) legitimate interest. The defendants said that there was no legitimate interest here as the plaintiffs looked merely to eliminate competition.

But the plaintiffs said they had a legitimate interest in protecting their ability to retain customers by virtue of their goodwill and reputation. And the agreement protects franchisees from immediately utilizing and profiting off of their confidential information and trade secrets. As to the former, the court cited to *Bad Ass Coffee Co. of Hawaii v. JH Nterprises, LLC,* 636 F. Supp. 2d 1237 (D. Utah 2009), and said that when the defendants switched overnight to another name, there might be a signal to customers that the defendants lost faith in the ReBath brand, so the plaintiffs indeed had a legitimate interest to protect. Thus, it did not need to consider the latter argument.

The defendants also argued the restriction was overly broad in that it restricted them from a 50 mile radius of their location, and prohibited all competition. However, the court simply said that other courts had upheld 50 mile restrictions, so the geographic restriction was reasonable. As to the "prohibits all competition" language, the court looked at the restriction and pointed out that it went only to bathroom remodels, so defendants could engage in other remodeling, plumbing work, etc. Thus it was narrow enough to be upheld.

The plaintiffs claimed the testimonials were "false advertising". The court said the analysis to use for a false advertising claim was whether the advertising: (1) contained a false statement of fact in a commercial advertisement; (2) actually deceived or has a tendency to deceive a substantial segment of its audience; (3) was deceiving and likely to influence a buying decision; (4) involved interstate commerce; and (5) injured plaintiff, either by direct diversion of sales or by a lessening of goodwill.

The defendants said the testimonials were truthful, that they had relied on their experience when performing the work and that they should be able to reap the benefits. They also argued that the nominative fair use doctrine protected their use and the testimonials did nothing to dilute the ReBath brand by identifying the defendants as a former ReBath franchisee. They did not dispute that the work was done using ReBath goodwill, proprietary materials, methods and products.

The court said that goodwill belongs to ReBath, and that the advertisement using that goodwill misleads consumers into believing that the defendants new brand is wholly responsible for that customer satisfaction depicted in the ads. The false statement has nothing to do with the defendant's performance, rather the issue is an implication that the new brand is that which earned the goodwill. And the nominative fair use doctrine (which might protect a statement such as that Michael Jordan formerly played for the Bulls) applies to trademarks, not goodwill. The court found that the defendants were capitalizing on the goodwill acquired from work performed as a ReBath franchise.

In considering irreparable harm, the court once again cites *Bad Ass Coffee* for the concept of the "overnight switch" effect on goodwill. And the court holds that the loss of customers might make it difficult for ReBath to establish another franchise in the territory.

In balancing the harms and considering the public interest, the court cites the defendant's decision to open a competing business in the face of the non-compete provision as a "self-inflicted" harm, and says that the defendants cannot use it to tip the balance on their favor. And, the court held that it is in the public interest to enforce valid contracts and make parties live up to their agreements.

A final note—the court granted the restriction for one year from the Order, preventing the defendants from benefiting from the delay caused by the consideration of the litigation.

C. *Mister Softee, Inc. v. Amanollahi* 2016 WL 5745105 (D.N.J. Sept. 30, 2016)

Mister Softee involved a relatively complex set of facts relating to trademark infringement after the sale by the franchisee of the ice cream trucks used in his franchised business to four others who continued to use the trucks with the plaintiff's trademarks after the sale. The franchisee's name remained on the franchise agreements and on two notes for the trucks, and he continued to remit royalties to Mister Softee from the operation of the four trucks by the new owners. When the franchisee moved the trucks to an unauthorized depot, and quit making royalty payments, Mister Smoothie considered those actions an intent to abandon the franchise and sent the franchisee a termination notice.

After the termination, the trucks continued to operate with Mister Softee's names and marks. The defendant asserted that he was not the franchisee as he had sold the franchises to the four new owners who were operating the trucks, and hence was not responsible for any trademark infringement or violations of the non-competition provisions of the agreement.

The court ruled for Mister Softee as to injunctive relief. However, the more interesting issue in the case was that of Mister Softee's request for lost future royalties.

The court said the NY standard to award future profits was that plaintiffs must show (1) the loss was caused by defendant's breach of contract, (2) that the amount lost can be proven with reasonable certainty, and (3) that the parties contemplated this type of damages at the time the contract was made. The court mused that the difficulties in proving up future profit are often addressed with a liquidated damages provision, but that this was not done here.

Looking at "Hornbook" law (author's quotes), the court said the non-breaching party had to decide between (1) terminating the contract and recovering liquidated damages, or (2) continuing the contract and recovering damages solely for the ongoing breach. According to the court, citing a number of other franchise cases, future lost profits are not awarded even when the termination is for failure to pay royalties. In a footnote the court said that it did not seem equitable that Mister Softee, without any effort to mitigate, could simply collect up to ten years' worth of royalties on an agreement that it terminated—they had two years during the non-compete to find replacement franchisees, and that was enough.

Accordingly, the court said that Mister Softee had faced a choice: terminate the agreements or stay with the agreements and sue for ongoing royalties.

D. *Pirtek USA, LLC v. Twillman*

2016 WL 5846978 (M.D. Fla. Oct. 6, 2016)

In the *Pirtek* case, the allegations were that the Twillmans "hoodwinked" Pirtek into signing a franchise agreement, in order to obtain confidential and proprietary information, and hire two of Pirtek's employees so that they could set up a competing business. Soon after getting the material/information, and hiring the two employees, the defendants initiated the cancellation procedure spelled out in the FDD and cancelled the franchise, receiving their money back from Pirtek. However, they then set up a competing business in the territory.

Pirtek, the hoodwinked, filed suit.

The court considered the defendants' argument that the "cancellation" was a rescission that voided the non-competes and other provisions of the franchise, but rejected it. The FDD procedure, according to the court, was merely to afford the franchisee the opportunity to change its mind. The provisions of the franchise agreement relating to confidentiality, non-competition and other post termination obligations remained in effect.

In enforcing the non-competition provisions, the court said on the issue of irreparable harm that there was a real and immediate threat to Pirtek's legally enforceable rights. Pirtek would be forced to compete with the Twillmans, now faced a substantial risk of losing its exclusivity in the market, and the durability of Pirtek's nondisclosure and non-compete agreements with its other franchisees might be subject to a greater threat of disruption or challenge.

On the issue of public interest, the court echoed what the other decisions considered above have said—there is a benefit to enforcement of a valid covenant non- compete and encouraging people to adhere to contractual obligations. This promotes the stability of business relations and reliability of contracts.

A side note—the defendants later challenged Pirtek's ability to request a permanent injunction in arbitration (the agreement mandated arbitration). The court ruled on December 7th, 2016 that Pirtek's request of a preliminary injunction in the court was not a waiver of its right to arbitrate the matter, including the question of whether a permanent injunction should issue.
Pirtek USA, LLC v. Twillman, 2016 U.S. Dist. LEXIS 168864 (M.D. Fla. Dec. 7, 2016).

E. *Robinson v. U-Haul Co. of Cal.*
209 Cal. Rptr. 3d 81 (Cal. Ct. App. Oct. 18, 2016)

This case is interesting for only one reason—do **not** pursue a non-compete claim in California, where non-competition agreements are prohibited by statute. U-Haul had attempted to enforce a non-compete agreement against Robinson, and after U-Haul failed, Robinson sued them in a civil complaint, and availed himself of California's Private Attorney General Action ("PAGA") to step into the shoes of the state Attorney General to enforce the statute. Result—more than $195,000 for malicious prosecution and $800,000 for the attorneys' fees in the PAGA case. Ouch.

F. *Fantastic Sams Franchise Corp. v. Mosley*

2016 WL 7426403 (S.D. Tex. Dec. 23, 2016)

The defendant franchisee did not renew his agreement, and set up a salon within 2 miles of the former location. There was evidence that the defendant used the same phone number, and had left a sign on the door of the space where the franchised business had been directing customers to his new location. The defendant had at least one bottle of shampoo with Fantastic Sams' logo in his new salon, his business license still reflected Fantastic Sams-Cypress Rosehill, the merchant authorization receipt reflected Fantastic Sams as the merchant, Fantastic Sams used similar black chairs in its salons, and there was a coupon containing a picture of his stylists at the old Fantastic Sams salon, with the paint colors and wall hangings of Fantastic Sams in the background.

Fantastic Sams sought to enforce a 5 mile radius two year non-compete, and the post termination obligations in the franchise agreement including de-identification among others. They also sought injunctive relief under trademark law for trademark and trade dress infringement and dilution.

The court had no issue with enforcing the non-compete, finding the time and territory of the restriction reasonable. It also had no issue in enforcing the post-term obligations of the franchisee, including the requirement to de-identify completely, change the telephone number, and return any materials the defendant still had.

Notably however, the court did not see sufficient basis for the trademark/trade dress infringement or dilution claims. The court referred to the evidence—a single bottle of shampoo, an out of date coupon, the merchant authorization receipt (for which the defendant offered evidence that he had attempted to rectify the problem), the license—these just did not offer enough for the court to believe that there would be any likelihood of confusion—for example, the customer would know that he was entering a salon with an entirely different name.

As to trade dress, the court said that layout and black chairs were functional, so no trade dress issue there. And it was too far removed to base a color scheme claim on the picture in the out of date coupon.

The dilution claim was also rejected by the court. The court did not feel that given all the circumstances that a customer would be confused as to whether he was in a Fantastic Sams salon.

In sum, the court felt that the injunction enforcing a five mile radius non-compete, together with an order requiring compliance with the post term obligations, would provide Fantastic Sams the relief it needed to protect its system. The injunction regarding the telephone number was as to the defendant and all those acting in concert with him.

II. Jurisdiction and Venue

A. *Jani-King Franchising, Inc. v. Falco Franchising, SA*
2016 WL 2609314 (Tex. App. May 5, 2016)

In this case it was alleged that the European defendants (both corporate and individual) had engaged in fraud to cover up their diversion of the business of their Jani-King franchise in Europe in violation of a non-compete in the franchise agreement.

More specifically, the plaintiff accused the defendants of providing false reports as to their business operations in order to convince the plaintiff that the business was declining, while in reality they were diverting the business to another entity.

The court first looked at whether the fiduciary shield doctrine immunized the individual defendants from the exercise of specific jurisdiction. The court held that the employee is not shielded from torts where the employee may be individually liable. The fraud was said to have been perpetrated by the representations of the named individual defendants, so they each could be found to be individually liable for the commission of a tort.

The court next looked at whether personal jurisdiction could be established as to each individual defendant. The standard, under Texas law, it said was: (1) the Texas Long Arm Statute permits the exercise of jurisdiction; and (2) the assertion of jurisdiction satisfies constitutional due-process guarantees.

Minimum contacts are established when the nonresident purposefully avails himself of the privilege of conducting activities within the forum state. According to the court they should consider: (1) the defendant's own actions, but not the unilateral activity of the other party, (2) whether the defendant's actions were purposeful rather than random, isolated, or fortuitous, and (3) whether the defendant sought some benefit, advantage, or profit by availing itself of the privilege of doing business in Texas.

One defendant regularly sent reports at the direction of the other three individual defendants that Jani-King alleged were false. As to that defendant, the court found that telephone and email regarding negotiation and performance of a contract between the Texas plaintiff and foreign defendants were not enough.

On the other hand, the court found as to the other individual defendants for minimum contacts that where it is alleged that a defendant made statements, or failed to disclose material information that the defendant in question had a duty to disclose, while physically present in Texas, the defendant is subject to specific jurisdiction in an action arising from the statement or omission.

In considering whether the exercise of personal jurisdiction offended traditional notions of fair play and substantial justice, the court said it would normally consider the following: (1) the burden on the nonresident; (2) the interests of the forum in adjudicating the dispute; (3) the plaintiff's interest in obtaining effective and convenient relief; (4) the international judicial system's interest in obtaining the most efficient resolution of controversies; and (5) the shared interest of the several nations in furthering fundamental substantive social policies.

However, the defendants argued only that (1) it would be enormously inconvenient, (2) Texas has little interest in adjudicating the dispute other than the fact Jani-King is a Texas company, (3) the relevant business and conduct in this dispute involves a Belgian company, and (4) Jani-King can obtain effective and convenient relief in Belgium.

As to the first, the court said that all nonresidents incur an additional burden—distance alone cannot ordinarily defeat jurisdiction. They have already shown their willingness to travel to Texas. Further travel to defend the lawsuit will not be overly burdensome to them.

In considering Texas's interest, the court noted the allegation that defendants committed a tort against a Texas resident in Texas.

And with respect to the fact that the claim involved a Belgian company, the court found that the law agreed to in the franchise agreement is Texas law. That was also the response of the court regarding the question of whether Jani-King could obtain convenient and effective relief.
So as to the three individual defendants, the court overturned the order of the trial court granting them a special appearance and denying Texas jurisdiction over them.

The court went through a similar analysis to affirm the trial court in its decision to deny a special appearance to the corporate defendant Falco Franchising and affirmed the court's jurisdiction over it. But as to Falco, it should be noted that it had agreed to U.S. jurisdiction in the Franchise Agreement.

B. *Baskin-Robbins Franchising LLC v. Alpenrose Dairy, Inc.* 2016 WL 3147645 (1st Cir Jun 6. 2016)

The court in *Baskin-Robbins,* in looking at whether to subject a defendant to jurisdiction in Massachusetts, engages in a similar analysis to that in the *Jani-King* case. Here there had been a long relationship between the defendant, Alpenrose, a territory franchisee of B&R, and the plaintiff, Baskin-Robbins, B&R itself. Alpenrose was a franchisee. At the outset of the relationship in 1965, B&R was headquartered in California. Alpenrose was an Oregon company, operating in Washington and Oregon. In 1998, B&R moved to Massachusetts.

As required by the franchise agreement every six years, Alpenrose sent its renewal to B&R in Massachusetts. In 2013, Alpenrose notified B&R that it wanted to transition out and would not be renewing the franchise agreement on its renewal date the following year. In the summer of 2014, while engaged in non-renewal discussions with B&R, Alpenrose notified B&R that it wished to revoke its non-renewal notice. Likely in order to get a little leverage, it said that if B&R refused to let it renew, it might be due compensation under Washington franchise law. Too late, B&R responded, stating it would not pay any compensation.

The two companies then raced to the courthouse in their respective jurisdictions. B&R got to its court first, and they asked for a declaratory judgment.

The trial court dismissed B&R's filing, saying that nothing in the parties' history suggested that Alpenrose intended to purposefully avail itself of the privilege of conducting business in Massachusetts. But the First Circuit Court of Appeals reversed.

The First Circuit looked at relatedness first and found that the notice letter and the revocation letters that Alpenrose sent to B&R in Massachusetts are what prompted the dispute, notwithstanding the Alpenrose assertion that the dispute arose from the franchise agreement. The letters set the controversy in motion.

On the question of purposeful availment, the court said the issue is whether the defendant deliberately targeted its behavior toward the society or economy of a particular forum. Random, isolated or fortuitous contacts are not enough. And the defendant cannot be swept in by the unilateral activity of another or a third party. There must be voluntariness and foreseeability. Here the court pointed to the renewal notices. And it pointed to the highly interactive business relationship with B&R in Massachusetts for 12 years.

In that regard, the court considered the precedent of the Supreme Court decision in *Burger King*, where the franchisee had voluntarily accepted long term and exacting regulation from Burger King's Miami headquarters and the Supreme Court viewed the matters at hand to thusly be "Florida Centric". But the court distinguished that relationship—saying Alpenrose and B&R did not at the outset contemplate a Massachusetts connection, nor during most of the performance of the agreement. And Alpenrose did not reach out to Massachusetts to solicit a right to renew—it was in the agreement. Because B&R had moved there, the court viewed that more as a unilateral activity that would not militate jurisdiction.

However, the court did not stop there. It noted that there were a number of physical contacts by the defendant with the state of Massachusetts. Alpenrose's Co-President paid a courtesy visit to B&R's headquarters in Massachusetts when B&R obtained new owners. The B&R Brand Advisory Council ("BAC") holds quarterly meetings in Massachusetts, and Alpenrose's director of franchise relations traveled there at least twice to attend BAC meetings. Royalty payments were sent monthly to B&R in Massachusetts, and remittance payments were sent each month from B&R in Massachusetts to Alpenrose. Over 14 years, the payments numbered over 180 to B&R and 176 to Alpenrose—a continuous transaction of business between them.

The "sockdolager" in this case (author's quotes—who says "sockdolager"?), according to the court, was that B&R performed a compendium of services in Massachusetts on Alpenrose's "behoof" (author's quotes of judicial language again)—product testing, processing of customer complaints, and product supply planning. The product testing consisted of Alpenrose sending samples of ice cream product to B&R in Massachusetts for testing. Per the court, Alpenrose can hardly claim, under these circumstances, that it was unforeseeable. These manifold activities were vital to the franchisor-franchisee relationship. Thus, Alpenrose deliberately targeted the Massachusetts economy and should reasonably foresee that, if a controversy developed, it might be "haled" (author's quotes again) into a Massachusetts court.

Lastly, there was the question as to whether the exercise of jurisdiction was fair and reasonable. See the factors for analysis in *Jani-King* above. Would litigating in Massachusetts be "burdensome"? From the court—the case law makes it "pellucid" (author's quotes again—last one—the court was likely responsible for the National Spelling Bee word list in 2012) that the burden must be special or unusual. Because the parties are of substantial means, cross country travel does not qualify.

On the question of Massachusetts' interest, the standard the court used was to determine the extent to which the state <u>has</u> an interest, not to <u>compare</u> the interests (the court's emphasis on those words).

Alpenrose conceded the third factor—plaintiff's convenience. As to the fourth and fifth factors, the court simply said that Massachusetts can effectively administer justice in the dispute, and has a legitimate stake in providing its citizens a convenient forum. Finally, the court said, not surprisingly, that a federal court sitting in Massachusetts (author's note—especially one with such a "fulsome" vocabulary) is fully capable of applying Washington law.

So the factors, analyzed, according to the court, do not show that jurisdiction over Alpenrose in Massachusetts is so unfair as to raise constitutional concerns. B&R's attempt to exercise jurisdiction over Alpenrose is consistent with due process. The court reversed the trial court on this issue.

III. Fraud/FDD Issues

A. *Yumilicious Franchise, LLC v. Barrie* 2016 WL 1375871 (N.D. Tex. Apr 6, 2016)

Yumilicious, a Texas franchisor, sued its franchisee Why Not, LLC, and several individual defendants, for breach of contract, and the defendants filed a countercomplaint with multiple counterclaims, including breach of contract, negligent misrepresentation, fraud, violation of the Texas Deceptive Trade Practices Act ("DTPA"), and the Texas and South Carolina Business Opportunity Acts ("BOA"). The district court found for Yumilicious on its contract claims and awarded damages. It dismissed Why Not's counterclaims.

Per the court, the Texas DTPA makes it illegal to represent that goods or services have characteristics or benefits they do not have, or fail to disclose information concerning goods or services known at the time of the transaction if such failure to disclose was intended to induce the consumer into the transaction.

Why Not alleged that Yumilicious violated the DTPA because: (1) it failed to provide updated disclosures or an updated FDD; (2) the FDD did not contain required disclosures regarding approved vendors and distributors for required products; (3) the FDD underestimated start-up costs; and (4) the FDD had some of the financial performance information previously provided by Yumilicious, but not all. They also alleged the Yumilicious CEO made statements re supply sources that were not accurate, including assurances about negotiations with a national distributor.

But Why Not did not allege that Yumilicious had knowledge that it failed to disclose. The court cited *Robinson v. Preston Chrysler-Plymouth, Inc.*, 633 S.W. 2d 500 (Tex. 1982) in saying one cannot be liable under the DTPA for failure to disclose facts about which he does not know. And in the view of the court, the statements made by the CEO did not constitute misrepresentations.

The court also pointed out that Why Not missed the other elements of a DTPA claim. It had not pled how it was a "consumer" protected by the DTPA. Nor did it plead reliance on the information in the FDD, or how it had suffered injury as a result of its reliance.

The court next looked at Why Not's claim that Yumilicious had violated the FTC Rule by making the same incomplete disclosures it made in the DTPA claim. Reaffirming that the FTC Rule does not provide a private right of action itself, the court addressed Why Not's claim that the DTPA incorporates the FTC Act and accordingly the FTC Rule on Franchising. It pointed out that the DTPA says that a violation of law other than this subchapter is not a violation of this subchapter unless it is declared by such other law to be actionable under this subchapter.

Hence an FTC Rule violation would have to be specifically referenced by some other law as a deceptive trade practice in violation of the DTPA in order for there to be a private right of action for an FTC Rule violation in Texas. And, as the court points out, it is not directly incorporated by any Texas law. Bringing it back to the first analysis, the court said that even if the FTC Rule violation was a deceptive trade practice, the counterclaims would be dismissed because the other elements of the DPTA were not pled.

The court also addressed the negligent misrepresentation claim. It said that there can be no recovery under tort theory for economic losses resulting from failure to perform under a contract. Even when the economic loss might be viewed as a result of the contracting party's negligence, the claimant has a contract claim and must recover under contract theory.

As to the fraud alleged based on the CEO's statements, apart from pleading issues here as well, the court pointed to the franchise agreement provision where the franchisee acknowledges that it has conducted an independent investigation of the business venture contemplated by this agreement and explicitly disclaims reliance. Under Texas law, according to the court, a statement disclaiming reliance is sufficient to waive a fraud claim. Author's note—include the disclaimers in the franchise agreement—they may not be effective in every instance, but can be helpful with the right facts.

The appeals court thusly affirmed the district court's dismissal of the counterclaims.

B. ***Caudill v. Keller Williams Realty, Inc.*** ***No 15-3313 (7th Cir July 6, 2016).***

Caudell is interesting only for what appears to be a flaw in the analysis of the court.

Caudell's company had been a franchisee of Keller Williams. The franchise was terminated and she brought suit against Keller Williams for a variety of contract claims, tort claims and violation of state statutes. Keller Williams and Caudell settled the matter, and the settlement contained a confidentiality provision that prohibited the parties from disclosing the details of the settlement. Later, Keller Williams included the settlement (and some detail) in its FDD and distributed it to some 2000 existing and potential franchisees, and others.

Caudell then asserted a claim for breach of the confidentiality provision in the settlement, and invoked a liquidated damage provision of $10,000 for each violation.

The court looked at the requirements of the FTC Rule (and state franchise law) as to whom the franchisor must distribute an FDD—prospective franchisees—and seems to say that any further distribution would be a violation of the confidentiality provision of the settlement agreement. It seems to overlook the fact that the FDD filing in the states is public record, accessible by request and in some states even on line to the general public.

Perhaps there is a settlement agreement drafting note here—carve out disclosure deriving from the fact that the settlement must be in the FDD, regardless of how that disclosure comes about. Maybe better, just get the clients to acknowledge that it will be in the FDD and there is no point in having a non-disclosure provision.

C. ***Legacy Acad., Inc. v. Dole-Smith Enters., Inc.*** **2016 WL 3208751 (Ga. Ct. App. June 9, 2016)**

Legacy is an example of a near miss by a franchisee on a somewhat bootstrap argument using an obscure Georgia statute to bring in a violation of the FTC Rule notwithstanding that the Rule does not include a private right of action. The statute, OCGA Section 51-1-6 enables one to sue on a tort basis for a violation/breach of a duty imposed by another law—here the FTC Rule. In the trial court, the jury awarded $40,000 in damages for negligence under that Georgia code section. But the appeals court reversed the decision of the trial court denying a motion for a JNOV by the franchisor based on the fact that the plaintiffs did not prove any damages. Thus, the award, and another award for negligent misrepresentation in the amount of $350,000 were thrown out.

But in Georgia, unlike the discussion of Texas law (the DPTA) in *Yumilicious* above, franchisors need to be mindful that OCGA section 51-1-6 may indeed effectively enable a private right of action relating to an FTC Rule violation.

D. ***Le Macaron, LLC v. Le Macaron Development LLC*** **2016 WL 6211718 (M.D. Fla. Oct. 24, 2016)**

This case involves allegations of fraud in the sale of the franchise and breach of contract. There were also claims of breach of the covenant of good faith and fair dealing, and tortious interference.

The court considers the franchise agreement's non-reliance clause and merger clause in looking at the fraud claims. While acknowledging that other courts seem to agree that merger and non-reliance clauses can prevent the element of reliance, the court also considers what level of specificity is required in the non-reliance clause. However, the court points out that here the clause specifically excludes the FDD, so false statements in the FDD would not be subject to non-reliance. The court also said that here it was not clear which of the representations at issue were specifically addressed by the clause. On the other hand, the pleadings themselves needed more specificity—so the plaintiffs were ordered to amend their complaint if they wanted those claims to be considered.

The plaintiffs also made claims under the Florida Deceptive and Unfair Trade Practices Act ("FDUTPA"). It is a per se violation of FDUTPA to violate the Federal Trade Commission Act, so under Florida law, an FTC Rule violation triggers a private right of action under FDUTPA, unlike the Texas law discussed in *Yumilicious* above. The plaintiffs claim was based on the fact that the FDD was amended 10 days after they executed the franchise agreement and the amended FDD contained material changes that would have led them to avoid the offering. This was a fraud claim, and the defendants asserted that the claim was implausible due to the fact that the plaintiffs later purchased a second store and the individual plaintiff later bought out his partner. The court again stated that the plaintiffs would need to amend to provide more specificity, since that claim was also based on “fraud”.

The plaintiffs also brought claims under the Florida Franchise Act (“FFA”). The FFA has prohibitions of specific misrepresentations and omissions during the sale of a franchise, and provides for recovery of all money invested. Once again, the court ruled that the plaintiffs needed more specificity in their complaint, as the claim was a conclusory statement of violation, notwithstanding the fact that the FFA’s prohibitions go to very specific types of representations or omissions. The court also said that the FFA claims may be subject to the merger and non-reliance clauses. However, the court cited to at least one decision that expressed doubt as to whether reasonable reliance was a requirement for an FFA violation—*Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp. 2d 1071 (D. Minn. 2007).

The plaintiffs alleged breach of contract claims based on the FDD and the franchise agreement. The court first said that the plaintiffs had raised no theory to support a claim that the FDD is a contract. It then referenced the defendant’s argument that the FDD expressly stated that “the terms of your contract will govern your franchise relationship”. Once again, however, the court only dismissed that claim without prejudice, apparently permitting the plaintiffs to somehow amend their complaint in a way that would support an argument.

The court did address the breach claims relating to the franchise agreement. The first breach claim was that there was a breach because an approved supplier did not provide suitable cookies, failed to properly label the boxes, and failed to provide gift boxes. Essentially, the plaintiffs asserted that was breach of the provision of the franchise agreement saying that the franchisee was to purchase from designated suppliers. The court said that the plaintiffs had again failed to provide a legal theory to support the claim of breach, since the issues were with a third party. Once again, the court dismissed without prejudice, apparently permitting the plaintiffs to somehow amend their complaint in a way that would support an argument.

The court said that two other breach claims—failure to provide grand opening assistance and failure to place information about one of the stores on the franchisor’s website—were sufficiently detailed to assert breaches.

The plaintiffs also claimed a breach of the covenant of good faith and fair dealing in that the defendants were to find a competent cookie supplier, they did not do so and they would not permit the plaintiffs do so. They also said the covenant was breached when the plaintiffs failed to enable them to have a proper grand opening, failed to properly market and advertise the stores, and failed to provide proper assistance.

On the covenant of good faith and fair dealing, the court said that Florida recognizes the covenant as being designed to protect the parties’ reasonable expectations. It said that it is usually raised when a question is not resolved by the terms of the contract, or when one party has the power to make a discretionary decision without defined standards. The covenant limits a decision making party from being able to act capriciously to contravene reasonable contractual expectations. All well and good, but then court said that the plaintiffs had failed to tie their claim to any specific contractual obligation, let alone explain how the covenant applies to performance of that obligation. So the claim was dismissed without prejudice, with an admonition that if the plaintiffs amend, they would need to eliminate the numerous conclusory legal allegations and include necessary factual allegations.

Finally, the plaintiffs alleged that the defendant's had tortiously interfered with their relationship with the individual plaintiff's former business partner, causing the franchises to fail and causing the partner to file a lawsuit against plaintiffs. The court lays out the elements: (1) existence of a business relationship between plaintiff and a third party; (2) defendant's knowledge of that relationship; (3) defendant's intentional and unjustified interference with the relationship; and (4) damages.

The plaintiffs described the interference as fraud, breaches of contract, and other actions and inactions. Once again the court said—impermissibly vague. Meanwhile, the defendants argued that it was not a stranger to the relationship with the plaintiffs and the former business partner as required by Florida law, since he was a party to the franchise relationship. The court dismissed the claim without prejudice, and tells the plaintiffs that they must include all necessary facts to state the claim.

The case is somewhat instructive, as it is a "kitchen sink" complaint, and the court addresses each count in turn, and while dismissing most, does so without prejudice and gives the plaintiffs guidance regarding what they need to revise in each case. In particular, it confirms how to get to a private right of action on an FTC Rule violation in Florida, and talks about the unicorn of franchise law, the covenant of good faith and fair dealing, without pre-judging the outcome.

E. *Zounds Hearing Franchising LLC v. Moser* 2016 WL 6476291 (D. Ariz. Nov. 2, 2016)

This case involves the issue of whether a broad general release bars a fraud claim based on fraud before the execution of the release. The claim is brought as a counterclaim in the action. The court finds that arguments relating to the statute of limitations are not relevant. If the parties, as here clearly intended the release to be a clean slate, then all claims, including fraud, are waived. Operational note—get a broad release whenever new consideration is given.

However, the court did permit the assertion of a claim for fraudulent inducement, even in the face of a release. It noted that there is a split on the issue among various jurisdictions, stating that Arizona law (applicable here due to the contract choice of law), supports parties' freedom of contract, but does not find a waiver relating to fraudulent inducement without an express manifestation of that intent. Drafting note—include a waiver of fraudulent inducement in general release provisions.

The court also looks at a Florida Franchise Misrepresentation Act ("FFMA") claim that was made, but concludes that the Arizona law provision wins out over a claim that the public policy of Florida should take precedence. In particular, the court points out that the drafters of the FFMA did not include an anti-waiver provision, and rules that the defendants have waived their right to bring a claim under Florida law because the agreement has an Arizona choice of law provision.

IV. Trademarks

A. *MPC Franchise, LLC v. Tarntino* 2016 WL 3512500 (2d Cir. Jun 27, 2016)

Reduced to its essence, this case stands for the proposition that even if registration of a mark has expired, if an applicant for the same mark knows that others have previously used the mark and are still using it, the applicant cannot represent to the USPTO that to the best of his knowledge and belief no other person, firm, corporation, or association has the right to use the mark either in "identical form" or "in such near resemblance…as to be likely…to cause confusion, or to cause mistake, or to deceive".

V. Definition of a Franchise

A. *Ervin Equipment Inc. v. Wabash National Corp.* 2016 WL 2892132 (N.D. Ind. May 17, 2016)

This case looks at the definition of a franchise under the Indiana unfair practices statue and the Indiana Franchise Act. The plaintiff bought and re-sold a specific type of the defendant's semi-trailers. The claims were precipitated by a termination of the relationship.

The Indiana unfair practices statute defines "franchise" as where the manufacturer or distributor grants a dealer rights to use a mark and there is a community of interest. The dealer must sell at least 12 vehicles a year. The court said the plaintiff met the community of interest standard. The dealer derives a large proportion of its revenue from the dealership and the dealer has made substantial investments in some way to the grantor's goods. Here the plaintiff derived 40% of its total revenue from the product. And the plaintiff had gone to numerous trade shows using the logo, and its employees participated in dealer meetings and sales trainings. That was enough for community of interest.

On the other hand, the Indiana Franchise Act defines a "franchise" as: (1) granting the right to engage in the business under a marketing plan or system prescribe in substantial part by the franchisor; (2) the business is substantially associated with the grantor's mark; and (3) the grantee pays a fee. The plaintiff here failed to meet the first part of the definition. That is, it did not operate under a marketing plan or system prescribed in substantial part by the manufacturer. The agreement said that the dealer would control its business and decision making to include its pricing and marketing.

The court allowed the unfair practices claim and dismissed the claims relating to the Indiana Franchise Act.

B. *Lofgren v. AirTrona Canada* 2017 WL 384876 (6th Cir. Jan. 27, 2017)

This case involved whether the defendant had sold a "franchise" without a disclosure statement in violation of Michigan law.

The parties were operating under a franchise that had been properly sold under Michigan law, when the plaintiff argued it bought a new, separate franchise for which sale the defendant did not provide a Michigan disclosure statement. The plaintiff wanted rescission of the second agreement. The plaintiff argued that the second was merely an expansion of the first, and that no "franchise" had been sold.

The court first said that the second business was materially different from the first. The court then looked at the elements of a franchise under Michigan law to determine if a franchise had been sold.

The defendant argued that it had not prescribed a system for the plaintiff's operation. But the court pointed out that the law did not require a complete sacrifice of independence, only general adherence to a business plan. Further, the court looked at whether the franchisor aids or assists the franchisee in training or obtaining locations, or in marketing. The defendant here was reliant on the plaintiff for training and obtaining business relationships, business uniforms and equipment. So the system part of the definition was met.

Next, the issue became whether the plaintiff had "paid a fee" for the new franchise. There was a sale of equipment involved, and the defendant argued that the dollars paid were solely for the equipment, and a mark-up in that regard did not meet the definitional element of a "fee". The question here according to the court was whether they had paid "in excess of a 'fair payment for goods purchased at a comparable level of distribution'". The second of two invoices listed out the equipment and prices—when the total was compared with the total of the equipment prices, there was a \$6,852 difference. And the defendant did not offer an explanation of the difference. The defendant was also not helped by the fact that the first invoice had stated that it was for "1 Franchise Michigan Location".

C. *Neubauer v. FedEx Corp.* 2017 WL 655434 (8th Cir. Feb. 17, 2017)

The FedEx contractor claimed he was a franchise under the North Dakota Franchise Investment Law ("NDFIL") among other claims.

The definition of a franchise under the NDFIL is that: (1) the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan prescribed in substantial part by a franchisor; (2) the operation is substantially associated with the franchisor's marks; and (3) required to pay a fee.

The court said that the plaintiff was not granted the right to offer, sell, or distribute services under the defendant's marketing plan. Rather, the plaintiff was an independent contractor providing transportation services to the defendant, and that the plaintiff received payment not from customers, but from the defendant. The defendant was not granted the right to offer or distribute services to customers.

VI. Antitrust

A. *Orologio of Short Hills, Inc. v. Swatch Group (U.S.), Inc.* 2016 WL 3454211 (3d Cir. June 24, 2016)

This is an antitrust case reflecting that the issue of a Robinson-Patman Act ("RPA") violations is alive and well. It also looked at the definition of a franchise under the New Jersey Franchise Practices Act ("NJFPA").

The NJFPA claim was that the plaintiff was a franchisee of the defendant and any termination of its agreement would have to comply with the NJFPA. The court said there was no "community of interest" in this case. According to the court, the factors for this analysis under the NJFPA are: (1) the licensor's control over the licensee; (2) the licensee's economic dependence on the licensor; (3) disparity of bargaining power; and (4) the presence of a franchise-specific investment by the licensee.

The court said that the alleged franchisee must establish that it was subject to the whim, direction and control of a more powerful entity whose withdrawal from the relationship would shock a court's sense of equity. There was no community of interest where the retailer relied (and could continue to rely) on a number of suppliers other than the alleged franchisor and had not been required to heavily invest in franchise-specific equipment or goodwill. The New Jersey courts are not persuaded even where the franchisee obtains 38% of its revenue from the alleged franchisor. Here the plaintiff thrived after losing the agreement, making it clear that it was not economically dependent on the defendant.

The alleged franchise specific investments were primarily inventory. But the defendant offered to buy that back. The plaintiff also alleged marketing, training, and advertising costs. But the court said as to those costs, they were par for the course for any store that sells products manufactured by a supplier.

Finally, the court said that there was no significant level of control. While there were rules and limitations relating to the sale of the watches, they were not so burdensome as to create the unfettered (the court's word) control typically present in a franchise.

No community of interest, no franchise. No franchise, no NJFPA claim.

However, the court did look at the differing offers from the defendant of marketing programs between the various dealers, and it held that there was enough on its face to make it a fact question whether there was a triable issue for an RPA violation.

B. *Window World of Baton Rouge, LLC v. Window World, Inc.*

2016 WL 6242945 (N.C. Super. Ct. Oct. 25, 2016)

The question in this case was whether the plaintiff window replacement franchisees stated a case under North Carolina antitrust law (which is based on US antitrust law) against a franchisor defendant that had changed a policy and thereafter required that the franchisees in the system buy and use only the franchisor's windows--whether, in effect, there was a contractual "lock-in" for the franchisees.

The court said that the effect of an advance disclosure of a tying arrangement is to prevent the purchaser from being "locked-in". That is, if the franchisee had advance notice of the ability of the franchisor to require purchases from a specified vendor, the prospective franchisee could make the decision to join another system and hence not be locked-in and limited to the franchisor's sources for its relevant market.

The franchise agreement here said: "Licensee expressly agrees that it will sell and install only and exclusively those products, goods, equipment and parts from vendors approved by Window World." This, in the court's view, clearly put the franchisees on notice that the franchisor retained the authority from the outset to require the franchisees to purchase only from a Window World approved vendor. Hence, there was no prohibited "lock-in" after the initiation of the franchise agreement.

VII. System Change

A. *Jade Grp., Inc. v. Cottman Transmission Ctrs., LLC* 2016 WL 3763024 (E.D. Pa. July 13, 2016)

This is an interesting case that brought to the fore the multiple issues and challenges for a franchisor that buys a competing system. The defendant's, a well-known transmission repair franchise system, acquired an even more well-known system—AAMCO. The parent in the acquisition was American Driveline. The American Driveline at first thought it would merge and rebrand all as AAMCO, but as a result of significant push back from Cottman branded franchisees, decided to operate two systems. Later, the American Driveline apparently decided that it would simply maintain the Cottman system, rather than vigorously support and grow it.

There were issues as to whether Cottman breached the franchise agreements in that it: (1) failed to fulfill its obligation to promote and protect the company's goodwill; (2) together with GPS, a third party, pushed the installation of rebuilt transmissions instead of the repair of transmissions to the detriment of the franchised stores profitability; (3) allowed AAMCO to pirate its national account business; (4) gutted its intercity warranty program by allowing store count to decrease; (5) failed to fulfill its obligations for assistance in obtaining a location and negotiating a lease; (6) failed to fulfill its obligations to assist with the layout of the stores and installation of equipment; (7) failed to provide assistance in finding and evaluating personnel; (8) failed~~ing~~ to provide or update Manuals relating to its change to more general repair centers; (9) failed~~ing~~ to provide initial and additional training programs; and (10) breached its obligations to provide advertising by scaling back.

The plaintiffs also said that the defendants intentionally were undermining the Cottman brand in a way that constituted tortious interference with the License Agreements. And plaintiffs alleged that pushing the rebuilt transmissions constituted tortious interference with their relationship with existing and future customers.

The plaintiffs asked the court to declare the License Agreements and covenants not to compete void.

The defendants asked the court to rule that the plaintiffs' claims rested on an unreasonable interpretation of the agreements requiring a perpetual increase in the number of shops. The court responded by saying that the claim is not that the agreements require a perpetual increase in the number of shops, but rather a claim that Cottman failed to develop, grow and protect the company's goodwill as required by the franchise agreement.

The court also ruled that the plaintiffs stated a claim for breach of contract on the other claims, notwithstanding the defendants' argument that the claims were a mere allegation that the assistance provided was less than before. The defendants interpreted the provisions as requiring that Cottman only provide some assistance and that it would not matter not how little they provided. The court responded by saying that Cottman's interpretation is not the only reasonable interpretation, so the court could not conclude there was no set of facts upon which the plaintiffs could prevail.

Because the events took place over a number of years, the defendants raised a statute of limitations defense. But the court said that even though there is a question as to when the claims arose, it would seem that they crystalized when American Driveline's CEO formally announced the plan to simply maintain the brand.

The plaintiffs also raised a good faith and fair dealing claim (the franchise unicorn returns), but the court on this issue said that the plaintiffs based their good faith and fair dealing claim on the same facts as their breach claim, and did not articulate any breach separate from the contract claims. Since they had an adequate remedy on their breach of contract claims, they could not state a good faith and fair dealing claim (the unicorn again fades into the mist).

The tortious interference claim against American Driveline was that by adopting a strategy to discontinue support for the Cottman system it caused Cottman to breach the franchise agreements. The tortious interference claim against GPS (the maker of rebuilt transmissions), was that it worked to convince customers to buy rebuilt transmissions rather than let the stores repair the transmissions.

American Driveline argued that the plaintiffs failed to state a claim for tortious interference because they could not state a claim for the underlying breach of contract, and that American Driveline's actions were privileged because they were merely protecting their corporate assets.

According to the court the analysis is: (1) existence of a contractual relationship; (2) an intent on the part of the defendant to harm the relationship; (3) the absence of privilege or justification; and (4) actual damages.

The court said that intent to harm requires only an intention to interfere, not malevolent spite. The inquiry as to whether privilege exists is fact intensive. Justification for recognizing a parent's privilege is, in part, to protect its interest in the financial stability of its subsidiary. However, the facts alleged suggest that American Driveline's conduct was motivated not by a desire to protect Cottman's assets, but by an interest in aggrandizing itself through the growth of Cottman's sibling AAMCO. So, the court ruled that it would be premature to dismiss the tortious interference claims.

As to the claim against GPS for tortious interference, the ~~plaintiffs alleged~~plaintiffs alleged that certain individuals working on behalf of American Driveline and GPS actively solicited prospective fleet customers to buy GPS transmissions rather than allowing the Cottman shops to repair transmissions. The court also declined to dismiss that claim since there were facts alleged that could support it.

Finally, since there remained facts to establish in order to conclude there was a breach, the court could not rule on the claims as a matter of law, so it ~~could not~~could not issue the declaratory judgment requested by the plaintiffs.

VIII. Indemnification

A. *L.A. Ins. Agency Franchising, LLC. v. Montes*
2016 WL 4415238 (E.D. Mich. Aug. 19, 2016)

This case interprets an indemnification provision, as the defendant was hoping to void the entire franchise agreement on the basis that the indemnification was so broad (per the defendant's assertion—indemnification for all claims, even those of the defendant against the plaintiff franchisor) as to negate any lability for the plaintiff franchisor, even for compliance with the terms of the agreement. That would have meant there was a lack of mutuality in the agreement.

The court looked at the language of the provision, which indemnified for claims arising out of the possession, ownership or operation of the franchised business, and said that this appropriately limited the scope of the indemnification, since the only party which possessed, owned and operated the franchised business was the franchisee. The franchisor was not exculpated for claims against it. The agreement was not void.

IX. Termination

A. *Steak N Shake Enter., Inc. v. Globex Co., LLC*
2016 WL 4743685 (10th Cir. Sept. 12, 2016)

This fairly straightforward case affirms the franchisors' right to terminate upon proper notice when the franchisee does not follow the system. Here the franchisee did not follow the franchisor's mandatory promotion, and even tried to hide it from its customers and over charge them. The trial court had granted summary judgment for the franchisor confirming the termination, and the appeals court had no problem affirming.

B. *H&R Block Tax Servs. LLC v. Strauss* **2017 WL 395119 (N.D.N.Y. Jan. 27, 2017)**

This case is interesting because it reflects Missouri law to the effect that unless a contract says it is intended to be perpetual, it is not. Here, the franchise agreement provided for automatic renewal every 5 years unless the franchisee is in default. The provision also said the franchisee could terminate upon 120 days notice at the end of any term. In many jurisdictions, this provision would be interpreted to provide for a perpetual agreement, subject only to termination based on breach, or in the event the franchisee chose not to renew and so notified the franchisor within the 120 day period. But here, the agreement had a Missouri choice of law provision.

H&R Block offered up a new form of agreement on a renewal in 2014, and the franchisee declined to renew on the new form. The franchisee began a competing business, which caused H&R Block to file suit to enjoin violation of the franchise agreement's non-compete.

The defendant filed a counterclaim for breach, saying that H&R Block had to automatically renew the agreement on the same terms, and because it had not, it had breached the agreement. The court ruled against the defendant, based on Missouri's aversion to perpetual agreements. And, the court also ruled against the defendant on H&R Block's non-compete claims.

C. *JTH Tax, Inc. v. Aime* ***2017 WL 640092 (E.D. Va. Feb. 15, 2017)***

This case is summarized by the Jim Croce song that ends with…"and you don't mess around with Slim."

JTH Tax is Liberty Tax Service. They had a franchise agreement with defendant, who had 9 franchised offices. He lost his EFIN number, which would have enabled Liberty to terminate his agreements. But instead, they entered into what they referred to as a Purchase and Sale Agreement ("PSA") where they bought his franchised businesses, and agreed to let him operate them, and sell them back to him when he got his EFIN number back.

The facts are somewhat complicated, but suffice it to say that the plaintiffs reneged on the PSA to re-sell the business to the defendant. Then they accused the defendant of violation of his non-compete, hence this lawsuit.

The defendant counterclaimed for breach of the PSA. When the judge finished the bench trial and ruled, the only things not cut were the bottom of Liberty's feet. Liberty had to pay the defendant $2,736,896.17. You don't go messin' with a man's dreams.

X. Good Faith and Fair Dealing

In this section, we will examine a couple of unicorn cases. They are out there.

A. *Valley Stream Foreign Cars, Inc. v. American Honda Motor Co.*

2016 WL 5239645 (E.D.N.Y. Sept. 22, 2016)

This is an auto dealer case. The court interestingly dismisses claims for breach of contract, and under the New York Franchised Motor Vehicle Dealer Act ("NYFMVDA"). But it then says the plaintiff has a plausible claim for breach of the implied covenant of good faith and fair dealing.

At issue was American Honda's Wholesaling Policy, and the failure of Honda to enforce it. Wholesaling is where another dealer or Honda uses intermediaries to sell vehicles in the territory of an authorized dealer. The policy is that wholesaling is prohibited, as it cuts into the profits of the authorized dealer in the area. Honda argues that the policy does not impose on it an obligation to strictly enforce the policy.

The plaintiff had people selling in its territory in violation of the Wholesaling Policy and asked Honda to enforce it. When Honda did not, the plaintiff sued for breach of its franchise agreement, and violation of the NYFMVDA. It also sued for violation of the implied covenant of good faith and fair dealing.

The court agreed with Honda that it was not a violation of the franchise agreement or the NYFMVDA. But the court found that the plaintiff had adequately alleged Honda has arbitrarily acted counter to its stated interest and the interest of its dealers by taking no steps to enforce its Wholesaling Policy, turning a blind eye to violations of the Policy. Where one party has discretion, good faith and fair dealing brings in an obligation to exercise that discretion reasonably and with proper motive, not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectation of the parties.

Note that this is not a finding of a breach of the implied covenant, but it was the only claim the court let go forward.

B. *Sonic Industries LLC v. Halleran* 2017 WL 239388 (W.D. Okla. Jan. 19, 2017)

This case was a suit by Sonic for failure to pay amounts due. But it contains a host of counterclaims, ranging from fraud to violation of the FFA, FDUTPA, the Oklahoma Business Opportunity and Sales Act and the Oklahoma Consumer Protection Act. More importantly for this discussion, there is a counterclaim for breach of the implied covenant of good faith and fair dealing, or bad faith.

The argument was that Sonic abused its discretionary authority or failed to exercise that authority in good faith. According to the court, Oklahoma recognizes the existence of the implied covenant in every contract, but it is usually not recoverable as a tort independent from a breach of contract, other than where there is a "special relationship" between the parties. This special relationship arises where there is disparity in bargaining power (an adhesion contract), and elimination of risk.

However, according to the court, Oklahoma has been reluctant to extend that theory beyond the insurance field. Here the relationship is one of franchisor and franchisee. The defendant has not offered evidence that there was a significant disparity of bargaining power, or that this was a contract of adhesion. So, the court did not permit the defendant to separate out the bad faith claim as an independent one, and dismissed that particular claim with prejudice.

C. *Prostar Wireless Grp., LLC v. Domino's Pizza, Inc.* 2017 WL 67075 (N.D. Cal. Jan. 6, 2017)

Prostar was a potential vendor to Dominos for a GPS tracking system to be used by the drivers to provide a wealth of real time information. "Potential" because there was never a formal contract entered between Prostar and Dominos. Instead, there were years of back and forth with Prostar working hard on developing the system and Dominos encouraging that work.

When Dominos finally told Prostar that it did not intend to buy a system from Prostar, Prostar sued on a number of theories, one of which was a breach of the implied covenant of good faith and fair dealing. Ultimately, this claim was rejected by the court, after it had rejected Prostar's claim for an implied-in-fact contract. The court said that the implied covenant of good faith and fair dealing inheres in every contract. But here, there was no contract. Once again, the unicorn fades into the mist.

XI. Transfers

A. *Raheel Foods, LLC v. Yum! Brands, Inc.* 2017 WL 217751 (W.D. Ky. Jan. 18, 2017

Raheel is the typical transfer case, but with some helpful substantive facts for the claimant. It was not just a claim that the franchisor had been unreasonable in not approving a transfer. Raheel had buyers for its franchised businesses, and it claimed that Yum denied approval for the buyers, then later approved the buyers for company owned stores.

Raheel asserted the following claims in its complaint: (1) intentional interference with prospective economic advantage; (2) negligent interference with prospective economic advantage; and (3) unfair competition based on Kentucky common law and the California Business & Professions Code Section 17200 (the "UCL"). The parties agreed that Kentucky law would apply.

As to the first, the court said that Kentucky law required a showing of malice or some significantly wrongful conduct. However, the court said a party can act with malice in the absence of "ill will". Malice in this context means merely intentional interference without justification. The real question is whether the actor's conduct was fair and reasonable under the circumstances.

But the court said that if the parties are competitors, one does not interfere improperly if the matter is involved in the competition, the actor does not employ wrongful means, the action does not create an unlawful restraint of trade, and his purpose is at least in part to advance his interest in competing.

Yum argued in general that they had the right to deny any sale, and that the exercise of legitimate contract rights cannot give rise to an intentional interference claim. But Raheel did not allege that the plaintiff's mere denial was improper—rather they alleged that there was an improper purpose—to take the buyers for themselves.

The court then looked at the competition issue. It said that Yum was privy to the terms of the Raheel deals and used its contract rights to handcuff Raheel and purloin their potential purchasers. The court said this was not ordinary competition. The court rejected the argument that a claimant must plead unlawful means such as fraud, deceit, or coercion when the parties are competitors. Wrongful means is enough.

The court let the first claim go forward. It does not define "wrongful means", but by its decision indicates that the conduct here was within the scope of "wrongful means".

As to the second claim, Raheel admitted that Kentucky did not recognize a claim based on negligent interference with prospective economic advantage, and asked the court if it could amend to assert negligence. The basic argument was that Yum had a general duty of care not to use the information received from the franchisees to derail the transactions for its benefit. The court rejected that argument, saying that there was no such general duty recognized under Kentucky law.

The court also rejected the third claim. Unfair competition would require some deception or intended deception of the public. That was not involved here at all. And the UCL variant was rejected as well—because the parties agreed to Kentucky law, the California UCL had no bearing. The court further stated as to the UCL that it was settled that a UCL claim could not be brought for claims for wrongful conduct outside of California. Raheel tried to argue that the decisions were made by Yum personnel in California (because that is where Raheel was when he interfaced with them), but the court pointed out that Yum is based in Kentucky.

Importantly, while the court rejected the last two claims, when it dealt with the first it seemed to make it clear that the facts supported Raheel's claims and that Raheel was likely to prevail.

XII. System Standards

A. *Noble Roman's, Inc. v. Hattenhauer Distrib. Co.* 2017 WL 640092 (S.D. Ind. Feb. 27, 2017)

This case stands for the proposition that if a franchisor wants to enforce the detail of a system standard issue, it cannot sit on its rights. The franchisor, Noble Roman's, sought to recover for the fact that the franchisee had used the wrong cheese on its pizza's for an extended period. But it was shown Noble Roman's knew of the issue for a long time, and that the error on the part of the franchisee was inadvertent and it corrected it as soon as it was apprised of the issue.

The claim was for a Lanham act violation—Noble Roman's sought recovery for damage to its mark brought about by failure to use the right cheese. The court ruled against Noble Roman's because of laches. It had not brought its claim promptly (the issue had continued for 4 years), further, the equities favored the defendant—the error was inadvertent and correction was made as soon as the error was called to its attention.

XIII. Defamation

A. *Rolle v. Cold Stone Creamery, Inc., et al.* 2017 WL 815365 (Fla. App. March 1, 2017)

Rolle was a former Cold Stone franchisee who participated in a CNBC documentary entitled “Behind the Counter: the Untold Story of Franchising”.

In response to the documentary airing, Cold Stone hired Bob Zarco to represent the Cold Stone Franchisee National Advisory Board. He wrote a letter to CNBC making certain claims critical of Rolle and demanded that the documentary be pulled from the air. He included his cell phone number and requested a call over the weekend to discuss the matter. Zarco also sent the letter to Janet Sparks of Blue Mau Mau who published an article on the Blue Mau Mau blog, including quotes from the letter.

Rolle sued for defamation.

The trial court dismissed the claims. It said that the statements were privileged in that they were made in litigation. However, the appeals court reversed, saying that it is not clear on its face from the letter that the matter was in litigation or that the statements made in the letter were “in litigation”, as there had been no complaint filed and litigation was not explicitly threatened in the letter. Further, the letter did not on its face assert that it was sent as a pre-suit notice, which would have made it privileged.

Practice note—where one intends to avail oneself of a privilege to shield from a defamation claim, this should be clearly stated in any correspondence, and the research done to ensure that the privilege is available. Too much is at stake for any shortcuts.