International Franchise Association
49th Annual Legal Symposium
May 15-17, 2016
JW Marriott
Washington, D.C.

2016 JUDICIAL UPDATE

Key Legal Trends Affecting Franchising

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ACKNOWLEDGEMENTS

The authors would like to thank Kathryn Hauff, an attorney at Gray Plant Mooty, Molly Littman, a law clerk at Gray Plant Mooty, and Matt De Antonio and Ted Pearce, attorneys at Bradley Arant Boult Cummings LLP, for their assistance in the preparation of this paper.

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INTRODUCTION

This year, the IFA is introducing a new approach to the Judicial Update. Instead of taking a quick look at every franchise-related case decided over the past year, the Judicial Update will take a longer look at a smaller number of cases and statutes – those that are significant for addressing new issues of law or signaling new trends. Case summaries will be followed by “practice points” – questions and suggestions concerning what guidance franchise lawyers can take from these cases.

I. JOINT EMPLOYER

The most significant developments in franchise law in the past year centered on the new legal standard for determining joint-employer status, which could potentially reclassify franchisors as joint employers of their franchisee's employees. Franchisors in opposition to the designation worry that the developments are fundamentally at odds with the purpose of franchising, *i.e.*, to allow franchisors to grow their brand while allowing franchisees to own and operate their own independent business. Support for the joint employer designation, on the other hand, stems largely from the prospect of giving labor unions the ability to bargain directly with companies over employment matters. Although the new standard's application to franchisors is far from resolved, developments over this past year have major implications for the industry, and franchisors need to address these changes to ensure the continued expansion of their brands.

In 2014, the California Supreme Court decided the celebrated *Patterson v. Domino's* case, holding that Domino's was not a joint employer by virtue of setting brand standards and therefore could not be held liable for a sexual harassment allegation made by a franchisee employee against her supervisor. Just four months later, however, the National Labor Relations Board (NLRB) announced it would sue McDonald's as a joint employer of its franchisees' employees under a new test for determining joint-employer status. Under the previous legal standard, a franchisor would be deemed a joint employer only if it exercised control over its franchisees' employees; however, the NLRB's suit announced a broader standard that would render a franchisor a joint employer even if rights the franchisor reserved and did not exercise indirectly affected the terms of the franchisees' employees.

In the midst of widespread consternation and uncertainty throughout the industry, the NLRB in April 2015 published a nonbinding advice memo to Freshii Development, LLC concluding that Freshii was not a joint employer under the previous control test and would not be a joint employer under the then-proposed indirect control test announced in the pending McDonald's case. On August 27, 2015, the NLRB announced in the landmark *Browning-Ferris Industries of California* decision that Browning-Ferris Industries was indeed a joint employer. In doing so, the NLRB overturned 30 years of precedent and formally adopted the new test for determining joint-employer status.

Although the new test continues to be litigated, another significant joint employer case was announced on September 25, 2015, in another suit against McDonald's. In *Ochoa v. McDonald's Corp*., a federal court in California denied McDonald's motion for summary judgment, holding that the franchisor did not exert sufficient direct control over the franchisee's employees to be classified as a joint employer under California law but could be found to have employer liability under an alternative "ostensible agency" theory, which would be determined at a later trial.

More recently, the federal district court in *Wright v. Mountain View Lawn Care, LLC*, decided that the franchisor was not a co-employer with its franchisee, finding that the relationship did not meet the determinative factors to establish joint employer status under Title VII. And in *Kucher v. Domino's Pizza*, a franchisee's employee filed a complaint against Domino's alleging the franchisor is a joint employer because it knew or should have known about its franchisees' unlawful wage practices in light of the control and oversight Domino's maintains over its franchisees.

Finally, state legislative bodies have attempted to join in the debate. Michigan, for example, recently passed a law clarifying that franchisors and franchisees are not co-employers.

A. ***Browning Ferris Indus. of Cal., Inc.,*** **362 N.L.R.B. No. 186**

In *Browning-Ferris Industries of California, Inc.*, a five-member panel of the NLRB addressed the 30-year-old standard for joint employer status, prefacing its need to revisit the standard on the fact that "the Board's view of what constitutes joint employment under the Act has narrowed, [and] the diversity of workplace arrangements in today's economy has significantly expanded." The NLRB panel further stated that it needed to "revisit and revise" the Board's joint employer standard to put it "on a clearer and stronger analytical foundation . . . [and] to best serve the Federal policy of 'encouraging the practice and procedure of collective bargaining.'"

Browning-Ferris (BFI) contracted with Leadpoint, a supplier firm, to provide workers for its facility. In June 2013, approximately 240 of these workers sued BFI claiming it was a joint employer for the following reasons:

- Leadpoint was responsible for recruiting, interviewing, testing, selecting, and hiring personnel to perform work for BFI. However, these employees were required to have the "appropriate qualifications consistent with all . . . instructions from BFI . . . ."

- Leadpoint was responsible for counseling, disciplining, reviewing, evaluating, and terminating personnel assigned to BFI, but BFI retained the authority to "reject any Personnel, and discontinue the use of any personnel for any or no reason." Furthermore, BFI <u>did</u> engage in two incidents of disciple of personnel.

- Leadpoint was responsible for determining the employees' pay rates, but it could not, without BFI's approval, "pay a pay rate in excess of the pay rate for full-time employees of BFI who perform similar tasks."

- BFI established the facility's schedule of working hours, while Leadpoint was responsible for providing employees to cover all three shifts. Furthermore, Leadpoint had no input on schedules, and Leadpoint was required to obtain signatures from authorized BFI representatives to attest to the accuracy of its employees' "hours of services rendered" forms; otherwise, BFI could refuse payment to Leadpoint for any time claimed.

- BFI determined how many workers it needed each day and dictated the number of workers to be assigned to a particular project, while Leadpoint could assign its employees to specific "posts." Before each shift, BFI's shift supervisors held meeting with Leadpoint's supervisors to present and coordinate the day's operating plan, during which BFI's managers dictated which "steams" would be operating and established the work priorities for the shift.

- Leadpoint periodically received substantive training and counseling from BFI's managers. Leadpoint, then, trained the new employees.

In the Board's 3-2 decision, it adopted a new "totality of the circumstances" and "right to control" standard which it applied retroactively. Under the Board's new test, it will find that:

> . . . two or more statutory employers are joint employers of the same statutory employees if they 'share or codetermine those matters governing the essential terms and conditions of employment.' In determining whether a putative joint employer meets this standard, the initial inquiry is whether there is a common-law employment relationship with the employees in question. If this common-law employment relationship exists, the inquiry then turns to whether the putative joint employer possesses sufficient control over employees' essential terms and conditions of employment to permit meaningful collective bargaining.
>
> We will no longer require that a joint employer not only possess the authority to control employees' terms and conditions of employment, but also exercise that authority. Reserved authority to control terms and conditions of employment, even if not exercised, is clearly relevant to the joint-employment inquiry . . . Nor will we require that, to be relevant to the joint-employer inquiry, a statutory employer's control must be exercised directly and immediately. If otherwise sufficient, control exercised indirectly—such as through an intermediary—may establish joint-employer status.

The Board went on to explain that examples of "essential terms and conditions of employment" include: "hiring, firing, discipline, supervision, and direction; wages and hours; the number of workers to be supplied; controlling scheduling, seniority, and overtime; and assigning work and determining the manner and method of work performance."

The dissent's disagreement of the majority's decision was two-fold: (1) the majority's decision was inconsistent with the law; and (2) the decision created no certainty and provided no basis for parties in a business relationship to protect themselves from being labeled a joint employer. Recognizing these arguments, the majority in footnote 120 wrote:

> The dissent is simply wrong when it insists that today's decision fundamentally alters the law with regard to the employment relationships that may arise under various legal relationships between different entities . . . [including] franchisor-franchisee [relationships] . . . . None of those situations are before us today, and we decline the dissent's implicit invitation to address the facts in every hypothetical situation in which the Board might be called on to make a joint-employer determination. As we have made clear, the common-law test requires us to review, in each case, all of the relevant control factors that are present determining the terms of employment. In this case, we are specifically concerned only with two employers: BFI and Leadpoint.

PRACTICE POINTS

Although the case has been appealed and the contours of the test will be defined in other cases through the courts, the National Labor Relations Board will apply the new standard immediately. Although this was not a franchise case, it could potentially have significant effects on the franchise industry, and leaves franchisors guessing as to how much indirect control they must have over their franchisees' employees to be rendered a joint employer. Certainly, franchisors must respond to Browning-Ferris by taking a more hands-off approach to their franchisees' employees, but what it means to "share or codetermine those matters governing the essential terms and conditions of employment" is nearly impossible to precisely ascertain, and does not allow franchisors the certainty that their businesses require. Between the new test's prohibition of controlling, even indirectly, a franchisee's employees, and trademark law's requirement that franchisors impose quality controls over its franchisee's brand use (lest the franchisor risks losing its trademark rights) the franchise industry is potentially left with a very narrow space in which to operate. Franchisors trying to avoid the consequences of the amorphous standard are forced to correctly draw the fine line between essential policing of brand standards, and unlawful control over franchisee employees. Although Browning-Ferris offered franchisor's little direction on where to draw that line, the Freshii Ad. Memo provided practical guidance to aid franchisors trying to avoid joint-employer status.

B. ***Nutritionality, Inc. d/b/a/ Freshii*, 13-CA-142297 N.L.R.B. Ofc. of Gen. Counsel (Apr. 28, 2015)**

On April 28, 2015, the National Labor Relations Board's Office of General Counsel released its "advice memorandum" concluding that neither Freshii nor its Chicagoland development agents were joint employers with Nutritionality because there was no evidence that Nutritionality shared or codetermined with Freshii matters governing the essential terms and conditions of employment of Nuritionality's employees.

Freshii, a fast-casual restaurant chain, contracted with a "development agent" in different geographic locations to start new franchises and help ensure mandatory board standards for its existing franchises. Nutritionality operated a single Freshii store in Chicago. In the summer of 2014, Nutritionality terminated one employee and disciplined and terminated another employee for attempting to unionize the workforce. The plaintiffs brought unfair labor practice claims against Freshii and Nutritionality as joint employers.

To determine whether Freshii was a joint employer, the Board looked at whether the two separate entities "share or codetermine those matters governing the essential terms and conditions of employment." That is, Freshii must "meaningfully affect matters relating to the employment relationship, such as hiring, firing, discipline, supervision, and direction." Other factors such as an employer's involvement in decisions relating to wages and compensation, the number of job vacancies to be filled, work hours, the assignment of work and equipment, employment tenure, and an employer's involvement in the collective bargaining process, are all relevant in determining whether the entities are joint-employers.

Applying this standard to Freshii's practices, the Board found that Freshii played no role in Nutritionality's decisions regarding hiring, firing, disciplining or supervising employees. The Board further stated that "[w]hile potential applicants are able to submit resumes through Freshii's website for employment at franchise locations, there is no evidence that Freshii screens the resumes or does anything other than forward them on to individual franchises." There was also no evidence that anyone other than Nutritionality was responsible for determining wages, raises, or benefits of its employees, consistent with the franchise agreement between Freshii and Nutritionality, which gives the franchisee the power to determine whether to use Freshii's personal policies or procedures and stated that Freshii "neither dictates nor controls labor or employment matters for franchisees and their employees . . . ."

Furthermore, the Board found that Freshii was not involved in Nutritionality's scheduling or setting work hours even though Freshii provided guidance on how to calculate labor costs to ensure that restaurants are not overstaffed and understaffed. While Freshii required trainings for each franchise that both the owners and managers must attend, the training dealt primarily with the restaurant's operations and not its employment practices. "At most," the Board stated, "Freshii's control over Nutritionality's operations are limited to ensuring a standardized product and customer experience, factors that clearly do not evince sharing or codetermining essential terms and conditions of employment."

The Board also found that it would not have made a difference if the Board returned to its traditional joint employer standard because Nutritionality and Freshii were not joint employers under either standard. Because Freshii did not significantly influence the working conditions of Nutritionality's employees, it did not directly or indirectly control or otherwise restrict the employees' core terms and conditions of employment and meaningful collective bargaining between Nutritionality and any potential collective-bargaining representative of the employees could occur in Freshii's absence.

PRACTICE POINTS

Although the nonbinding Freshii Advice Memorandum did not give franchisors bright-line standards for determining joint employer liability, it did highlight factors franchisors can expect to be considered in the new "totality of the circumstances" standard. The Freshii Advice Memorandum should also reassure franchisors that they can avoid the joint employer standard after Browning-Ferris, especially given the similarities between Freshii's system and other franchise systems.

Franchisors can limit the extent of their risk of joint-employer status in a number of ways. First, franchisors should make clear in their franchise agreements and operations manuals that they do not control employment matters such as hiring, firing, disciplining, scheduling, payment, and benefits, and they should affirmatively state that these matters are reserved solely to the franchisee. Although franchisors must include certain standards in their agreements and other documentation in order to adequately police their trademarks and ensure customers have a consistent experience, they should expressly state that these controls are solely for uniformity and quality assurance.

Next, franchisors should ensure that the franchisee, the franchisee's employees, and the general public are aware that the franchisee is an independent contractor, and that the franchisee's employees are not employed by the franchisor. The franchisor can accomplish this by requiring signage that the franchised unit is independently owned and operated, adding appropriate language to its franchise agreements, and prohibiting use of the franchisor's trademarks on the franchisee's employee evaluation forms, benefits statements, payroll checks, and employee handbooks. Finally, franchisors should limit their interactions to a franchisee's management-level employees and avoid giving suggestions or advice to other employees of the franchisee.

***C. Ochoa v. McDonald's Corp.*, No. 14-cv-02098, 2015 WL 5654853 (N.D. Cal. Sept. 24, 2015)**

In *Ochoa v. McDonald's Corp.*, the plaintiffs alleged that McDonald's was jointly liable for the Labor Code violations of its franchisee. To support its joint-employer liability claim, plaintiffs alleged that McDonald's exercised direct control over the franchisee. Plaintiffs submitted evidence such as McDonald's power to terminate franchise agreements, power to decline to renew existing agreements, and power to impose technology, personnel, and training requirements on its franchise operations. The court acknowledged this evidence and even found it clear that "McDonald's has the ability to exert considerable pressure on its franchisees." Ultimately, however, the court held that the "evidentiary showings about McDonald's strength as a franchisor do nothing to negate or call into question the dispositive fact that the authority to make hiring, firing, wage, and staffing decisions at the Smith restaurants lies in Smith and its managers—and in them alone." The court further held that McDonald's "mere monitoring" of customer service metrics—such as crew scheduling and staffing—was not “active employee control.” McDonald’s monitoring and review of the franchisee was not considered “control” because McDonald’s would have had to “resort to economic and business relationship sanctions to motivate Smith to implement service changes,” which underscored its lack of direct authority and control.

The plaintiffs also alleged that because McDonald’s required its franchisees to use its proprietary software, which included functions for timekeeping, crew scheduling, inventory, and positioning, it had exercised sufficient control over the franchisee to make it a joint-employer. However, the court again disagreed, stating that “[m]any companies supply employment-related software that might as a practical matter be necessary for a franchisee to use, and plaintiffs’ position would unreasonably expose them to employer liability for programming or bugs that result in labor law violations.”

In making its determination, the court relied heavily on *Martinez v. Combs*, 49 Cal. 4th 35 (2010), in which the Supreme Court of California held that a farmer and the produce merchants through whom the farmer sold his fruit were not joint employers. The court in *Martinez* reasoned that even though the merchants would check the packed containers as workers brought them from the field, would explain to the farmer and his foreman how the merchant wanted the strawberries packed, and would sometimes speak directly to the workers, that did not establish that the merchant was an employer because the merchant lacked “the authority to directly control their wages, hours or conditions” and “there was no evidence that the farmer’s employees viewed the field representatives as their supervisors or believed they owed their obedience to anyone, but the farmer and his foreman.” Similarly here, the court ruled that any control that McDonald’s exercised over its franchisee was not enough to categorize it an “employer” and that there was no evidence that McDonald’s “exercised control over wages, hours or working conditions.”

Although the court held that McDonald’s could not be classified as an employer under the standard set out in *Martinez*, it denied the defendant’s motion for summary judgment because there was evidence that McDonald’s was liable under an “ostensible agency” theory. As the court described, ostensible agency exists where (1) the person dealing with the agent does so with reasonable belief in the agent’s authority; and (2) that belief is “generated by some act or neglect of the principal sought to be charged.” The plaintiff-employees have stated they believed McDonald’s was their employer because they wear uniforms, serve food, receive pay stubs with McDonald’s trademark and also may apply for a job on McDonald’s website. McDonald’s provided no evidence to contradict plaintiffs’ claim, and the claim against McDonald’s under an ostensible agency theory moved forward.

PRACTICE POINTS

Ochoa is one of a number of pending cases against McDonald’s seeking to hold the franchisor liable as a joint employer with its franchisees. Although the case does not cite or even mention the Browning-Ferris decision, McDonald’s was one of the franchisors over which the minority in Browning-Ferris expressed concern. On one *hand, the Ochoa decision should bring some comfort to franchisors—that despite the decision in Browning-Ferris, the extent to which the new standard is set is far from resolved. On the other hand, McDonald's did not come away from the case unscathed. The court found that under an "ostensible agency" theory, the franchisor could still be classified as a joint employer. Franchisors can learn from the Ochoa case by taking the steps described above to ensure that franchisees' employees know they are employed by independent businesses.*

D. *Wright v. Mountain View Lawn Care, LLC,* No. 7:15-cv-00224, 2016 WL 1072506 (W. Va. March 11, 2016)

In *Wright v. Mountain View Lawn Care, LLC,* a West Virginia federal district court concluded that U.S. Lawns, a lawn care franchisor, was not a joint employer of a franchisee's employee. Plaintiff Lisa Wright filed her complaint on May 11, 2015, alleging violations of Title VII of the Civil Rights Act, 42 U.S.C. §2000e, *et seq.*, for gender discrimination, harassment, and retaliation against franchisor U.S. Lawns and franchisee Mountain View Lawn Care, LLC. Wright primarily argued that U.S. Lawns was a joint employer because it provided extensive support to Mountain View, exerted sufficient control over the franchisee, and because Wright wore a U.S. Lawns uniform, drove a U.S. Lawns logoed truck, and received correspondence from her employer on U.S. Lawns letterhead. Alternatively, Wright also argued that U.S. Lawns and Mountain View should be considered a single, integrated employer for jurisdictional purposes, or that U.S. Lawns should be held liable for the Title VII violations under an apparent agency theory.

The court relied primarily on *Butler v. Drive Automotive Industries of America, Inc.*, 793 F.3d 404 (4th Cir. 2015) and concluded that U.S. Lawns was not a joint employer of Mountain View's employees. In *Butler*, the Fourth Circuit determined that multiple entities may be considered employers for purposes of Title VII by considering nine factors:[1]

(1) Authority to hire and fire the individual;
(2) Day-to-day supervision of the individual, including employee discipline;
(3) Whether the putative employer furnishes the equipment used and the place of work;
(4) Possession of and responsibility over the individual's employment records, including payroll, insurance, and taxes;
(5) The length of time during which the individual has worked for the putative employer;

[1] Joint employers, for purposes of Title VII liability, are two or more independent entities that share or co-determine matters governing the essential terms and conditions of employment and exercise significant control over the same employees. This is separate and distinct from the joint employer standard adopted by the NLRB in its *Browning-Ferris* decision and the standards outlined by the DOL Wage and Hour Division Administrator under the Fair Labor Standards Act in his Administrator's Interpretation 2916-1.

(6) Whether the putative employer provides the individual with formal or informal training;
(7) Whether the individual's duties are akin to a regular employee's duties;
(8) Whether the individual is assigned solely to the putative employer; and
(9) Whether the individual and putative employer intended to enter into an employment relationship.

The court noted that none of the factors were dispositive and that the element of control remained the "principal guidepost" in the analysis. The court explained that the first three factors, the most important factors in the test, all weighed in favor of U.S. Lawns, and that the remaining factors were either neutral or also weighted in U.S. Lawn's favor. Specifically, the court found that U.S. Lawns had no authority to hire or fire Wright, that Wright's personnel records were signed by Mountain View and were on Mountain View's letterhead, and that Wright's trucks and trailers were not furnished by U.S. Lawns, although they bore the U.S. Lawns logo. Additionally, the court found persuasive that U.S. Lawns did not provide training to Wright, and that Wright's work as a landscaper was fundamentally different from the tasks performed by U.S. Lawn's employees.

The court further held that U.S. Lawns and Mountain View were not liable under a single, integrated theory of employer liability, under which several companies may be considered so interrelated that they constitute a single employer for purposes of the Title VII statutory scheme, nor was U.S. Lawns liable under an apparent agency theory for substantially the same reasons the court concluded against a finding of joint employer status.

PRACTICE POINTS

The U.S. Lawns case again illustrates that joint employer determinations are fact specific. It is instructive in this case that the court found it important that the employee's records were signed by Mountain View and on Mountain View letterhead, unlike the Ochoa case, where the employee's pay stubs had McDonald's logo on them.

E. *Kucher v. Domino's Pizza, Inc.,* No. 1:16-CV-02492 (S.D.N.Y. Apr. 4, 2016)

On April 4, 2016, Riad Kucher, a former employee of five different Domino's franchised restaurants, filed suit in the Southern District of New York against Domino's Pizza, Inc. as his joint employer for a variety of wage violations. The complaint alleges that Kucher was forced to work over 20 hours per week off-the-clock, was not paid overtime compensation, had certain wages withheld, and was fired for complaining about wages being withheld. While other recent complaints seeking joint employer qualification for franchisors have focused their analysis on factors such as scheduling, training, and the identifying of franchisees as independent contractors—practices which franchisors can largely modify—the current complaint strikes at franchising itself. The crux of Kucher's argument is that Domino's knew or should have known about its franchisees' unlawful wage practices because "…Domino's maintains a high level of control and oversight of these franchise locations and had access to, *inter alia*, bookkeeping, payroll and timekeeping records, and has the ability to audit these records," controls the franchise locations through operational standards contained in the franchise agreements, and had the power to, but did not, terminate the franchisee employing Kucher for its non-compliance with the operational standards.

The complaint goes on to provide a laundry list of essential aspects of franchising evidencing Domino's control over its franchisees' employees. Specifically, the complaint includes argument that Domino's controlled Kucher's work by: performing routine inspections of its franchised locations, setting mandatory policies and procedures for the employees, controlling advertising, regulating employee behavior by dictating employee uniforms, creating training and development programs, providing operational support to franchisees on store operation, controlling the inventory and menu for its franchisee's stores, requiring franchisees to establish and retain financial records, and implementing a point-of-sale system which allows Domino's to access franchisee's financial records automatically or upon request. Notably, the complaint highlights a number of instances where government entities have fined Domino's restaurants for labor violations, and explains, "Domino's cannot continue to hide behind its franchise model—which allows it to reap massive revenues totaling almost $2,000,000,000 per year—and disclaim any responsibility for the conduct of its franchisees, while it is well aware that it flouts the law and mistreats its employees."

PRACTICE POINTS

Despite the complaint's portrayal of Domino's, it would be difficult for the federal district court to classify the franchisor as a joint employer unless the court is willing to squarely disagree with the California Supreme Court's 2014 decision in Patterson v. Domino's, and effectively inhibit the practice of franchising entirely. The legal standard for determining joint employer status has, however, changed since 2014, and is ripe for courts to define and interpret.

F. Michigan Franchise Investment Law § 445.1504b

Revisions to the Michigan Franchise Investment Law (MFIL) went into effect on March 22, 2016. The revisions attempt to limit a franchisor's exposure as a joint employer with its franchisees by amending MFIL to state that the "the franchisee shall be considered the sole employer of workers for whom it provides a benefit plan or pays wages except as otherwise specifically provided in the franchise agreement." The Michigan legislature also passed bills with similar language modifying the definition of employer under several other laws, including the Payment of Wages and Fringe Benefits Act.

PRACTICE POINTS

Although the MFIL was revised, the analysis and advice is still the same. Franchisors must ensure that it is clear that the franchisees are solely responsible for terms and conditions of their employee's employment.

With Browning-Ferris Industries appealing the National Labor Relations Board's ruling on February 26, 2016, and the existence of certain legislative proposals in Congress, it is possible that the expanded new test will not come to fruition. With both the NLRB's suit against McDonald's and the Ochoa v. McDonald's case ongoing, continued legal developments are certain. If enforced, however, the contours of the new test will surely develop for years to come, and franchisors will need to continue taking steps to minimize their risk of being classified as joint employers.

II. BRAND PROTECTION

Decisions by courts in the United States and in Canada this year clearly signaled the importance of protecting the franchise brand. In two cases, courts recognized franchisors' right to terminate franchisees for failure to implement required remodeling and for failure to abide by system-wide pricing and promotion requirements. In another case, a court affirmed a franchisor's duty to protect the system's brand against aggressive competition and against the harms to brand image that result from failure to enforce system standards.

A. *Dunkin' Donuts Franchising LLC v. Claudia III, LLC*, 2015 WL 4243534 (E.D. Pa. July 14, 2015)

A federal court in Pennsylvania granted summary judgment in favor of franchisor Dunkin' Donuts' on its claims that franchisee Claudia III breached its franchise agreement, infringed Dunkin's trademarks, and violated a covenant not to compete. The court then entered a permanent injunction barring Claudia III from operating its store as an unlicensed Dunkin' Donuts® shop.

Dunkin' Donuts terminated Claudia III's franchise agreement after the franchisee failed to complete a remodeling of its shop required by the agreement. The remodeling project stalled after state health officials refused to approve the architect's plans for the project, which involved locating a bathroom over a plugged drinking water well, known as a "well stub." (The architect, chosen from the franchisor's approved list, had completed more than 100 remodeling projects for Dunkin'.)

Despite the termination, Claudia III continued operating as a Dunkin' Donuts® shop, using the franchisor's trademarks and trade dress and continuing to pay royalties and advertising fees. Dunkin' continued to accept Claudia III's payments and continued to conduct inspections of the store, which Claudia III passed. Nevertheless, Dunkin' sued Claudia III and sought a preliminary injunction to prevent the franchisee's continued alleged infringement of its intellectual property.

The court in August 2014 denied Dunkin's motion for a preliminary injunction, (E.D. Pa. Aug. 11, 2014). Dunkin' proved that it had the right to terminate Claudia III for failure to remodel as the franchise agreement required, the court concluded, but it did not show that it was suffering irreparable harm. The court noted that the franchisee had complied with other provisions of the agreement, that the shop was in good condition, and that its current design, even if not up to date, still provided "an enjoyable and quality experience." The court also found that the balance of harms tipped in Claudia III's favor because the entry of an injunction would be a "death knell" for its business. Thus, the court permitted Claudia III to continue operation while the case played out. Soon after that ruling, in the fall of 2014, the franchisee ceased paying royalties and advertising fees to Dunkin'.

After losing its motion for preliminary injunctive relief, however, the franchisor won its motion for summary judgment. The court held that Claudia III breached the franchise agreement by failing to complete the required remodeling and by failing to pay royalties and advertising fees to the franchisor. The court noted that "even if Dunkin' were partially responsible for the default," that would not defeat the franchisor's breach of contract claim.

The court granted summary judgment on Dunkin's trademark infringement and unfair competition claims based on Claudia III's continued, unauthorized use of the marks after termination. The court also found the franchise agreement's covenant not to compete enforceable against Claudia III under Massachusetts law, specified in the agreement. The covenant prohibited the franchisee from selling products that were the "same or substantially similar to those sold in Dunkin' Donuts or Baskin-Robbins stores and located within five miles of any other Dunkin' or Baskin-Robbins store" for two years following termination. The covenant should be enforced, the court concluded, because it "protected a legitimate business interest, contained reasonable limits on its temporal and geographic reach, and did not harm the public interest."

Thus, based on "the public's interest in the enforcement of contracts and trademark law," the court entered a permanent injunction against Claudia III, prohibiting its continued use of the franchisor's marks and requiring it to abide by the franchise agreement's covenant against competition.

PRACTICE POINTS

Why did the tables turn between the court's rulings on Dunkin's motion for a preliminary injunction and its motion for summary judgment? The court may have been sympathetic to the franchisee at the preliminary injunction stage, given that the required remodel stalled because of problems with the plans submitted by the franchisor-approved architect, and given that the franchisee at that time was complying with all other requirements of the agreement. The court also may have been reacting to the

United States Supreme Court's admonition in eBay, Inc. v. MercExchange, LLC*, against simply presuming irreparable harm from infringement of intellectual property rights.* See *547 U.S. 388, 392-94 (2006). Soon after the preliminary injunction was entered, the franchisee stopped paying amounts owed to Dunkin' under the franchise agreement. This failure to pay fees may well have been a factor in granting the franchisor's summary judgment motion.*

B. *Dunkin' Brands Canada Ltd. v. Bertico, Inc.*, 2015 QCCA 624 (Apr. 15, 2015)

The Quebec Court of Appeal in April 2015 affirmed that franchisor Dunkin' Brands' agreements with its franchisees impose an implied duty on the franchisor to take reasonable steps to protect and enhance the brand against competition.
Dunkin' Donut's sales dropped precipitously in Quebec in the mid-1990s, as competitor Tim Hortons came on strong. By 2012, the number of Dunkin' stores in Quebec had shrunk from more than 200 to only 13, while the number of Tim Hortons stores grew from 60 to more than 300.

Canadian franchisees who had operated 32 Dunkin' Donuts stores during the 1990s and 2000s sued Dunkin' Brands Canada for breach of contract. They alleged that the franchisor's failure to protect the brand in Quebec constituted a breach that caused millions of dollars of losses resulting from the dramatic drop in the system's market share and profitability.

After a 71-day trial, the Quebec Superior Court on June 21, 2012, rendered a judgment holding Dunkin' Brands liable for breach of contract and awarding damages of \$16.4 million, including \$7.36 million for lost profits and \$9.05 million for lost investment value. The trial court found that Dunkin' Brands failed to respond to competition from Tim Hortons, failed to require its own franchisees to comply with system standards, thus damaging the Dunkin' brand, and failed to provide field support to its franchisees.

The franchisor appealed, arguing that the trial court imposed obligations on Dunkin' that it never assumed and held it to a standard that would force it to guarantee profits to its franchisees. The Quebec Court of Appeal disagreed and affirmed the trial court's decision on liability. Nevertheless, the appellate court reduced the award of damages to \$10.9 million, including \$4.4 million for lost profits and \$6.5 million for lost investment value.

First, the appellate court affirmed the trial court's finding that Dunkin' had a contractual obligation to protect the brand by promising to "protect and enhance both its reputation and the demand for the products of the Dunkin' Donuts System." This interpretation of the franchise agreement was reasonable because it explicitly rendered the franchisor responsible to "continue its efforts to maintain high and uniform standards of quality thus protecting and enhancing the reputation of Dunkin' Donuts Canada and the demand for the products."

The franchise agreement also implied such a duty, the appellate court concluded, because it committed the franchisor to take "different steps to assist the franchisees at the start of the franchise operation and over the life of the contract." This assistance included: agreeing to make available a training program, providing operating procedures, providing assistance in the pre-opening, opening, and initial operation of the shop; maintaining a continuing advisory relationship, including consultation with the franchisee regarding marketing, merchandizing, and general business operations; providing operating manuals and making on-going revisions to them; setting out standards, specifications, procedures, and techniques for the franchisee to follow; reviewing and approving proposed advertising prepared by the franchisee through the life of the agreement; and administering the advertising fund composed of contributions from all franchisees and providing programs designed to increase sales and further develop and enhance the public reputation and image of Dunkin' Donuts Canada.

The appellate court also determined that Dunkin' Donuts, by its actions, had communicated its responsibility to support the brand. For instance, the court stated:

> Unlike in other arrangements where a franchisor might merely provide[] a license and some modest start-up advice, the Dunkin' Donuts franchisees were by no means left to their own devices after their launch in this quick-service restaurant business. . . The Franchisor took on a role in choosing appropriate franchisees and approving new acquirers of existing franchises, of advising franchisees at the start of the venture, of offering assistance to them along the way to be sure that each franchisee respected the system upon which the reputation of the brand rested. The franchisee relied on the Franchisor assuming this role to justify his or her investment.

Therefore, the court held that "the agreement was a 'relational' one which, as is often the case in such long-term agreements, did not spell out all of its terms." But because these implicit obligations formed part of the long-term relationship, the trial court was reasonable in finding that the franchisor imposed upon itself the duty to support this brand.

Finally, the appellate court affirmed the trial court's determination that the franchisor "owed an obligation of good faith toward the franchisees, including a duty, in cooperation with them, to respond and adjust to new market conditions." This obligation of good faith gave rise to duties to refrain from taking actions that would wrongfully cause the franchisees harm, and to "assist and cooperate with the [f]ranchisees by taking certain active measures in support of the brand." Thus, the appellate court concluded, Dunkin' owed a duty of good faith to its franchisees extending through the life of the agreement, and the franchisees were entitled to rely on the franchisor "to take reasonable measures to protect them from the market challenge presented by Tim Hortons."

Dunkin' Brands sought leave to appeal this decision to the Supreme Court of Canada, but on March 17, 2016, its application was denied.

PRACTICE POINTS

Although Dunkin' Brands deemed the Superior Court's judgment "unprecedented in the annals of franchise law, not only in Quebec and Canada, but also in the United States," as a practical matter the decision, based on the Quebec Civil Code, is not binding outside of that province.

The decision may offer a roadmap for revisiting and revising certain provisions of franchise agreements going forward. First, franchisors may want to make explicit in their agreements that they make no guarantees regarding the success of the system, and that they may withdraw from a market or discontinue development at their sole option. Second, franchisors may want to limit "aspirational" language in recitals and contract provisions, such as the language in the plaintiff's contracts regarding "protecting and enhancing the reputation" of the system. Third, franchisors may want to make explicit in their agreements the limits on their obligation to protect the brand. That said, to the extent they do undertake these obligations – including, for example, enforcing brand standards – they should be vigilant in carrying out those obligations and documenting that they have done so. Finally, franchisors may want to consider a more balanced approach to the duties imposed on franchisors and franchisees, so that the judiciary will not feel compelled to provide that balance itself, by reading franchisor-specific duties into the agreement.

C. ***Steak n Shake Enterprises, Inc. v. Globex Co.*****, 110 F. Supp.3d 1057 (D. Colo. 2015)**

Franchisor Steak n Shake was justified in terminating the franchise agreements of Colorado franchisees who refused to comply with a system-wide promotion that offered "4 Meals Under $4," a federal court in Colorado ruled in June 2015. Not only did the franchisees fail to use the marketing materials Steak n Shake provided highlighting the "Under $4" menu promotion, they also "got rid of everything in both restaurants that would have alerted a customer to the fact that [the franchise] was supposed to be offering $4 meals." Without Steak n Shake's knowledge or consent, the franchisees printed and used their own menus, which priced these menu items a la carte at $5.08, rather than at the promotional price of $3.99.

After receiving complaints from customers at the franchisees' restaurants about their pricing, Steak n Shake discovered the franchisees' failure to comply with the system-wide promotion. Steak n Shake issued a default notice for the franchisees' failure to offer the "Under $4" menu, printing menus without the franchisor's consent, altering franchisor-issued marketing materials, and overcharging for menu items. Steak n Shake offered the franchisees an opportunity to cure these defaults within two days, but they failed to do so, and their agreements were terminated. Nevertheless, they continued operating as holdover franchisees.

Steak n Shake sought and was granted a preliminary injunction preventing the franchisees from continuing to operate their restaurants in violation of the post-termination obligations of their franchise agreements and of Steak n Shake's trademark rights. Steak n Shake then moved for summary judgment.

The franchisees argued that they were wrongfully terminated because they did not receive a 30-day cure period. The court rejected this argument, concluding that the franchisees knowingly overcharged for menu items and failed to offer mandatory promotions – violations that allowed for immediate termination under the franchise agreements.

The franchisees also brought counterclaims for breach of an implied duty of good faith, based on an argument that Steak n Shake did not allow them to operate their restaurants profitably. The court rejected this argument, concluding that terms a party has bargained for cannot be negated by an implied duty.

PRACTICE POINTS

Steak n Shake's franchise agreement expressly signaled the importance of uniformity in menu offerings, pricing, and promotions in protecting its brand. The agreement requires the franchisee to acknowledge that "maintaining uniformity in every component of the operation of the System is essential to the entire chain . . . including a designated menu (including maximum, minimum, or other prices the Franchisor specifies for menu items and mandatory promotions)." The agreement also requires the franchisee to comply with the franchisor's pricing "to the fullest extent the law allows." Franchisors may want to review their franchise agreements to expressly tie requirements for uniformity in the system – including honoring system-wide promotions – to protecting the brand.

III. PRIVACY

Data security breaches make the headlines daily, and breaches involving franchise systems are no exception. The Federal Trade Commission has aggressively pursued businesses that fail to keep individuals' data safe. The courts have upheld the Commission's authority to do so under the FTC Act, specifically, in a case involving a franchisor and its franchisees.

The new emphasis on data security threats is not confined to the United States. Franchisors that do business in other countries now must take into account the laws and regulations from other jurisdictions, including the European Union's latest initiatives to strengthen and harmonize Europe's regulation of data privacy.

A. *FTC v. Wyndham Worldwide Corp.,* 799 F.3d 236 (3d Cir. 2015)

The Federal Trade Commission's authority to sue private companies under the FTC Act for failing to keep consumers' personal information secure was upheld by the U.S. Court of Appeals for the Third Circuit in an opinion issued on August 24, 2015. On the heels of that opinion, on December 11, 2015, the FTC reached a settlement with the defendants, including Wyndham Worldwide Corp.; its subsidiary, Wyndham Hotel Group, LLC, which franchises 7,000 hotels; Wyndham Hotels and Resorts, LLC; and Wyndham Hotel Management, Inc. In effect, the Wyndham decision establishes that the FTC can regulate data security practices for Wyndham and other companies even without promulgating formal regulations.

The FTC's lawsuit alleged unfair or deceptive acts or practices in violation of the FTC Act, stemming from breaches of the property management system used by Wyndham (the franchisor) and its franchisees. A criminal organization hacked into the Wyndham system on three occasions between April 2008 and January 2010, first gaining access through a Wyndham-branded hotel's local computer network. As a result of these three breaches, more than 619,000 consumer payment card account numbers were compromised, and many were exported to a domain registered in Russia. Many consumers' accounts incurred fraudulent charges, with more than $10.6 million in fraud losses.

The FTC alleged that Wyndham's data security practices were "deceptive and unfair acts" prohibited by Section 5(a) of the FTC Act, 15 U.S.C. § 45(a). The practices were allegedly unfair because they failed to protect consumers' data, and deceptive because they misrepresented that Wyndham used "commercially reasonable efforts" and "industry standard practices" to keep data collected from hotel guests secure.

Specific practices claimed to violate the Act included: failing to use readily available security measures, such as firewalls; storing credit card information in clear text; failing to implement reasonable information security procedures before connecting local computer networks to corporate-level networks; failing to address known security vulnerabilities on servers; using default user names and passwords for access to servers; failing to require employees to use complex user IDs and passwords to access company servers; failing to inventory computers to appropriately manage the network; failing to maintain reasonable security measures to monitor unauthorized computer access; failing to conduct security investigations; and failing to reasonably limit third-party access to company networks and computers.

Wyndham moved to dismiss the FTC's complaint, on the ground that the FTC had no authority to assert an unfairness claim involving data security without first formally promulgating regulations to satisfy principles of fair notice. The International Franchise Association filed an amicus brief in support of Wyndham's motion to dismiss. The IFA argued that the FTC's deception claim was inconsistent with basic principles of franchise law, including that "a franchisor may be held liable for the actions of its franchisee only when it directly controls the franchisee's conduct."

The IFA also argued that the FTC's deception claim "overlooks" the explicit disclaimer in Wyndham's privacy policy, which stated:

> Our Franchisees.
> Each brand hotel is owned and operated by an independent Franchisee that is neither owned nor controlled by us or our affiliates. Each Franchisee collects Customer Information and uses the Information for its own purposes. We do not control the use of this Information or access to the information by the Franchisee and its associates.

These arguments were unavailing. The district court denied Wyndham's motion. 10 F. Supp. 3d 602 (D. N.J. 2014). Nevertheless, the court granted a motion by Wyndham to certify its ruling for an interlocutory appeal.

On appeal, Wyndham argued that the FTC did not have the authority to regulate data security under the "unfairness prong" of the FTC Act, and that, even if it did, Wyndham did not have fair notice that its specific data security practices could fall short of the statute's requirements. The Third Circuit disagreed.

In affirming the district court's ruling, the Third Circuit relied on the FTC Act's policy statement, which provides that to be "unfair," the offending act must cause substantial injury to consumers that is not reasonably avoidable and not outweighed by countervailing benefits to consumers or competition. Wyndham argued that its acts did not fall within the plain meaning of "unfair"—that is, unscrupulous, unethical, inequitable, or marked by injustice, partiality, or deception. The court ruled there is no requirement that an act be unscrupulous or unethical to be deemed unfair, but, even if that requirement did exist, the FTC's complaint would satisfy it. The court also ruled that even where a company is victimized by criminals, its conduct need not be the *most* proximate cause of an injury for the company to be liable for foreseeable harms.

Finally, the court held that Wyndham had fair notice of the data security standards it was required to follow and could reasonably foresee that its data security practices might fall within the purview of the FTC Act. In support of this conclusion, the court cited the inquiry set out in 15 U.S.C. § 45(n), which asks whether "the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition." The court conceded that this standard is "far from precise," but concluded that the standard informs parties that the relevant inquiry is a cost-benefit analysis of factors such as "the probability and expected size of reasonably unavoidable harms to consumers given a certain level of cybersecurity and the costs to consumers that would arise from investment in stronger cybersecurity."

<u>Wyndham's Settlement with the FTC</u>

On December 11, 2015, the FTC entered into a settlement agreement with the Wyndham defendants, resulting in a stipulated order for an injunction. The stipulated order applies to Wyndham's company-owned hotels; it does not apply to Wyndham's franchised hotels.

The order requires Wyndham to establish and maintain for 20 years a comprehensive information security program to protect payment card data collected or received by Wyndham-owned properties in the United States. Franchised properties are not subject to this requirement, but Wyndham must implement safeguards to control data security risks arising from network connections between franchised hotels and Wyndham's corporate data center.

The order also requires Wyndham to undergo annual independent assessments and get certifications of compliance with the Payment Card Industry Data Security Standard (PCI DSS).[2] As part of this process, Wyndham also must confirm that franchised hotels' computer networks are separate from Wyndham's system and beyond Wyndham's ability to control. An independent third-party auditor must certify that Wyndham safeguards its connections with its franchised hotels, and that Wyndham undertakes the comprehensive risk assessment laid out in the PCI-DSS risk assessment guidelines. If any additional data breach involving more than 10,000 credit card accounts occurs, Wyndham must obtain and provide to the FTC an assessment of the breach.

The settlement and order did not require Wyndham to pay any penalty or admit any liability.

PRACTICE POINTS

Data breaches pose tremendous risks for franchisors and franchisees alike – not only from potential liability to regulators and private litigants, but more importantly, from potential damage to the brand and disruption of business.

The first of Wyndham's three data breaches came through the local computer network of one of its franchised hotels in Arizona. Wyndham had expressly stated in its privacy policy that "We do not control the use of [customer] Information or access to the information by the Franchisee and its associates." Yet this disclosure did not shield the franchisor from liability. The Wyndham settlement with the FTC recognizes the distinction between franchisor and franchisees, but it also requires Wyndham to implement safeguards to control data security risks arising from network connections between franchisees and the franchisor's corporate data center. The bottom line is that the more franchisors are connected to their franchisees' systems, the more liability they may face for data breaches, and the more they must do to ensure that safeguards for data are in place.

[2] The Payment Card Industry Security Council, established a decade ago by the major credit card companies, promulgated the PCI DSS to ensure that cardholder and payment data handled by companies involved in credit card transactions would be kept secure.

This principle holds true for PCI-DSS compliance obligations as well. Franchisors must comply with PCI-DSS standards for all systems connected to any database in which they process or store payment card information. Thus, the more connected franchisee systems are to the franchisor's database, the more involved the process of PCI-DSS compliance will be for the franchisor.

After franchisors assess the vulnerabilities of their own systems and implement any needed safeguards against data breaches, they may want to consider developing guidelines for franchisees for safeguarding data. They may also want to ensure that their franchise agreements include requirements for the franchisee to comply with all relevant PCI standards and data protection laws and regulations.

A. New European Union Decisions and Initiatives Regulating Data Security

1. *Schrems v. Data Protection Commissioner*, Case C-362/14 (Oct. 6, 2015)

A safe harbor framework used since 2000 by U.S. businesses to transfer personal data from the EU's 28 member countries to the United States was declared invalid by the Court of Justice of the European Union (CJEU) in a decision issued on October 6, 2015.

The case that led to this judgment stemmed from an individual request that the Irish Data Protection Commissioner prohibit the transfer of his personal data to the United States because the data would not be adequately protected under U.S. law. The Commissioner rejected the request on the ground that U.S. law was deemed sufficiently protective under the safe harbor framework. The Irish High Court, reviewing the Commissioner's decision, asked the CJEU to rule on whether the Commissioner was bound by this view of U.S. law or could undertake its own review.

The CJEU held that the safe harbor framework does not prohibit a national authority from examining an individual's claim that another country's law does not ensure adequate protection of his data. The CJEU further held that the European Commission exceeded its power in restricting national authorities' review of this issue.

2. EU-U.S. Privacy Shield Framework

On February 29, 2016, the U.S. Department of Commerce and European Commission released the EU-U.S. Privacy Shield Framework, created to provide companies in both the United States and the European Union with a mechanism to comply with EU data protection requirements when personal data is transferred from the EU to the U.S. To join the Privacy Shield Framework, a U.S.-based company must "self-certify to the Department of Commerce and publicly commit to comply with the Framework's requirements." These requirements include:

- ‘Informing individuals about data processing’ by including in its privacy policy a declaration of the organizations commitment to comply with the principles; including a link to the Department of Commerce’s Privacy Shield website and a link to the website or complaint submission form; and informing individuals of their rights to access their personal data, the requirement to disclose personal information in response to a lawful request by public authorities, and the organizations liability in cases of onward transfer of data to third parties.

- ‘Maintaining data integrity and purpose limitation’ by limiting personal information to the information relevant for the purposes of processing.

- ‘Ensuring Accountability for data transferred to third parties’ by complying with the notice and choice principles; entering into a contract with the third-party controller that provides that such data may be only processed for limited and specified purposes . . .; and to abide by guidelines for transferring personal data to a third party acting as an agent.

- ‘Cooperating with the Department of Commerce’ by responding promptly to inquiries and requests by the Department of Commerce for information relating to the Privacy Shield Framework.

- Maintaining ‘[t]ransparency related to enforcement actions’ by making public any relevant Privacy Shield-related sections of any compliance or assessment report submitted to the FTC if the organization becomes subject to an FTC or court order based on non-compliance.

- ‘Ensuring commitments are kept as long as data is held’ by annually certifying its commitment to apply the Principles to information received under the Privacy Shield Framework if it chooses to keep such data or provide adequate protection for the information by another authorized means.

The Privacy Shield Framework further grants rights and legal remedies to members of the EU, including:

- The right to bring a complaint directly to a privacy shield participants and receive a response within 45 days;

- The right to receive an independent recourse mechanism at no cost to the individual;

- The right submit a complaint to a data protection authority in the EU and have it received, reviewed, and a resolution complete within 90 days;

- The right to receive enforcement assistance in appropriate cases; and

- The right to pursue legal remedies through private causes of action in U.S. state courts for claims such as misrepresentation.

The FTC has committed to "vigorous enforcement" of the Privacy Shield Framework, including "prioritizing referrals from EU Member State privacy regulators, the Department of Commerce, privacy self-regulatory bodies, and independent recourse mechanisms. Lastly, the Privacy Shield participant must commit to binding arbitration at the request of the individual to address any complaint not resolved by other means.

3. EU General Data Protection Regulation

The European Parliament on April 14, 2016, adopted the EU's General Data Protection Regulation (GDPR), intended to strengthen data protection across the European Union. The GDPR supersedes the 28 different Member States' laws and the EU's 1995 Data Protection Directive. The GDPR will be published in the EU's *Official Journal* and will enter into force 20 days after that. The regulation then will have a two-year implementation period.

The GDPR will apply to data controllers and data processors alike. This means the rules will cover both franchisors (which typically control consumer data) and franchisees (which may be both controllers and processors). The GDPR will apply not only to controllers and processors established in the EU, but also to those outside the EU if their activities relate to offering goods and services to individuals within the EU.

Requirements for transparency and accountability will increase significantly under the GDPR. Data controllers must provide information concerning the handling of individuals' personal data in a form that is concise, understandable, and easily accessible. In addition, data controllers must notify regulators of breaches involving personal data within 72 hours after learning of the breach. They must also promptly notify individuals in cases where a breach is likely to pose a high risk to them.

Regarding accountability, companies will be required to implement privacy policies and security measures, perform impact assessments of data protection, and in some cases appoint data protection officers. Both data controllers and processors will be required to fully document their actions. Enforcement authorities may impose administrative fines of up to 20 million Euros or 4 percent of worldwide turnover for the preceding year.

The GDPR prohibits the transfer of data to countries outside the EU unless the country provides an "adequate" level of protection for the data. And "adequate" status will be harder to demonstrate, in keeping with the *Schrems* ruling by the CJEU, discussed above. To facilitate data transfers, the GDPR encourages the use of binding corporate rules and approved codes of conduct.

PRACTICE POINTS

Sweeping changes in the regulation of data security, long in the works, have come to fruition over the past year in the European Union. The General Data Protection Regulation, expected to enter into force in the first half of 2016 and be fully implemented by 2018, will create one regulatory scheme throughout the EU – at least in theory. In practice, the regulatory bodies of the 28 member states may take a bit longer to see eye to eye.

Penalties for failure to comply – including fines of up to four percent of annual global revenue – show a new determination on the part of the EU to get companies doing business in Europe to take data security seriously. This makes compliance, and documentation of efforts to comply, more important than ever before. Stricter consent requirements for use of personal information and stricter attention to consumers' rights to object will be critical.

With the U.S. – EU Safe Harbor Agreement invalidated in October 2015, companies must turn their attention to the newly released Privacy Shield Framework, intended to facilitate compliance with EU data protection requirements when personal data is transferred from the Europe to the United States. Particularly important are the provisions of the Privacy Shield Framework that strengthen enforcement rights and remedies for EU members – including provisions for private rights of action in U.S. courts.

IV. ARBITRATION

Decisions this past year underscored that courts will not hesitate to enforce arbitration clauses – but that the parties' contract must be crystal clear about the claims that can be arbitrated and the scope of the arbitrator's mandate.

A. ***Chorley Enterprises, Inc. v. Dickey's Barbeque Restaurants, Inc.*, *and* *Trouard v. Dickey's Barbeque Restaurants, Inc.*, 807 F.3d 553 (4th Cir. 2015)**

In an opinion issued on August 5, 2015, the Fourth Circuit reaffirmed the longstanding principle that arbitration is fundamentally a creature of contract and rejected several arguments that would have rewritten the contracts between the parties.

Dickey's Barbeque Restaurants, Inc. (Dickey's), a Texas-based franchisor of quick-serve barbecue restaurants, had executed franchise agreements with two sets of Maryland franchisees, the Chorleys and Justin Trouard and Jessica Chelton, requiring the parties to arbitrate all disputes "arising out of or relating to" the agreements (the Arbitration Clause). But a separate provision of the agreements stated that the

Arbitration Clause "shall not require" the franchisees to waive their right to file a lawsuit alleging a cause of action arising under Maryland Franchise Law in any court of competent jurisdiction in Maryland (the Maryland Clause). Dickey's maintained that it had to include the Maryland Clause in the agreements because Maryland regulations prohibit franchisors from requiring a franchisee to waive its right to file a lawsuit asserting claims under the Maryland Franchise Registration and Disclosure Law (the Maryland Franchise Law) in any court of competent jurisdiction in the state.

A dispute over arbitrability arose when the franchise relationships turned contentious. Dickey's claimed the franchisees violated their franchise agreements by "running their restaurants poorly" and initiated an arbitration in Texas asserting several common law claims. The franchisees then filed lawsuits in Maryland federal court claiming that that Dickey's misrepresented start-up and other costs in violation of the Maryland Franchise Law.

The franchisees moved to enjoin arbitration, arguing that their entire disputes should be heard in federal court. Dickey's responded by moving to compel arbitration or, alternatively, to stay the lawsuit, arguing that the entire disputes should be arbitrated.

The district court held that both sides' readings of the Arbitration Clause and the Maryland Clause were plausible, thus rendering the franchise agreements ambiguous. The court ordered a jury trial on the issue of arbitrability. On an appeal of this issue, the Fourth Circuit disagreed. It held that the plain language of the two provisions required arbitration of all disputes except for the narrow carve-out for Maryland Franchise Law claims.

The Fourth Circuit rejected several arguments the parties asserted to try to avoid this result. First, it rejected the notion that the potential for conflicting results should cause the court to pick a single forum for the entire disputes. Under the Federal Arbitration Act (the FAA), the parties' contract controls, even if the result is piecemeal litigation, the appellate court reasoned:

> [I]f the parties had wanted to avoid potentially conflicting results—and thorny questions regarding the preclusive effect of a potential award—they could have agreed on a single forum for all their claims. But they did not. We will not rewrite their agreements to save them from their own self-imposed, inefficient arbitration procedures.

The Fourth Circuit also rejected Dickey's argument that the Maryland Clause should be invalidated because it violates the FAA. Dickey's maintained that the Maryland Franchise Law effectively prohibits arbitration of claims asserted under that statute because a franchisor would violate the state statute if it required a franchisee to waive its right to litigate those claims in the courts of Maryland. Thus, Dickey's argued, it had no choice but to include the Maryland Clause in its franchise agreements.

The Fourth Circuit rejected Dickey's position that the Maryland Franchise Law required claims arising under that statute to be carved out of arbitration clauses. Citing the Maryland Court of Appeals' decision in *Holmes v. Coverall North America*, 649 A.2d 365 (Md. Ct. App. 1994), the Fourth Circuit explained that the Maryland Franchise Law merely "grants franchisees a right to sue for violations of that Law, but does not say where that suit must take place." The Maryland Clause went further than the statute required by expressly granting the franchisees the right to file their claims in Maryland.

Furthermore, even if the Maryland Franchise Law did prohibit arbitration, Dickey's inclusion of the Maryland Clause was still voluntary, the Fourth Circuit concluded. Instead of including the clause in its franchise agreements, Dickey's could have chosen not to do business in Maryland, or filed a declaratory judgment action challenging any requirement that claims arising under the Maryland Franchise Law must be carved out of an arbitration agreement.

Dickey's attempted to appeal the Fourth Circuit's decision to the United States Supreme Court on the basis that the Maryland Franchise Law wrongly forced Dickey's to include the Maryland Clause in the franchise agreements. The International Franchise Association (IFA) submitted an amicus brief in support of Dickey's petition for certiorari. The Supreme Court on April 18, 2016, denied the petition. On remand, the district court stayed the Maryland federal court action pending resolution of the arbitration.

PRACTICE POINTS

This decision reinforces that arbitration is a creature of contract, and courts are loathe to relieve parties from bargained arbitration agreements (or, in the case of the Maryland Clause, an express agreements not to arbitrate). Although the Fourth Circuit declined to compel arbitration for the franchisees' claims, the silver lining for pro-arbitration parties is the Fourth Circuit's clear statement that a franchise agreement's arbitration clause may cover claims arising under the Maryland Franchise Law. Thus, a broad arbitration clause "enforceable to the fullest extent permissible under Maryland law" would be an appropriate substitute for the Maryland Clause.

B. ***DIRECTV, Inc. v. Imburgia, 1*****36 S.Ct. 463 (2015); and *Chesapeake Appalachia, LLC v. Scout Petroleum, LLC*, 809 F.3d 746 (3d Cir. 2015)**

Two decisions in 2015 regarding class arbitration waivers demonstrate that even though the highest court in the land has repeatedly found class arbitration waivers enforceable, lower courts are hesitant to fully embrace such waivers.

1. *DIRECTV, Inc. v. Imburgia*

The United States Supreme Court's opinion in *DIRECTV*, issued on December 14, 2015, emanates from its earlier opinion in *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011). In *Concepcion*, the Supreme Court held that the FAA preempted the "California Rule," which prohibits class waivers that completely foreclose class relief. Under *Concepcion*, it is permissible for a party to a contract to bargain for an arbitration clause and insist that the other party waive the right to seek class relief in such arbitration.

In *DIRECTV*, the Supreme Court reversed a California state court decision that attempted to circumvent *Concepcion* under the auspices of a choice of law provision. In that case, DIRECTV's customer contracts contained an arbitration clause with a class waiver, along with a provision that stated the arbitration clause would be invalided if it violated the "law of your state." The state court interpreted the "law of your state" provision to mean that the parties intended the invalid, preempted California Rule to govern their contract. Accordingly, the state court invalidated the arbitration provision.

On appeal, the Supreme Court recognized that arbitration clauses – even those with class waivers – can be invalidated on state law grounds, such as unconscionability or failure of consideration. But arbitration agreements must be placed "on equal footing with all other contracts." In other words, a lower court cannot create special rules to invalidate arbitration agreements if those rules do not apply equally to all other contracts.

In this case, the state court's decision did not place arbitration agreements "on equal footing with all other contracts." (To the contrary, the Supreme Court could not imagine any setting other than arbitration where a reference to the "law of your state" would be interpreted to include an invalid, preempted law.) Instead, the Court appeared to view the state court's decision as an obvious attempt to avoid the holding of *Concepcion*.[3]

2. Chesapeake Appalachia

In *DIRECTV*, the trial court determined whether a class waiver was enforceable. Often, however, a party will request that the arbitrator make that determination. In *Chesapeake Appalachia*, the Third Circuit announced a bright-line rule that parties may not delegate the question of class arbitrability to an arbitrator merely by incorporating the American Arbitration Association's (AAA's) rules in their agreement. This ruling, issued on October 8, 2015, arguably creates a circuit split between the Third and Sixth Circuits, on one hand, and the Second, Fifth, Eighth, Ninth, Eleventh, and Federal Circuits, on the other hand.

[3] In fact, Justice Breyer, who dissented in *Concepcion*, wrote the majority opinion in *DIRECTV* in which he cited the Constitution's Supremacy Clause.

In 2008, Chesapeake (as lessee) entered into oil and gas leases with Pennsylvania landowners (the lessors), under which Chesapeake agreed to pay royalties to the lessors. Each of the leases included an arbitration provision requiring that any dispute concerning a lease would be arbitrated. The lease did not address whether the court or the arbitrator should decide questions of arbitrability, but it did require that all arbitrations proceed in accordance with AAA rules. Those rules give arbitrators power to decide the scope and validity of the arbitration agreement, as well as whether the agreement permits class arbitration.

In 2014, Scout (which had purchased lease rights from some landowners) brought a class arbitration proceeding against Chesapeake. Scout claimed Chesapeake had paid insufficient royalties to it and to other similarly situated lessors. In response to the arbitration demand, Chesapeake filed a declaratory judgment action in the Middle District of Pennsylvania, arguing that the district court, and not the arbitrators, should decide whether the arbitration agreement permitted class arbitration. This argument—that the arbitration agreement does not permit class arbitration—is significant because, if accepted, it would effectively eliminate Scout's ability to seek classwide relief. In a summary judgment order, the district court agreed with Chesapeake and ruled that the question of class arbitrability was for the court. Scout then appealed the district court's decision to the Third Circuit.

Parties, of course, may delegate arbitrability questions to the arbitrator. But, as the Supreme Court has held, the delegation must be "clear and unmistakable." *Rent-A-Ctr., W., Inc. v. Jackson*, 561 U.S. 63, 79 (2010) (citing *AT&T Techs., Inc. v. Commc'ns Workers of Am.*, 475 U.S. 643, 649 (1986)). In *Chesapeake Appalachia*, the question for the Third Circuit was whether the leases, by incorporating the AAA rules, "clearly and unmistakably" delegated to the arbitrator the question of class arbitrability. The Third Circuit concluded the delegation was not clear and unmistakable, and it therefore held that the district court should decide whether the leases permitted class arbitration.

In reaching this conclusion, the Third Circuit found it significant that, outside of the reference to the AAA rules, the leases "do not expressly mention class arbitration [or] the availability of class arbitration." Moreover, the Third Circuit concluded that the leases' incorporation of the AAA rules was also insufficient to "clearly and unmistakably" delegate the issue of class arbitrability, largely because the reference to the AAA rules created a "daisy-chain of cross-references" that was too complex to allow for a clear delegation of the class arbitrability question.[4]

The Third Circuit reached this decision despite acknowledging that the AAA rules "expressly grant[ ] the arbitrator the power to rule on objections concerning the arbitrability of any claim" and "indicate that the arbitrator must determine whether the arbitration agreement permits class arbitration." Despite the unambiguous nature of

[4] The Third Circuit noted that the AAA's website identifies more than fifty sets of rules. The arbitration clause at issue, however, never referred by name to the specific subset of rules that applies to class arbitrations.

these rules, the Third Circuit felt that the organization of the rules was so complex that it foreclosed the possibility of a "clear and unmistakable" delegation.

The Third Circuit also noted that at least six other circuits – the Second, Fifth, Eighth, Ninth, Eleventh, and Federal Circuits – have held that "incorporation of the [AAA] arbitration rules constitutes clear and unmistakable evidence that the parties agreed to arbitrate arbitrability." The Third Circuit distinguished these cases on the basis that they did not involve class arbitration, which the Court deemed inherently different than bilateral arbitration because: class arbitration involves many disputes among hundreds or thousands of parties; the presumption of privacy is lesser in class arbitrations; and the arbitrator's award in a class arbitration would bind absent parties. Moreover, and the commercial stakes of class actions are the same, while the judicial review is limited. On the other hand, the Sixth Circuit has decided this question, and has reached the same conclusion as the Third Circuit. *See Reed Elsevier, Inc. ex rel. LexisNexis Div. v. Crockett*, 734 F.3d 594, 599 (6th Cir. 2013).

PRACTICE POINTS

Although Chesapeake Appalachia's is not a franchise case, its holding is significant for franchising because it affects the ability to obtain classwide relief. Despite the Supreme Court's clear signal that a franchisor can effectively foreclose the possibility of franchisee class actions by insisting upon arbitration agreements that include a waiver of class relief, both DIRECTV and Chesapeake Appalachia demonstrate that courts are hesitant to release full control of certain matters to arbitrators.

To avoid this result of Chesapeake Appalachia and ensure that class arbitrability determinations are delegated to an arbitrator, franchise agreements subject to interpretation by the Third Circuit must do more than simply incorporate the AAA rules. The agreement must expressly state that an arbitrator shall make all decisions regarding the arbitrability of, and the ability to obtain, class relief.

V. ADVERTISING

U r @ risk if u break the rules when u promote ur brand. But complying with the rules can feel like trying to hit a moving target, because both the law and the technology related to advertising, marketing, and promotion are constantly changing. The decisions below interpreting the Telephone Consumer Protection Act, which governs voice and text message advertising, illustrate the perils of this changing landscape. And another slippery slope for franchisors this year has been product advertising that does not quite measure up to product offerings – or so the class action plaintiffs say. Two notable examples of this trend are discussed below.

A. *Lennartson v. Papa Murphy's Holdings*, No. C15-5307 RBL (W.D. Wash. Jan. 5, 2016)

A federal court in Washington denied summary judgment to pizza franchisor Papa Murphy's, sued in a class action over text message advertisements sent to customers who had not provided sufficient "prior express written consent" to be contacted, as required by the TCPA. Papa Murphy's argued that successive orders issued by the Federal Communications Commission (FCC) in 2012 and 2015 regarding what constitutes consent under the TCPA were unclear. Papa Murphy's maintained it should not be liable for texts sent to customers who had given their consent in the form permitted under an order issued by the FCC in 1992 – one that took a less exacting view of what constitutes consent. The court was not persuaded. In an order issued on January 5, 2016, it concluded that Papa Murphy's did not meet the current standard for consent, and that any confusion it may have had about that standard was no excuse for failure to comply.

The FCC's 1992 order under the TCPA provided that individuals who knowingly released their telephone numbers were deemed to have consented to be autodialed. The FCC's 2012 order imposed more stringent requirements for consent. The new order defined "prior express written consent" as "a written agreement authorizing delivery of advertisements or telemarketing messages by an autodialer to the signatory's telephone number." The 2012 order required the written agreement to include a "clear and conspicuous disclosure" that "entering into the agreement is not a condition of purchase, an electronic signature is enforceable, and by executing the agreement, the signatory authorizes the seller to deliver telemarketing text messages using an autodialer." The FCC granted telemarketers that had obtained consent under the 1992 order until October 16, 2013, to comply with the new requirements for consent.

In 2015, in response to a petition for clarification filed by marketing industry groups, the FCC issued an order reiterating that telemarketers could not satisfy the 2012 order's requirements merely by having consent in writing; the consent had to meet the definitional requirements of "prior express written consent" set out in the 2012 order. The FCC's 2015 order acknowledged, however, that the petitioners could have reasonably concluded that consent previously given in writing would remain valid even if it did not meet the additional requirements of the 2012 order.

Lennartson claimed that Papa Murphy's violated both the 2012 and 2015 FCC orders because it continued through June 2015 texting individuals who had given their consent only by providing their contact information on Papa Murphy's website. Papa Murphy's moved for summary judgment, arguing that the prior express consent it had obtained under the 1992 order remained valid because it was in writing, and the FCC conceded that its 2012 Order could have reasonably been interpreted that way. Papa Murphy's also argued that the 2015 order represented an agency adjudicatory restatement that the court could not apply retroactively because it caused a significant change in the law.

The court denied Papa Murphy's motion for summary judgment, holding that the provision of the FCC's 1992 order that consumers who knowingly released their phone numbers consented to be autodialed was not "grandfathered" under the Commission's subsequent orders requiring more explicit written consent. The court also concluded that the FCC's 2015 order applied retroactively because it did not create a substantial change in the law but instead simply affirmed a rule articulated three years earlier. "Papa Murphy's reliance 'on its own (rather convenient) assumption that unclear law would ultimately be resolved in its favor is insufficient to defeat the presumption of retroactivity' upon clarification," the court concluded. It held that Papa Murphy's failed to comply with the 2012 order and that the 2015 order applies retroactively to October 16, 2013.

Motions to Stay TCPA Cases

The court in *Lennartson* nevertheless granted a motion by Papa Murphy's to stay further proceedings in the case until the United States Supreme Court decides whether a plaintiff may bring a private right of action in federal court based only on a violation of a federal statute, where the plaintiff has suffered no concrete harm and could not otherwise invoke the jurisdiction of the federal court. *Robbins v. Spokeo, Inc.,* 742 F.3d 409 (9th Cir. 2014) *cert granted*, 135 S. Ct. 1892 (2015). Lennartson argued that *Spokeo* is irrelevant because some putative class members allege actual injury in that they must pay their cell phone service providers for each message they received. The court disagreed, concluding that *Spokeo* could either simplify or complicate the class certification process depending on whether the putative class could be limited to those who paid their providers for each message Papa Murphy's sent them.

Other federal district courts had stayed other TCPA cases pending the outcome of the United States Supreme Court's decision in another TCPA class action, *Campbell-Ewald Co. v. Gomez*. 768 F.3d 871 (9th Cir. 2014), *aff'd*, 136 S. Ct. 663 (2016). In *Gomez,* the Supreme Court held that an unaccepted offer of complete relief to the named plaintiff in a class action does not moot that plaintiff's claim.

Still other federal district courts have stayed other TCPA cases pending the outcome of at least a dozen petitions seeking review of the FCC's 2015 order that were consolidated and are pending in the U.S. Court of Appeals for the District of Columbia Circuit. *See, e.g., Petition for Review*, *ACA Int'l, et al. v. FCC*, No. 15-1211 (D.C. Cir. July 10, 2015); *Petition for Review*, *Salesforce.com Inc., v. FCC*, No. 15-1290 (D.C. Cir. Aug. 26, 2015); *Petition for Review*, *Consumer Bankers Assoc. v. FCC*, No. 15-1304 (D.C. Cir. Sept. 1, 2015). Among the issues addressed in these petitions are: how consent is given; how consent is revoked; what constitutes an "autodialer"; how to avoid liability for calling a wireless number reassigned from a customer who had given consent to one who has not; and who is a "called party" under the statute.

PRACTICE POINTS

The TCPA is confusing, but confusion is no excuse for failure to comply with it – at least as best one can. Penalties for failure to comply are steep: $500 per violation, which can be trebled if the violation is willful. This, of course, makes the TCPA fertile ground for class actions.

The basic principles of the TCPA provide at least some guidance for establishing best practices, including the following: if previously given consent does not meet the standards of the FCC's 2012 order, then get new consent; guard against contacting numbers that are reassigned, unless the new holder of the number gives new consent; provide a clear and conspicuous method for opting out of receiving messages; and scrupulously respect requests to opt out.

Franchisors must also consider potential liability for franchisees' TCPA violations. The more control or influence a franchisor exerts over franchisees' decisions to use robocall and text message advertising, to conduct these telemarketing campaigns in a particular way, or to select or approve telemarketing vendors for use by franchisees, the higher the risk of liability may be for the franchisor. Franchisors should emphasize to franchisees the importance of keeping current and in compliance with the TCPA and the risks involved if they fail to do so.

B. ***In re Subway Footlong Sandwich Mktg. v. Sales Practices Litig.*, MDL No. 13-02439, 2016 WL 755640 (E.D. Wisc. Feb. 25, 2016).**

A federal court in Wisconsin gave final approval to the settlement of a consolidated consumer class action against the franchisor of Subway restaurants, Doctor's Associates, Inc., alleging deceptive marketing and sales practices from advertising that Subway sandwiches were "footlongs" and "six-inch" subs even though some were shorter than that. In an order issued on February 25, 2016, the court concluded that: the settlement was fair; the named plaintiffs and class counsel adequately represented the class; the named plaintiffs' request for $5,000 in incentive awards was reasonable; and class counsel's request for $520,000 in costs, expenses, and fees (which the court deemed "modest by class-action standards"), was reasonable.

These cases were inspired by the publicity that resulted when an Australian teenager in January 2013 posted a picture on Facebook of a Subway® footlong sandwich he purchased that was only eleven inches long. Over the next six months, complaints were filed across the country alleging that Doctor's Associates had engaged in unfair and deceptive marketing practices regarding the length of the sandwiches. Each case was pleaded as a class action and sought money damages, attorney fees, and injunctive relief under the consumer protection laws of all 50 states and the District of Columbia. Seven complaints were consolidated in this action.

The court pointed out a fundamental weakness in the plaintiffs' case: that all loaves are baked from the same quantity of dough and ingredients, and all contain a standardized amount of meat and cheese. Thus, "as a practical matter, the length of the bread does not affect the quantity of food the customer receives."

The settlement provided that this would be an "injunction only" class settlement formalizes changes Doctor's Associates made after the first class action was filed, including: making "measuring tools" available to store employees, incorporating the twelve-inch requirement in all training materials for new franchisees and employees, and making bread measurements part of the franchisor's restaurant inspections.

In its order, the court rejected several of the class members' objections to the lack of monetary relief. In particular, the court found the plaintiff's claims for monetary relief relatively weak because distributing a settlement of $525,000 to millions of consumers would be impractical, and plaintiff's request for a coupon settlement would require each independent franchise owner to bear the cost of a coupon settlement. Thus, the court approved the settlement and found the incentive awards and attorney's fees reasonable.

C. *Pincus v. Starbucks Corp.*, No. 1:16-cv-04705 (N.D. Ill. April 27, 2016)

Starbucks now faces a class action lawsuit similar to the actions against Subway – this one alleging the Starbucks misrepresents the amount of cold drink that a customer will receive, under-filling the drinks with less cold drink liquid than advertised on its menu and making up the difference with ice. Plaintiff Stacy Pincus claims that she and millions of other similarly situated purchasers of Starbucks' cold drinks over a ten-year period "would not have paid as much if anything for the Cold Drinks had the true facts regarding the true amount of fluid ounces they were getting been disclosed." Her complaint asserts claims for breach of express warranty, breach of implied warranty of merchantability, negligent misrepresentation, unjust enrichment, violation of the Illinois Consumer Fraud and Deceptive Business Practices Act, and violation of the Illinois Uniform Deceptive Trade Practices Act.

PRACTICE POINTS

As long as class actions are with us, lawsuits such as these will be, too. And social media makes it easier for these actions to gain traction. Within six months after an Australian teenager posted a photograph on Facebook of his shorter than foot-long footlong sub, class actions had been filed across the country.

Franchise systems can attempt to mitigate their risks of such actions by including disclaimers when advertising their products that size may vary. They can also emphasize, through training efforts and store inspections, the importance of giving consumers what the system's advertising tells them they will get.

VI. ACCIDENTAL FRANCHISE

This year, like every year, there are cases involving the "accidental franchise." The Federal Trade Commission's definition of a franchise includes three elements—the right to use a trademark, payment of a franchise fee, and significant control or assistance—and more than a dozen states have similar laws. If an agreement meets all three definitional elements, regardless of what the relationship is called in the agreement, the relationship will be classified a franchise. While it is not a new legal development that franchise laws apply to business relationships regardless of the contracting parties' intent to establish a franchise relationship, these cases illustrate that even sophisticated businesses can get caught in the web of franchise laws. Accidental franchises will continue to be a trend for years to come.

B. *Cycle City, Inc. v. Harley Davidson Motor Co.*, Cv. No. 14-00148 HG-RLP, 2015 WL 3407825 (D. Haw. May 26, 2015)

In *Cycle City*, Cycle City argued that the license agreement between it and Harley-Davidson constituted a "franchise" under the Hawaii Franchise Investment Law (HFIL), and that Harley-Davidson violated the law by not dealing in good faith, imposing unreasonable and arbitrary standards of conduct, and failing to renew a distribution agreement and license agreement. Cycle City (Harley-Davidson's exclusive Hawaii distributor for 48 years) and Harley-Davidson were parties to a distribution agreement under which Cycle City was the exclusive distributor of Harley-Davidson motorcycles and products in Hawaii (the Distribution Agreement) and owned two Harley-Davidson dealerships in Hawaii. Cycle City also had a license agreement with Harley-Davidson under which it had the right to manufacture certain goods bearing Harley-Davidson's trademarks for sale to other Harley-Davidson dealers and third party retailers (the License Agreement). Harley-Davidson elected not to renew the Distribution Agreement or the License Agreement, and Cycle City brought suit under the HFIL.

In moving for dismissal of the suit, Harley-Davidson contended that the License Agreement was in fact not a franchise because Cycle City had not paid Harley-Davidson a "franchise fee," and therefore was not governed by the HFIL. Specifically, Harley-Davidson argued that (1) the provisions in the License Agreement pertaining to the payment of royalties did not constitute the payment of franchise fees; and (2) the License Agreement was not the type of arrangement intended to be regulated as a franchise under HFIL. Harley-Davidson moved for partial dismissal of Cycle City's complaint, and the district court denied its motion.

Under the HFIL, the parties' License Agreement would qualify as a franchise if it satisfied three criteria: (1) it must have been an agreement expressly or implicitly granting Cycle City a license to use Harley-Davidson's trade name, service mark, trademark, or logotype; (2) there must have been a community interest between Cycle City and Harley-Davidson; and (3) Cycle City must have been required to pay, directly or indirectly, a franchise fee to Harley-Davidson. The district court found that Cycle City had plausibly alleged these three facts.

While Harley-Davidson admitted that the License Agreement granted Cycle City the right to use Harley-Davidson's trademark, Harley-Davidson argued that neither the second nor third prong was satisfied. First, Harley-Davidson argued that the royalty payment that the License Agreement required Cycle City to pay did not constitute a franchise fee. However, the court disagreed, finding instead that a franchise fee means "any fee or charge that a franchisee or subfranchisor is required to pay or agrees to pay for the right to enter into a business or continue a business under a franchise agreement, including, but not limited to any fee or charge based upon the amount of goods or products purchased by the franchisee from the franchisor or subfranchisor, *any fee or charges based upon a percentage of gross or net sales whether or not referred to as royalty fees*" (emphasis in original).

Harley-Davidson attempted to argue that the royalty fee was not a franchise fee by pointing to the exemption under the definition of a franchise fee under the HFIL for the purchase of goods at a bona fide wholesale price; however, the fees that Cycle City paid Harley Davidson under the License Agreement were royalties paid for the right to use Harley-Davidson's trademark and not for the purchase of goods. As a result, such exemption did not apply.

Harley-Davidson also argued that there was no "community of interest" between the two parties. However, applying the non-exhaustive list of factors from *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of U.S. of America, Inc.*, 549 F.3d 1079 (7th Cir. 2008), the court found a franchise relationship. For example, Cycle City had a license to use Harley-Davidson's trademarks, Cycle City paid Harley-Davidson a fee, Harley-Davidson had the right to approve all licensed products and promotional materials, and Cycle City was required to limit sales to Hawaii.

In summary, Cycle City argued that Harley-Davidson "exercised substantial control over its sale and distribution of the licensed products" and that Cycle City made substantial investments in the business. Noting that while "[t]here is not precise line between when a company is simply a distributor of a manufacturer's trademarked goods and when the company is a franchise . . .[t]he mere licensing of a trademarked good, without more, does not give rise to a franchise relationship. [However, h]ow much more is required is a matter of degree, and in many cases such as this one, a question for the fact finder." Accordingly, the court denied Harley-Davidson's motion to dismiss.

PRACTICE POINTS

Like many industry regulations, franchise laws are complex, nuanced, and failure to comply can result in significant penalties. Consequently, licensors may try to avoid franchise classification by omitting one of the three definitional elements. Summarized above, Cycle City *is a classic accidental franchise case which demonstrates that the intent of the parties is irrelevant to creating a franchise relationship.* Cycle City *also helps to clarify the second definitional element, the payment of a franchise fee. In* Cycle City*, the court made clear that although the purchase of goods at wholesale price would not constitute payment of a franchise fee, an agreement that merely licenses the mark* *for a fee without any exchange of goods would not enjoy such exemption. The court also emphasized that in determining whether a trademark license is a franchise, the analysis is fact specific. In structuring any relationship when there is a payment of a fee (other than for the purchase of goods at a bona fide wholesale price) and the license of a trademark, counsel must be very careful in structuring the relationship to ensure that their clients do not accidentally step into franchising.*

B. *Lofgren v. AirTrona Canada*, No. 2:13-cv-13622, 2016 WL 25977 (E.D. Mich. Jan. 4, 2016).

In *Lofgren v. AirTrona Canada*, the federal court addressed whether the parties' relationship constituted a franchise. In 2009, the plaintiff Lofgren purchased certain equipment from AirTrona Green Technologies through defendant Sam Barberio, allowing Lofgren to operate a vehicle-deodorizing business under the name AirTrona. Two years later, Lofgren purchased additional equipment from defendant AirTrona Canada, again through Sam Barberio, which allowed Lofgren to add vehicle-sanitation to his offered services.

By 2013, Lofgren decided to stop operating his business and attempted to sell the business to AirTrona Canada. After the two parties could not reach an agreement, Lofgren filed suit to unwind the transactions with both AirTrona entities and Sam Barberio, and to be put back in the financial situation he was in prior to his first purchase in 2009. Lofgren claimed that this was possible because the two agreements in 2009 and 2011 were franchise agreements under Michigan Franchise Investment Law (MFIL), and that the defendants had violated these agreements. While AirTrona Canada defaulted, Barberio remained a defendant and contested Lofgren's claims.

The court rejected Lofgren's first contention that the 2009 transaction was a "franchise" on procedural grounds, but did find that Lofgren's 2011 purchase was a "franchise" under the MFIL. Under the MFIL, a franchise is:

> a contract or agreement, either express or implied, whether oral or written, between two or more persons to which *all* of the following apply:
> (a) A franchise is *granted* the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; (b) A franchisee is *granted* the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and (c) The franchisee is *required* to pay, directly or indirectly, a franchisee *fee*.

Barberio argued that the 2011 transaction was not a franchise agreement because it did not grant Lofgren the rights to use the AirTrona trademark and marketing plan because he had already been granted that right; Lofgren was not required to pay

AirTrona Canada a fee in 2011; and even if he did pay AirTrona Canada, that payment did not constitute a franchise fee.

The court dismissed Barberio's arguments, instead finding that (1) Lofgren was not required to be given *new* rights because the MFIL covers substitutions of modified or amended franchise agreements, thus the rights granted prior to the 2011 purchase were sufficient; (2) Lofgren did pay a franchise fee, even though it was not *required*, because an invoice showed that Lofgren paid $20,000 directly to AirTrona Canada in 2011 for "1 Franchise Michigan Location;" and (3) the payment was, in fact, a "franchise fee" because he paid AirTrona Canada more than the bona fide wholesale price for the goods. The court also found it "notable" that "both parties thought they were entering into a franchise based on the language of the invoice," and that after Lofgren paid the "franchise fee," he wrapped his van in AirTrona marks.

To address the "marketing plan or system" prong, the court found the evidence showed that AirTrona provided Lofgren the technical training to run his business; Barberio promised Lofgren training in sales techniques and three car dealerships that would use his services; and AirTrona Canada asked for Lofgren's customer list to send marketing materials, asked him to report weekly sales figures, supplied recommended pricing for the services, and had his van wrapped in their trademark to advertise the business." Thus, the 2011 transaction was a "franchise" under the MFIL.

Lastly, with respect to whether Barberio violated this agreement, the court examined only whether § 8 of the MFIL, which prohibits the sale of a franchise "without first providing franchisee, at least 10 business days before the execution by the prospective franchisee of any binding franchise or other agreement or at least 10 business days before the receipt of any consideration, whichever occurs first, a certain disclosure statement." Barberio admitted to failing to give a disclosure statement to Lofgren, but he argued that the exemption under the extension or renewal of an existing franchise agreement under § 6 of the MFIL applied.

The court disagreed, finding that the exemption was not applicable because there were material changes in the 2011 agreement, such as an agreement with a new company, AirTrona Canada; Lofgren's business materially changed by adding a new sanitation service; and Lofgren received additional training.

PRACTICE POINTS

The court in Lofgren *added further clarification to the definition of a franchise fee in holding that to satisfy the payment element, it is sufficient that a fee was in fact paid, regardless of whether such fee was required. The court's analysis in* Lofgren *is also significant because it illustrates that a licensor can create a franchise relationship through later modifications or amendments to the original agreement. In addition, the court in* Lofgren *noted that it agreed with the defendant that the franchisee's business did not fail because it was a franchise, but that Lofgren was still entitled to rescission as a franchise under state law. Counsel for franchisors are encouraged to review exemptions to franchise laws and read them narrowly.*

VII. FINANCIAL PERFORMANCE REPRESENTATIONS

Today, the majority of franchisors include financial performance representations (FPRs) in their FDD. FPRs give franchisors the tools that they need to answer their prospective franchisees questions about how much money the franchised business makes, while providing franchisees with valuable information to evaluate their investment. Despite the increase in FPRs provided as part of the FDD, franchisors continue to get tripped up by providing financial information outside the FDD, and the *Coraud* case below provides a roadmap to franchisees to bring a claim under state franchise laws. In addition, there will be a renewed focus on FPRs in the next couple of years as the North American Securities Administrators Association finalizes its commentary on FPRs that will provide more information to franchisors, franchisees, and state examiners on the structure and content of FPRs.

A. Coraud, LLC v. Kidville Franchise Co., 109 F. Supp. 3d 615 (S.D.N.Y. 2015).

In *Coraud v. Kidville*, the Southern District of New York held that a provision in a franchise agreement disclaiming a franchisee's reliance on statements made outside of the franchise disclosure document was sufficient to defeat a claim for common law fraud. However, the provision did not bar a cause of action for statutory fraud under the New York Franchise Sales Act (NYFSA).

The plaintiff, franchisee Coraud, brought its suit against Kidville on the ground that the representations made by Kidville and its franchise sales team during the negotiation process differed from Coraud's actual revenues and costs, alleging that these representations constituted both common law and statutory fraud. In particular, Coraud alleges that during the franchise sales process, Kidville worked with Coraud to develop a business model that included a profit and loss spreadsheet with inputs for expenses and revenue. Coraud alleges that it relied entirely on Kidville to fill in the business model, and eventually had a complete business model that had first year revenues of $600,000, which Kidville represented to Coraud was "in the ballpark." Kidville also provided Coraud with an FDD that estimated the initial investment to open the franchise at $259,405 to $417,750.

On the basis of this representation, Coraud entered into a franchise agreement with Kidville. Coraud eventually spent over $680,000 (or 63% higher than the high end of the estimated initial investment) to open the facility, and Coraud had revenue of only $168,000 in the first year.

Kidville denied these allegations and moved to dismiss based on a clause in the agreement that disclaimed liability for representations made as to "volume, sales, income or profits of a Kidville facility" that were not expressed in the disclosure document.

The court granted Kidville's motion to dismiss Coraud's common-law fraud claim but denied Kidville's motion to dismiss Coraud's claims under the NYFSA. With regard to the common-law fraud claim, the court held that Coraud could not prevail because the disclaimer covered "the very matter" of which Coraud claimed it was defrauded. With respect to the NYFSA claim, however, the court held that the antiwaiver clause found within the NYFSA voids any franchise agreement provision that relieves an individual of a duty or liability established under the Act. This includes provisions that may waive fraud claims like the disclaimer in Coraud's franchise agreement. The court made clear that the policy underlying the NYFSA supported this interpretation and that the statute was enacted to protect New York residents who might be defrauded by salespeople who fail to provide full and complete information to the potential franchisee.

PRACTICE POINTS

As the primary policy rationale underlying all federal and state franchise laws is to protect potential franchisees from fraud, the Coraud case should come as no surprise. Importantly, Coraud reinforces the fact that courts will strictly enforce franchise laws' anti-waiver provisions and may serve as a model to other courts in analyzing state franchise laws' anti-waiver provisions.

Coraud also illustrates the importance of following the Federal Trade Commission's Franchise Rule and state franchise laws while selling franchises. Coraud should serve as a reminder to franchisors to review any representations in its FDD closely and provide comprehensive training to their franchise sales teams on franchise sales compliance.

B. NASAA FPR Commentary

On October 1, 2015, the North American Securities Administrators Association (NASAA) issued a proposed franchise commentary on financial performance representations (FPR Commentary). The FPR Commentary was issued to supplement NASAA's 2008 Commentary on the Franchise Registration and Disclosure Guidelines (2008 Commentary). NASAA gave the franchise community until November 2, 2015, to respond with comments to the FPR Commentary. NASAA received a number of comments, and those comments are still under advisement. The FPR Commentary addressed the following items:

1. 2008 Commentary. The FPR Commentary reissued the questions and answers stated in the 2008 Commentary that addressed FPRs, including the exclusion of costs from the definition of financial performance representations, the use of pro formas, and the use of disclaimers.

2. Use of Data from Company-Owned Outlets. The FPR Commentary analyzed a franchisor's ability to use data from company-owned outlets in its FPR. Notably, the FPR Commentary prohibits a franchisor from making a gross sales FPR based on company-owned outlets alone if there are operational franchisees. It does allow a franchisor to make a gross sales FPR based on company-owned outlets alone if there are no operational franchisees. A franchisor may make a gross profit or net profit FPR based on company-owned outlets alone, provided the franchisor discloses gross sales information from all operational franchisees and the company-owned outlets' actual costs are adjusted to account for material differences between franchised and company-owned outlets, such as a royalty fees or the price a company-owned outlet pays for proprietary products.

Importantly, the FPR Commentary does not allow a franchisor to make a gross profit or net profit FPR based on company-owned outlets alone if the franchisor has no operational franchisees because a franchisor has no experience with costs that franchisees may actually incur in order to adjust its company-owned outlets' cost information. The FPR Commentary also requires a franchisor to separate the data from company-owned outlets and franchised outlets. The only exception is if a franchisor has a small number of franchisees where the identity of those franchisees would be apparent if the data was separated and only if the gross sales are not materially different. The FPR Commentary makes it clear that a franchisor may disclose net profit without including all costs, provided that the FPR includes all costs of operation and explains what costs are not included (*i.e.*, taxes, depreciation and amortization). Finally, a franchisor must identify the sources of all data used in the FPR and which data is actual data or adjusted data.

3. Use of Subsets. The FPR Commentary clarified that a franchisor may make an FPR based on a subset of outlets, provided that the subset shares the same characteristics and the FPR has reasonable basis, is accurate, and is not misleading. However, a franchisor may not make an FPR based only on the performance of the best performing outlets without also disclosing subsets of the lowest performing outlets. The FPR Commentary also stated that a franchisor with less than 10 substantially similar company-owned and franchised outlets in operation for one year would not have enough outlets to make an FPR based on a subset of the small number of outlets.

4. Averages and Outliers. The FPR Commentary requires a franchisor that includes an average in its FPR to also include a median of the same data in an attempt to avoid having the average data skewed by high performers. In addition, a franchisor may not use an FPR created using a "material number" of results that are not typical of franchised outlets.

5. Use of Forecasts and Projections. The FPR Commentary clarified that any FPR projection must be based on historical data from the brand being offered. An FPR projection cannot be based on historical data from other brands or competitive brands.

6. Disclaimers. The FPR Commentary echoed what franchise examiners have being saying for years – a franchisor may not modify the admonition provided in the 2008 Commentary. A franchisor may only modify the admonition if the language clearly does not fit the FPR presented. A franchisor also may not include additional disclaimers beyond the admonition.

PRACTICE POINTS

The FTC Franchise Rule requires that a franchisor making an FPR have a reasonable basis for the data presented, but it provides little guidance beyond that requirement. The FPR Commentary is an attempt to define what a reasonable basis is and to give a franchisor some guidance in how to structure its FPR. The challenge that NASAA faces in drafting the FPR Commentary is that franchising is a very diverse business model with companies from many different industries. As a result, not every FPR will fit into the categories addressed in the FPR Commentary. Due to the amount of feedback NASAA received from the FPR Commentary, a final version has not yet been issued, and NASAA may even issue another draft of the FPR Commentary seeking additional comments.

Once the FPR Commentary is finalized, franchisors must be ready to examine their FPRs and make appropriate changes. It is hoped that the FPR Commentary also will reduce the number of comments from state examiners on FPRs as both the examiners and franchisors will have a roadmap to follow. In the meantime, some state examiners are already pushing franchisors on certain issues addressed in the FPR Commentary, such as separating data from company-owned and franchised outlets or pulling out potential outliers.

VIII. POST-TERM COVENANTS AGAINST COMPETITION

Following the termination or expiration of a franchise agreement, franchisees typically have to comply with several obligations, including honoring a covenant not to compete following the term of the franchise agreement. Although the enforcement of covenants against competition is not new to franchising, it continues to be an area of the law that is frequently litigated and continues to develop.

A. ***Cellairis Franchise, Inc. v. Duarte*, 2:15-cv-001010-WCO, 2015 WL 6517487 (N.D. Ga. Oct. 21, 2015)**

In October 2015, the Northern District of Georgia granted plaintiff Cellairis' motion for a preliminary injunction to enforce restrictive covenants against defendant Duarte, a former officer and employee who had been involved in finding and negotiating mall leases for Cellairis and had owned an interest in a business that operated three Cellairis franchises. After Duarte resigned from his position and sold his interest in the franchises, he became involved in at least two competing wireless businesses. Cellairis further alleged that Duarte used his contacts with representatives from local malls to negotiate sites for competitive wireless locations. Cellairis alleges that these actions were in violation of the franchise agreement's restrictive covenants which included noncompete and nondisclosure clauses during and after the term of the agreements.

Applying the Georgia law respecting restrictive covenants that was passed in 2010, the court found that the parties had a valid contract and that the restrictive covenants were enforceable. Under Georgia law, a restrictive covenant must be a reasonable restraint on competition, including duration, territorial coverage, and scope of activity prohibited. First, the court found the two-year noncompete a reasonable duration, as a two year limitation is presumably reasonable under Georgia law. The court also found the geographic limitation reasonable. Duarte was restricted from competing within a 10-mile radius of the former franchised business or within a 10-mile radius of any Cellairis business that was in operation at the time of termination.

The court noted that Cellairis is an international company and despite its geographic reach, Cellairis sought only a narrow geographic limitation. Finally, the court found that the limitation placed on the scope of activity was also reasonable because Duarte was only prohibited from being involved in a business "offering cellular telephone accessories, other wireless accessories and/or related products or services including cellular telephone and wireless device repair" and was not restricted from involvement in other types of businesses.

The court agreed with Cellairis that Duarte's involvement with a cellular retail store within a ten-mile radius of a Cellairis store was a breach of the restrictive covenant. While Duarte argued that he needed to work in the wireless industry to have gainful employment, Cellairis highlighted several emails and text messages implicating admissions from Duarte that he was in violation of the noncompete, and the court noted Duarte could use his leasing experience in other industries. Therefore the court found that Cellairis had a substantial likelihood of success on the merits of its breach of contract action.

In determining irreparable harm, the court found that Duarte's release of confidential information posed a risk of irreparable harm, particularly because the wireless industry is competitive and has a relatively low cost of entry. Furthermore, this release of confidential information harmed Cellairis' brand and goodwill. The court noted that it is reasonable for a franchisor to "prohibit previous franchisees and parties bound by the franchise agreement, given likely sensitive information received in those capacities, from competing in the same industry, and for a short time after, their agreement."

PRACTICE POINTS

This case illustrates the importance of drafting narrowly tailored restrictive covenants that a court may find reasonable, and the terms of competitive activity courts are likely to find unlawful. Notably for franchisors, the court in Duarte found the noncompete clause contained in Cellairis' agreement with its former employee to be reasonably narrow—it only restricted the employee from competing in the same industry, for only two years, and only within a ten-mile radius of any of the franchised units. The court also took into account that the industry was highly competitive and had a relatively low cost of entry, which similarly situated franchisors should be aware of when drafting their own restrictive covenants. Although many franchisors like broadly drafted covenants against competition, they may sometimes find that more narrowly *drafted provisions can offer better protection by increasing the likelihood of enforceability.*

B. ***H&R Block Tax Services, LLC v. Strauss*, No. 1:15-cv-0085 (LEK/CFH), 2015 WL 4094649 (N.D.N.Y. July 7, 2015)**

Plaintiff franchisor, H&R Block, brought an action against a former franchisee and two of her former employees for continuing to perform tax preparation services in violation of the franchise agreement's noncompetition provision. In a previous motion, the court rejected the franchisee's arguments that the noncompete was too broad geographically, and upheld the post-termination covenant that prohibited competition within 45 miles of the previous franchised location.

The July 7, 2015 Order relates to the franchisee's failure to comply with the court's previous order enjoining her from offering tax return preparation services within 45 miles of her former franchised location and from soliciting previous H&R Block clients. H&R Block filed a motion alleging that the former franchisee was in contempt of the previous order by continuing to prepare income taxes at a location less than 45 miles from her previous franchise location and continuing to solicit clients by advertising "tax services" on the sign outside her former office, running a newspaper advertisement for her services, and receiving clients' materials at her previous franchised location and then transporting them to her new location to conduct the actual tax preparation.

After the former franchisee conceded that her new office was within 45 miles of her former franchise, and that she was providing income tax services at the new location, she argued that: she had made a good faith effort to comply with the geographic restrictions; the newspaper ad had been prepared weeks before and she had no control over its publication; and she had not removed or altered the sign outside of her former franchised location due to inclement weather, but would do so immediately.

The court rejected the former franchisee's arguments and found her in contempt for violating the previous court order. In particular, the court ruled that the plaintiff had not met her burden of establishing a lack of diligence to avoid a contempt finding because she continued to operate the new business even though she knew it was only 42.5 miles from her prior franchise location, she never contacted the newspaper to cancel the advertisement, and she never took steps to cover up the sign located outside of her previous office.

To remedy H&R Block's injuries, the court extended the restrictive covenant for an additional year and ordered the former franchisee to pay H&R Block royalty payment in the sum of $17,200 or 40% of the franchisee's $43,000 revenue generated during the contempt period. This number was based on the royalties agreed upon in the franchise agreement. Lastly, the court awarded H&R Block $15,616.40 in attorneys' fees and costs.

NOTE: The author's firm represented a party in this lawsuit.

PRACTICE POINTS

Strauss illustrates courts' willingness to strictly enforce the terms of a non-compete – in this case, holding a franchisee in contempt for violating a 45-mile restriction by only 2.5 miles. Strauss also shows that a failure to comply with reasonable restrictive covenants may result in significant damages based on the royalty rates in terminated agreements, as well as attorney fees and costs.

C. Nebraska Seller-Assisted Marketing Plan Act, Neb. Rev. Stat. § 59-1701

On April 8, 2016, revisions to Nebraska's Seller-Assisted Marketing Plan Act (the SAMP Act) took effect. The SAMP Act revisions defined "non-compete agreement" to be "any agreement between a franchisor and a franchisee, a guarantor, or any person with a direct or indirect beneficial interest in the franchise that restricts the business activities in which such persons may engage during or after the term of the franchise." The SAMP Act was further revised to allow courts in Nebraska to use the "blue pencil" rule in evaluating franchise noncompete agreements. Importantly, these changes apply to agreements entered into before the revised SAMP Act went into effect.

PRACTICE POINTS

Before the SAMP Act was revised, Nebraska was one of the few states that refused to apply the "blue pencil" rule to covenants against competitions. With the passage of the revised SAMP Act, franchisors seeking the enforce a non-compete under Nebraska law will have the comfort to know that if a court finds that the restrictions against competition are too broad, the court will have the authority to reduce the scope of competition rather than just refusing to enforce the noncompete covenants.

IX. COMMON LAW CLAIMS

Courts reached opposite results in two decisions involving claims that franchisors breached covenants of good faith and fair dealing in their financial representations to prospective franchisees.

A. ***Tervon, LLC. v. Jani-King of California, Inc.*****, No. 14-cv-2648, 2015 WL 4135162 (S.D. Cal. July 8, 2015)**

A federal court in California denied a motion by franchisor Jani-King of California, Inc. (Jani-King) to dismiss franchisees' claim of breach of the implied covenant of good faith and fair dealing, even though the court dismissed the franchisees' breach of contract claim for failure to state a claim.

The franchisees had entered into two franchise agreements with Jani-King in 2008 and 2010. In March 2011, Jani-King submitted a bid to the City of San Diego to provide cleaning services at Qualcomm Stadium after events. Jani-King quoted $0 for every third day of cleaning, as well as $0 for cleaning the parking lot, outside concrete areas, stairs, escalators, elevators, and end zones. These projects were expected to take two-and-a-half to three days of eight-hour work shifts to complete. The City, noticing the $0 bids, contacted Jani-King to warn that it had failed to include estimates for costs. Jani-King informed the City that its quotes were correct. It was awarded the contract.

In June 2012, Jani-King and the franchisees met to discuss the possibility that the franchisees would take the Qualcomm account. At the meeting, Jani-King presented spreadsheets demonstrating that the franchisees would earn a profit for clean-up after each game played at the stadium. Instead, however, the franchisees incurred significant losses on the account. They sued Jani-King to recover these losses, claiming they had relied on Jani-King's statements when they agreed to the Qualcomm contracts.

Jani-King moved to dismiss the action on the ground that the franchisees had failed to allege a breach of contract and thus could not allege breach of the covenant of good faith and fair dealing. The court dismissed the franchisees' breach of contract claim for failure to state a claim, but it refused to dismiss their good faith and fair dealing claim. The court held that in California, a plaintiff can show the breach of an implied covenant without pleading or proving a breach of a specific contractual provision.

The franchisees sufficiently pled the existence of a contract, even if they failed to sufficiently allege the breach of a specific provision, the court found. It then concluded that Jani-King interfered with the franchisees' right to receive the benefits of their contracts, "namely to 'permit the Franchisee the right to profit from its efforts.'" Thus, these allegations were sufficient to sustain a claim for breach of the covenant of good faith and fair dealing, the court held, denying Jani-King's motion to dismiss that claim.

The court also denied Jani-King's motion to dismiss the franchisees' common-law fraud claims, rejecting the franchisor's argument that the claims were not pled with sufficient particularity pursuant to Fed. R. Civ. P. 9(b). In support of this conclusion, the court noted that the franchisees alleged misrepresentations of expected profits "verbally as well as on spreadsheets," alleged failure to disclose relevant information and numbers related to the contract, alleged that the franchisor was made aware of its underbid by a phone call from the city and thus knew that its numbers were incorrect, and alleged that but for the franchisor's concealment and misrepresentations, the franchisees would not have accepted the Qualcomm contract.

A claim for intentional infliction of emotional distress did not survive Jani-King's motion to dismiss. The franchisees claimed that as a result of their significant losses on the Qualcomm contract, they could not pay their employees. The employees in turn became "very angry and upset," which caused the franchisees emotional distress. The court held that "false promises of monetary gains do not constitute extreme or outrageous conduct," a required element for proving intentional infliction of emotional distress.

B. *Cornerstone Investment Partners, LLC v. Steak n Shake Enters., Inc.*, No. 2:14-cv-06581, 2015 WL 4094630 (D.N.J. July 6, 2015)

A franchisee's claims for fraud and breach of the covenant of good faith and fair dealing against franchisor Steak n Shake were dismissed by a federal court in New Jersey after the court found that the franchisee failed to identify any specific provision of its agreement that was breached.

In 2012, Cornerstone Investment Partners, LLC (Cornerstone) contacted Steak n Shake about opening a Steak n Shake "Signature" franchise, a new line of franchises opened by the franchisor. When Cornerstone sought to open the franchise, Steak n Shake refused to provide cost estimates for its Signature franchise model; instead, it provided historical estimates of Steak n Shake "Classic" restaurants. Cornerstone was not satisfied with these estimates and repeatedly requested estimates for the Signature franchise model. In response, Steak n Shake's vice president of franchise operations allegedly told Cornerstone it could "rely on the data associated with the Classic restaurants because food and labor costs for the Signature model would be less than those of the Classic model."

After opening its restaurant in late 2012, Cornerstone experienced "significant operating losses stemming from unexpectedly high costs." Cornerstone requested changes in the standard of performance mandated by the franchise agreement in order to accommodate for these costs, but Steak n Shake refused to allow the changes. Cornerstone then brought an action alleging, among other things, fraud and breach of contract due to a violation of the covenant of good faith and fair dealing.

The court granted Steak n Shake's motion to dismiss both the fraud and good faith and fair dealing claims, concluding that Cornerstone had not pled that any "specific provision" of the franchise agreement was breached. Cornerstone claimed it relied on Steak n Shake's misrepresentations regarding the food and labor costs. The court rejected this argument, however, because the information provided was "historical financial performance representations," and Cornerstone did not allege that Steak n Shake failed to disclose any information it was required to disclose. Further, the franchise agreement explicitly stated that "no representative for [Steak n Shake] may make any historical cost information representations outside of those provided in [the agreement]." Thus, Cornerstone did not adequately plead fraud or a violation of the covenant of good faith and fair dealing, the court concluded, dismissing those claims.

PRACTICE POINTS

Tervon and Cornerstone illustrate what a difference a jurisdiction can make. In Tervon, a California federal court held that a franchisee could show the breach of an implied covenant of good faith and fair dealing even without pleading or proving a breach of any specific contract provision. Thus, the court in that case dismissed the *franchisees' breach of contract claim for failure to state a claim, but allowed their claim based on good faith and fair dealing to survive. In Cornerstone, on the other hand, a federal court in New Jersey dismissed a franchisee's claim for breach of the covenant of good faith and fair dealing because the franchisee failed to identify any specific provision of the agreement that the franchisor had breached.*

X. LEGISLATIVE UPDATES

In addition to the legal developments arising out of courts and administrative law bodies over the past year, local and state lawmakers have also enacted laws that directly impact the franchise industry. From California's AB 525 impacting the franchise relationship to state and local laws increasing the minimum wage, the franchise community has seen a significant increase in legislative activity, and we expect such activity to continue in 2016.

A. California's AB 525

On October 11, 2015, Governor Jerry Brown signed California bill AB 525 into law—a sweeping reform which made it considerably more difficult for franchisors to terminate, refuse to renew, or refuse to consent to a transfer of a franchise in California. The bill applies to all franchise agreements entered into or renewed after January 1, 2016. The bill was passed with bipartisan support. The new or modified restraints on franchisors include the following:

- Franchisors must provide franchisees with additional time to cure a default before termination. Franchisors may not terminate a franchise prior to the expiration of its term except for good cause, which is limited to "the failure of the franchisee to substantially comply with the lawful requirements of the franchise agreement imposed on the franchisee after being given notice." The law requires a reasonable opportunity to cure the failure of no less than 60 days, but no more than 75 days, from the date of the notice of noncompliance. Previously, good cause was defined as "the failure of the franchise to comply with any lawful requirement of the franchise agreement after being given notice and reasonable opportunity to cure the failure within 30 days."

- It is now unlawful for a franchise agreement to "prevent a franchisee from selling or transferring a franchise . . . to another person, provided that the person is qualified under the franchisor's then-existing and reasonable standards for approval of new or renewing franchisees, as specified, and the parties comply with specified transfer provisions." A franchisee cannot sell, transfer, or assign a franchise without the franchisor's consent; however, consent can only be withheld if the buyer, transferee, or assignor does not meet the standards for new or renewing franchisees or the parties fail to meet specified transfer provisions.

- Prior to a sale, assignment, or transfer of a franchise, the franchisee must now notify the franchisor, in writing, of the franchisee's intent to sell, transfer, or assign. In return, the franchisor, within 15 days, must notify the franchisee of the approval or disapproval of the proposed sale, assignment, or transfer. Such notice must be in writing and delivered by courier to the franchisee or sent by receipted mail. In the notice, the franchisor must communicate its standards for approval of new or renewing franchisees. Unless disapproved by the franchisor, the proposed sale, assignment, or transfer is deemed approved under the law.

- Franchisors that prevent a terminated or nonrenewed franchisee from "retaining control of the principal place of the franchise business" are now required to purchase "all inventory, supplies, equipment, fixtures and furnishings purchased or paid for under the terms of the franchise agreement or any ancillary or collateral agreement." This is a change from the previous law, which only required franchisors to *offer* to repurchase from the franchisee its resalable current inventory.

- Lastly, the bill entitles a franchisee to receive from the franchisor "the fair market value of the franchise business and assets, as well as resulting damages, if a franchisor terminates or fails to renew a franchise in violation of the act." Further injunctive relief is also available.

PRACTICE POINTS

The bill, which amends the California Franchise Relations Act, has been criticized primarily for lacking clarity. For example, under the bill, franchisors that prevent a terminated or nonrenewed franchisee from "retaining control of the principal place of the franchised business" are required to purchase the franchisee's assets, and it is unclear whether language in franchise agreements, conditional lease assignments, or leases that give franchisors certain approval rights with respect to the franchise premises are sufficient to have deprived a franchisee of "control." Additionally, franchisors that ultimately purchase the assets must do so "at the value of the price paid minus depreciation," which is difficult to ascertain unless the franchisor is aware of all of the franchisee's assets, the price paid by the franchisee for the assets, and the extent to which those assets have depreciated.

Despite this and other ambiguities, franchisors are able to mitigate the impact of the law on their business by revising their franchise agreements to establish procedures for addressing purchasing obligations and requiring franchisees to report asset acquisition costs. In addition, franchisors should create written transfer standards in advance of a transfer request and review their franchise agreements' transfer provisions to ensure there is enough flexibility to supplement the transfer conditions.

B. Minimum Wage Cases

Increases to the minimum wage at the local and state level also will have a tremendous impact on the franchise industry. Most laws increasing minimum wage exempt small businesses, or allow them to phase-in wage increases on a less aggressive schedule, but the Seattle minimum wage ordinance and the New York Labor Commission's Wage Order targeting quick-serve restaurants have treated many independently owned franchisees as large employers due to their relationship with the franchise network.

1. *Int'l Franchise Assoc., Inc. v. City of Seattle*, 803 F.3d 389 (9th Cir. Sept. 1, 2015).

In September 2015, the 9th Circuit upheld the district court's denial of a preliminary injunction which the International Franchise Association (IFA) sought in order to prevent the City of Seattle from classifying independently owned and franchised businesses as large employers under its recently enacted minimum wage ordinance (the Ordinance). The Ordinance classified franchisees that were part of franchise systems with 500 or more employees as large employers, increasing the minimum wage to $15 per hour by 2017. Other employers have until 2021 to increase the minimum wage to $15 per hour. In particular, the appellate court rejected the IFA's claims that the Ordinance violated the dormant Commerce clause, the Equal Protection Clause, the First Amendment, the Lanham Act or the Washington State Constitution. The court also held that the IFA would not suffer irreparable harm if the Ordinance was enacted.

First, the court responded to the IFA's argument that the Ordinance violated the dormant Commerce Clause of United States Constitution which prohibits state and local regulations that improperly discriminate against or burden interstate commerce. While the court noted that the Ordinance "arguably imposes costs on a class of businesses said to be highly correlated with out-of-state firms or interstate commerce," the court ultimately held that the IFA could not establish that Seattle franchisees are "out-of-state entities" discriminated against by the Ordinance, nor that the franchises "are so interstate in character relative to non-franchises that a distinction drawn on this basis interferes with interstate commerce." In fact, the court noted that the very entities that were going to be impacted by the Ordinance were the independently owned businesses operating in Seattle and not an out-of-state franchisor. The court also upheld the district court's finding that there was no discriminatory purpose behind the Ordinance. While certain Seattle officials questioned the validity of the franchise model, the court found that the purpose of the law was not to burden interstate commerce. Thus the court upheld the district court's refusal to grant a preliminary injunction against the City of Seattle under the dormant Commerce Clause.

Second, the court determined that the Ordinance did not violate the Equal Protection Clause of the United States Constitution, which requires states to give each person in its jurisdiction equal protection under the law. The court upheld the district court's finding that the classification of independently owned franchised businesses as large employers had a legitimate purpose and that there was a rational relationship between franchises and their classification as large employers. The court believed that franchises were better able to "handle the faster phase-in schedule," and there were economic benefits available to franchisees that were not available to other small businesses, the relationship between franchises and their classification was rational.

Specifically, the court noted, "[i]t is legitimate and rational for Seattle to set a minimum wage based on economic factors, such as the ability of employers to pay those wages."

Third, the court upheld the district court finding that the IFA's First Amendment challenge lacked merit. In particular, the court found that because "Seattle's minimum wage ordinance is plainly an economic regulation that does not target speech or expressive conduct," "[t]he conduct at issue—the decision of a franchisor and a franchisee to form a business relationship and their resulting business activities—exhibits nothing that even the most vivid imagination might deem uniquely expressive."

Fourth, the court rejected the IFA's argument that the Ordinance was preempted by the Lanham Act, which protects federally registered trademarks from state interference. The IFA argued that because the definition of a franchise is based on the license of a trademark, the Ordinance interfered with the use of these trademarks in Seattle. The court rejected that argument and agreed with the district court, finding that the Ordinance was not preempted by the Lanham Act. Minimum wages have traditionally been regulated at the state and city levels, and it should be assumed that no federal law will preempt these types of laws unless there was clear intent – which there was not under the Lanham Act.

Fifth, the court concurred with the district court that the Ordinance did not violate the privileges and immunities clause of the Washington State Constitution, which prohibits laws that discriminate between state citizens. The court rejected the IFA's argument that the Ordinance violated the Washington State Constitution for two reasons. First, the Ordinance would only violate the privileges and immunities clause if the Ordinance pertained to a fundamental right of the state's citizens. The IFA failed to show that treating franchised businesses different from other small businesses for the purposes of setting the minimum wage that these businesses must pay to their employees is not a fundamental right. Second, Seattle's classification of franchised businesses as large employers was based on Seattle's belief that franchised businesses had material advantages over non-franchised businesses and was therefore based on reasonable distinctions.

Finally, the court rejected the IFA's argument that franchised businesses would suffer irreparable harm if the Ordinance was enacted. The IFA argued that franchised businesses would be at a competitive disadvantage as it relates to non-franchised businesses because franchised businesses would face higher labor costs. While the court found that the district court had erred in rejecting the IFA's evidence of competitive injury, the IFA still failed to show irreparable harm in the evidence it presented. In addition, the court determined that it was in the public interest in having workers receive increased wages.

Although the Ninth Circuit upheld the district court's denial of a preliminary injunction to prevent the City of Seattle from enforcing the minimum wage increase on franchisees, the plaintiffs have appealed, and the Supreme Court should decide whether it will grant certiorari before the end of the 2016 term.

PRACTICE POINTS

In this case, the IFA did not argue that Seattle could not raise the minimum wage, but only argued against its discriminatory treatment of franchisees. Supporters of exempting franchisees from the small business classification have argued that franchisees enjoy unique economic advantages that give them the ability to handle an accelerated wage phase-in—namely, that franchisees are part of a network, benefit from the economies of scale regarding advertising and supply chain management, and have the ability to negotiate their royalty fees with franchisors. On the other hand, those in the franchise industry worry that the Ordinance will cause franchisees to reduce employment, raise prices, rely on great automation, and earn lower margins that will threaten the viability of their businesses. Importantly, franchisees have also pointed out that they pay for the perceived advantages of franchising through royalties and other franchise fees. The franchise industry is monitoring discussions about minimum wages closely and waiting to see if other state or local governments attempt to target franchised businesses.

2. *Nat'l Restaurant Assoc. v. Commiss. Labor*, Docket No. 15-001 (N.Y. Industrial Board of Appeals, December 9, 2015);
and
Nat'l Restaurant Assoc. v. Commiss. Labor, Docket No. 522160 (N.Y. App. Feb. 5, 2016)

In 2015, the New York Labor Commissioner issued an order raising the minimum wage for certain employees in the fast food industry to up to $15 per hour. The Wage Order applies to:

> any establishment in the state of New York (a) which has a primary purpose of serving food and drink items; (b) where patrons order or select items and pay before eating and such items may be consumed on the premises, taken out, or delivered to the customer's location; (c) which offers limited service; (d) which is part of a chain; and (e) which is one of thirty (30) or more establishments nationally, including: (i) an integrated enterprise which owns or operates thirty (30) or more such establishments in the aggregate nationally; or (ii) an establishment operated pursuant to a Franchise where the Franchisor and the Franchisee(s) of such Franchisor own or operate thirty (30) or more such establishments in the aggregate nationally.

The National Restaurant Association appealed that decision to the New York Industrial Board of Appeals (IBA) alleging that the appointment of the wage board (which recommended the Wage Order) was contrary to law and that the Wage Order itself violated applicable law. The IBA disagreed and upheld the Labor Commissioner's Wage Order. New York Labor Law § 655 permitted the Labor Commissioner to appoint a wage board that had representatives for both employers and employees (the Wage Board). The National Restaurant Association objected to the appointment of an individual representing the employers' interests who had no background in the fast food industry and the appointment of an officer of a labor union to represent the employees' interests. The IBA found the appointments lawful, noting that the statute does not require that the individual representing the employers' interests be part of the fast food industry. Likewise, the statute does not prohibit the nomination of an employees' representative from a labor union actively campaigning for an increase in the minimum wage.

The IBA also found that the Wage Order did not violate the statute. New York Labor Law § 654 states that when establishing the minimum wage, the Wage Board must "consider the amount sufficient to provide adequate maintenance and to protect health… the value of the work or classification of work performed, and the wage paid in the state for work of like or comparable character." The IBA found that the Wage Board considered all three factors after reviewing a substantial amount of evidence and found that "current wages paid to fast food workers in New York are not sufficient to meet the costs of living, that the value of fast food work is reflected in the difficultly of the tasks performed and the profit the work creates for the industry, and that fast food establishments in New York pay the lowest annual wages within the broader food services sector." In addition, the IBA found that nothing in the statute prohibited the Wage Board from applying the minimum wage requirement only to fast food chains with 30 or more locations nationally. The IBA also noted that the Wage Board found fast food chains are better able to absorb wage increases.

The National Restaurant Association appealed the IBA's decision to the New York Supreme Court. The National Federation of Independent Businesses and the IFA submitted an amicus brief.

The amici argue that the Wage Order unfairly targets small businesses because a franchisee is defined as a "person or entity to whom a franchise [is] granted," the result being that "a small business who owns one franchise in New York will be unfairly subject to the increased minimum wage merely because it associates with a nationwide brand." The problem with this, the amici contend, is that "the Wage Board seemingly failed to consider the fact that the franchisor and the franchisee are separate, independent companies," such that "[f]ranchisees are just like other small business owners" who "oversee all the day-to-day operations of their businesses, make all their own labor and employment decisions, including hiring, firing, and how much to pay their employees[, and . . .] pay all the rent, taxes, and financing costs."

Second, the amici argue that the commissioner's order is both arbitrary and capricious, and lacks evidentiary support. Specifically, the amici argue that "in reaching its recommendations, the Wage Board cited no empirical evidence establishing why a fast food establishment operating more than 30 locations is situated differently from one with less than 30 locations." Nor, the amici contend, did the Board provide any evidence that "'fast food establishments with' 30 or more locations nationwide are any better situated to support the imposition of such a significant wage increase." Lastly, the amici question why the Wage Board distinguished franchises from traditional businesses as more suited to handle the increased minimum wage.

Third, the amici argue that "imposing a higher minimum wage on employers affiliated with out-of-state companies is discriminatory and violates the commerce clause." Citing the Wage Board's conclusion that the "'$15 wage rate [should] be applicable only to fast food chains with 30 or more locations nationally, since chains of this size are better equipped to absorb a wage increase due to greater operational and financial resources, and brand recognition,'" the amici argue that this conclusion is inconsistent with the Order's definition of franchise, for "the definition makes clear that the minimum wage rates also apply to any single franchisee, so long as the franchise brand operates more than 30 establishments nationally." Thus, the amici argue, "[it] is clear from the Wage Board's report and recommendations that it intends interstate franchise businesses, and those businesses affiliated with interstate franchise businesses, to bear a greater economic burden of an increased minimum wage rate as compared to similarly situated New York businesses."

PRACTICE POINTS

The New York Order increasing the minimum wage to $15 per hour for workers at fast food chains with at least 30 locations nationally was unusual in that it was created through the state's executive branch, rather than through the legislature. The governor of New York, Andrew Cuomo, directed the labor commissioner to convene a panel which proposed the minimum wage increase and which was ultimately accepted by the labor commissioner.

The National Restaurant Association appealed this decision to the New York Industrial Board of Appeals, arguing that the panel's actions were unlawful under New York's labor statutes. Although the Board decided against the National Restaurant Association, the appeal was necessary to exhaust all administrative remedies before the Association would have the option of bringing the issue before the New York courts. The National Restaurant Association appealed the decision in the New York Supreme Court, and that appeal is pending. This decision will be impacted by the recent New York law that requires a state-wide increase in minimum wage for all employers.

C. Minimum Wage Legislation

The minimum wage trend only continues to grow in 2016, and two states recently enacted legislation to raise the minimum wage for all businesses in the entire state.

1. California: CAL. Lab. Code Sec. 1182.12.

In April 2016, California legislators passed a law to raise the state's minimum wage from $10 to $15 an hour. Known as the "Fair Wage Act of 2016," the law incrementally increases the minimum wage by $1 every year until it reaches $15 per hour in 2022. Businesses of 25 employees or less have until January 1, 2018, to initially increase their minimum wage to $10.50 per hour, and until 2023 to meet $15 per hour. After 2023, the law provides for a 0% to 3.5% increase in wages for inflation.

2. New York: NY Lab. LAW Sec. 652 and NY Workers' Comp. LAW Sec. 200 et seq.

On the same day in April 2016, New York's Governor Cuomo signed two labor laws: one increasing New York's minimum wage to $15 per hour, and another granting workers the right from their employer to a 12-week paid family leave. The two-tiered minimum wage law sets different wage requirements depending on geographic location: the minimum wage for most business in New York City will increase to $15 per hour by the end of 2018; Nassau, Suffolk, and Westchester counties will reach $15 by the end of 2021; and the rest of the state will reach $12.50 by the end of 2020. The state's $12.50 wage has the potential to increase to an amount determined by the state labor commissioner and the director of the budget after 2020. For small business, New York's law gives businesses of 10 employees or less one extra year to implement the increase.

PRACTICE POINTS

The National Restaurant Association and the IFA have vehemently opposed these wage hikes. Unlike the Seattle Ordinance and the previous New York order, these laws appear to target all businesses the same. As a result, for the purposes of application of the California and New York laws, an independently owned franchised business will only have to evaluate the number of its own employees in determining when it must comply with these laws.

Looking ahead to the rest of 2016, we anticipate that cities and states will continue to evaluate the minimum wage and that the minimum wage debate will continue to be a prominent point of discussion in the upcoming presidential election.