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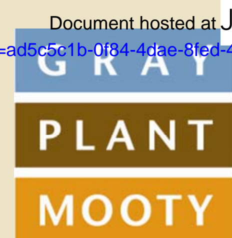

The GPMemorandum

TO: **OUR FRANCHISE CLIENTS AND FRIENDS**

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

Quentin R. Wittrock, Editor of *The GPMemorandum*

DATE: **April 10, 2008 – No. 106 – Distribution Issue**

This issue of *The GPMemorandum* focuses on topics of interest to companies that use distributors and dealers rather than managing a system of franchisees. The topics this quarter include termination, arbitration, applicability of state statutes, and more. Here are our summaries of some of the most recent developments of interest to manufacturers and others who supply products through dealers and distributors:

BUSINESS OPPORTUNITIES

FTC SEEKS COMMENTS ON PROPOSED BUSINESS OPPORTUNITY RULE

On March 18, 2008, the Federal Trade Commission announced the publication in the Federal Register of a revised notice of public rulemaking (RNPR), seeking comments on a modified version of the Commission's proposed Business Opportunity Rule.

The NPR is a follow-up to the business opportunity rule portion of the FTC's April 2006 notice of public rulemaking (NPR). The April 2006 NPR addressed long-awaited revisions to the 1978 Franchise Rule and also proposed adoption of a new and separate rule relating specifically to business opportunities. The definition of the term "business opportunity" in the proposed rule is designed to cover such business arrangements as vending machine routes, rack display operations, and envelope-stuffing opportunities. Unlike franchises, "business opportunities" are not necessarily characterized by the right to use a trademark. Under the Commission's proposed rule, the sale of business opportunities would be subject to certain disclosure requirements that are different from, but not entirely unlike, the disclosures required for the sale of franchises. However, the sale of a "franchise" offered in compliance with the revised Franchise Rule is exempt from the requirements of the proposed Business Opportunity Rule.

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The revisions to the proposed rule come as a result of the Commission's review of comments submitted in response to the April 2006 NPR. According to the Commission's announcement, the revised Business Opportunity Rule "would not reach multi-level marketing companies or certain companies that may have been swept inadvertently into scope of the April 2006 proposal" and also "streamlines the requirement to disclose material information by eliminating requirements to disclose the number of cancellations and refund requests that a business opportunity seller receives or the litigation history of sales personnel."

The deadline for submission of comments to the revised Business Opportunity Rule proposal is May 27, 2008. The FTC's notice can be found at http://www.ftc.gov/opa/2008/03/busrule.shtm. The text of the RNPR itself can be viewed at http://www.ftc.gov/os/2008/03/R511993business.pdf.

TERMINATIONS

THIRD CIRCUIT HOLDS THAT FAILURE TO BUILD SHOWROOM CONSTITUTES GOOD CAUSE TO TERMINATE

The United States Court of Appeals for the Third Circuit in *Maple Shade Motor Corp. v. Kia Motors Am., Inc.*, 2008 WL 111041 (3d Cir. Jan. 11, 2008), affirmed summary judgment in favor of an automaker on its dealer's unlawful termination claim. The court found that the dealer's failure to build a showroom was a material term of the dealership agreement that had been breached. The Third Circuit relied on prior case law – under the New Jersey Franchise Protection Act – that holds that a franchisor has good cause to terminate when a franchisee breaches a material term of a franchise agreement.

The Third Circuit also affirmed summary judgment in favor of the manufacturer on the dealer's claim that the company improperly denied the transfer of the dealership. The appellate court stated that the maker properly rejected the transfer because the dealership had been terminated and, thus, had no franchise rights to transfer.

MAINE FEDERAL COURT DENIES INJUNCTION TO PREVENT TERMINATION OF DEALERSHIP

Holding last month that the Maine Franchise Act does not create a "new set of standards" for temporary restraining order and injunction requests, the United States District Court for the District of Maine refused to stop the termination of a heavy equipment dealership in *Frank Martin Sons, Inc. v. John Deere Construction & Forestry Co.*, 2008 WL 787680 (D. Me. March 21, 2008). The court instead applied a standard test

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weighing factors such as the plaintiff's likelihood of success on the merits and alleged irreparable harm.

The plaintiff's main argument was one made often – that termination was not allowed if the supplier had not terminated other dealers in the same situation. The plaintiff wanted the court to read the statutory language about renewal "on terms then equally available to all its distributors or dealers" to trump the "good cause" language allowing termination and non-renewal. The court held that the plaintiff's reading of the Maine statute to prohibit a termination for good cause "would make little sense."

TERMINATION FOLLOWING DEATH OF DEALER DID NOT VIOLATE MISSOURI STATUTES

The United States District Court for the Eastern District of Missouri recently granted a manufacturer's motion to dismiss several counts of a complaint relating to the termination of a John Deere dealership. In *Heisel v. John Deere Const. & Forestry Co.,* 2008 WL 53232 (E.D. Mo. Jan. 2, 2008), the court found that John Deere's termination of a long-standing dealership following the death of its principal did not, as a matter of law, violate the Missouri Farm Equipment Act or the Missouri Construction Equipment Act. Both of these statutes prohibit dealership terminations unless there is "good cause" for the termination. However, "good cause" is defined under both statutes to include "withdrawal from the dealership of an individual proprietor." The court found that the term "withdrawal" includes the death of the proprietor.

The court also dismissed the plaintiff's claims for breach of contract and breach of the implied covenant of good faith and fair dealing. The dealership agreement in question required the company to continue a relationship with the heirs of the dealer's principal only if the company believed the heirs "to be capable of carrying out the obligations thereunder," which the company apparently did not believe.

VIRGINIA FEDERAL COURT DISMISSES COUNTERCLAIM AGAINST SUPPLIER AND ENFORCES TERMINATION OF AT-WILL DISTRIBUTION AGREEMENT

In *Frank Brunckhorst Co., L.L.C. v. Coastal Atlantic, Inc.*, 2008 WL 276409 (E.D. Va. Jan. 29, 2008), the court granted a national distributor's motion to dismiss a counterclaim brought by one of its regional distributors who had been terminated. The plaintiff, a national distributor of Boar's Head deli products, sued the regional distributor for trademark infringement and nonpayment. The defendant regional distributor countersued on numerous grounds, including breach of contract, tortious interference, and fraud.

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In dismissing the counterclaims, the Virginia federal court first determined that the plaintiff did not breach the contract under Virginia law because the "at-will" contract involved in this case, which contract was oral and had no definite duration, was terminable at any time by either party for any reason. The defendant argued that the contract had an agreed-upon duration because the plaintiff promised the defendant exclusive distribution rights so long as it continued to promote and built brand identification for the Boar's Head brand. However, the court found that under Virginia law, an agreement for an exclusive distributorship conditioned upon one's best efforts to promote a brand does not transform a contract terminable at will into one that can be terminated only for just cause. The court noted that even if this were the case, enforcement of the oral contract would be barred by the statute of frauds because it could not be have been performed within a year. The court also noted the longevity of the parties' 23-year distribution relationship, which demonstrated that the defendant had more than enough time to operate its distributorship and recoup its investment before the plaintiff terminated the at-will contract.

As to the defendant's tort claims, the court found that the plaintiff could not tortiously interfere with an at-will contract that it chose to terminate. The tortious interference claims also failed since the defendant made no allegations that the plaintiff employed any illegal or independently tortious means, violated a trade or professional standard, or conducted itself unethically. The court held that the defendant failed to state properly its fraud claims, noting that the plaintiff's alleged duties that gave rise to the purported misrepresentation were based in contract and not tort. The court further held that even if the plaintiff had concealed certain "activities or motives" to take over the defendant's distribution network, no constructive fraud existed because the plaintiff had no duty outside the contract to disclose those actions to the defendant. Although the court characterized some of the plaintiff's actions as "perhaps unsavory", it acknowledged those actions to be within its legal rights.

ARBITRATION

MICHIGAN DISTRICT COURT GRANTS IN PART MOTION FOR SUMMARY JUDGMENT BASED ON AGREEMENT TO ARBITRATE

The United States District Court for the Eastern District of Michigan recently granted in part McBride Research Laboratories, Inc.'s motion for summary judgment, finding that the parties' broad contractual agreement to arbitrate in Georgia any disputes arising out of or relating to the distributor agreement required dismissal of the plaintiff's claim. *Prude v. McBride Research Laboratories, Inc.* (E.D. Mich. Feb. 8, 2008).

The plaintiff argued that he was not bound by the agreement to arbitrate because the agreement was unenforceable under section 27(f) of Michigan's Franchise Investment

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law in that the contract required arbitration to be conducted in Georgia. The court found that Section 27(f) of Michigan's Franchise Investment Law is preempted under the Federal Arbitration Act, thus even if the distributor agreement were found to be governed by the Michigan statute, the plaintiff was foreclosed from arguing that the arbitration clause in the distributor agreement was unenforceable.

The plaintiff also argued that McBride had waived its right to compel him to arbitrate his claims because it filed a motion for summary judgment in which it simultaneously argued that the plaintiff's claims were subject to arbitration and thus must be dismissed and, inconsistent with that first argument, that the plaintiff could not show that the parties' commercial relationship fell within the scope of Michigan's Franchise Investment Law. The court rejected this argument and found that McBrides's actions were not inconsistent with an intent to assert its right to compel arbitration, thus McBride had not waived its right to arbitrate.

NEW HAMPSHIRE COURT DISMISSES CLAIMS SUBJECT TO ARBITRATION

In *C.V. Sullivan Co., Inc. v. Graham Web International, Inc.*, 2008 WL 249060 (D.N.H. Jan. 28, 2008), a federal court in New Hampshire granted a manufacturer's motion to dismiss state-law claims that the court found to be subject to arbitration. Sullivan was terminated as a distributor of beauty supply products manufactured by GWI pursuant to a "Sullivan Distribution Agreement." Sullivan filed suit, alleging that GWI breached its implied contractual obligation to act fairly and in good faith, engaged in unfair and deceptive trade practices, and tortiously interfered with Sullivan's contractual relations with its customers.

In moving to dismiss Sullivan's state-law claims, GWI argued that each claim related to or arose under or out of the Sullivan Distribution Agreement or other agreements that contained arbitration provisions. Although the Sullivan Distribution Agreement expired in 2003, Sullivan remained bound by its arbitration provisions because the parties' course of dealing demonstrated they were continuing to operate under that agreement's terms. The court rejected Sullivan's argument that it was not bound by the arbitration provision in the other agreements, which it had obtained via an assignment. The court noted that an assignee accepts rights and obligations of the assignor and is in the same position at which the assignor stood at the time of assignment.

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LOUISIANA COURT ADDRESSES QUESTIONS OF ARBITRABILITY

In *Volvo Trucks North America, Inc. v. Crescent Ford Truck Sales, Inc.*, 2008 WL 506099 (E.D. La. Feb. 21, 2008), the court considered questions regarding the arbitrability of a suit between an automobile manufacturer and one of its dealers. After Volvo issued Crescent Ford a notice of non-renewal of the parties' dealer agreement, Crescent filed a petition with the Louisiana Motor Vehicle Commission ("LMVC") to preclude the termination, arguing that Volvo failed to properly allege just cause for the termination as required under Louisiana law. As part of the proceedings before the LMVC, Volvo then filed a motion to compel arbitration pursuant to the terms of the dealer agreement. When that motion was denied, Volvo filed a petition for review in state court. The state-court action was pending when Volvo also filed a complaint in federal district court seeking an order directing the parties to proceed to arbitration, enjoining Crescent and the LMVC from setting the case for trial on the merits prior to a final decision regarding the right to arbitration, and for a declaratory judgment that various provisions of the federal Automobile Dealer's Day in Court Act were applicable to the rights of the parties.

Crescent responded with a motion to dismiss the federal action. It contended that the court lacked subject matter jurisdiction and also should decline to hear the matter pursuant to applicable abstention doctrines. Volvo argued that the court had subject matter jurisdiction because its claims implicated both the Federal Arbitration Act ("FAA") and the Automobile Dealer's Day in Court Act ("ADDCA"). The court held that the FAA did not provide an independent basis for jurisdiction, nor did three of the cited sections of the ADDCA. Section 1226 of the ADDCA, however, did provide subject matter jurisdiction; that provision states that arbitration may be used to settle a controversy involving a motor vehicle franchise "only if after such controversy arises all parties to such controversy consent in writing to use arbitration to settle such controversy." The parties disputed whether that provision was applicable during the period in question. That question was one of arbitrability, which was the key issue before the court, so it did create a basis for subject matter jurisdiction.

Crescent also argued that the court should abstain from exercising jurisdiction under the *Burford* and *Younger* abstention doctrines. The court disagreed. It held that abstention under either doctrine was not required. The court noted that its limited inquiry into the validity and enforceability of the arbitration clause would not unduly intrude into Louisiana's processes of governing automobile sales, and that abstention generally is not proper in a suit to determine whether parties are entitled to arbitration under the FAA.

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DEFINITION OF A FRANCHISE

CALIFORNIA FRANCHISE LAW HELD NOT APPLICABLE TO DISTRIBUTION ARRANGEMENT

In *Gabana Gulf Distrib. v. Gap Int'l Sales Inc.*, 2007 WL 4145105 (N.D. Cal. Jan. 9, 2008), a federal district court in California confronted the issue of what constitutes a franchise, finding that an International Sales Program Distributor License Agreement ("ISP Agreement") between distributors and defendants Gap International Sales, The Gap, Banana Republic, and Old Navy (collectively "GAP") was not subject to the California Franchise Relations Act because the distributors' operation was not substantially associated with GAP's trademarks or other commercial symbols.

The distributors had brought a breach of contract claim against GAP alleging violation of the CFRA. The parties each filed for summary judgment regarding the issue of whether their relationship, as described in the ISP Agreement, constituted a franchise under the California franchise statute. The court held that the parties' relationship was not a franchise because the distributors' business was not substantially associated with GAP's trademarks or other commercial symbols (the second element of the franchise definition). It found that GAP's ISP Agreement with the distributors specifically prevented them from using GAP's trademarks, and the court held that simply because the manufactured items of clothing that the distributors sold had GAP's marks on them did not convey a broader right of use to the distributors. In addition, the court refused to consider the distributors' use of reporting forms containing GAP's logos as evidence of substantial association with GAP's trademarks, because the distributors' use of the forms with the public contravened the terms of the ISP Agreement.

The court did find there to be a triable issue regarding whether GAP breached the covenant of good faith and fair dealing by terminating the ISP Agreement with the distributor without cause, so the court denied GAP's motion for summary judgment on that point.

PROCEDURE

SEVENTH CIRCUIT AFFIRMS DISTRICT COURT'S DISMISSAL OF CAR DEALERSHIPS' LAWSUIT

In *Ridge Chrysler Jeep, LLC v. DaimlerChrysler Financial Services Americas LLC*, 2008 WL 441758 (7th Cir. Feb. 20, 2008), the United States Court of Appeals for the Seventh Circuit affirmed a district court's dismissal of two car dealerships' lawsuit based on the dealerships' deceit. The lawsuit had been based on the manufacturer's exercise of its right to require dealerships to pay up front for inventory. After Chrysler exercised its

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right to the up-front payment, two dealerships responded with a lawsuit under the Automobile Dealers' Day in Court Act, accusing Chrysler of effectively ending the franchises without adequate cause.

The magistrate judge found that the CEO and principal owner of the two dealerships lied about efforts to obtain loans from sources other than Chrysler and failed to produce computer data. Further, the plaintiffs' complaint asserted allegations of racial discrimination by Chrysler as allegedly evidenced by notes from Chrysler, but the plaintiffs were unable to produce any such notes during discovery. In addition, the CEO and principal owner of the two dealerships used the time when Chrysler was an involuntary creditor to pay himself $1 million of a loan to the dealerships that was supposed to be subordinated to Chrysler's position. Based on the dealerships' misconduct, the district court dismissed the action. The dealerships appealed, arguing that there is a strong presumption against dismissal as a sanction and that only "clear and convincing evidence" can support outright dismissal.

The Seventh Circuit held that the dealerships' appellate arguments were uniformly unconvincing. The court of appeals noted that neither a statute nor the Constitution requires an elevated burden for dismissal as a sanction, when the burden in the underlying suit is the preponderance of the evidence. Regardless, the court found that the district court's findings were sufficient under any standard. The lower court demonstrated that the CEO and principal owner of the two dealerships lied to the court, and the lawsuit entailed an abuse of the federal court's process and the plaintiffs behaved like a "pack of weasels."

CONNECTICUT SUPREME COURT ORDERS PARTY TO STOP MAKING DISPARAGING REMARKS IN VIOLATION OF SETTLEMENT AGREEMENT

Manufacturers and franchisors who settle cases with their dealers and franchisees often do so in part to stop harm to the supplier's reputation in the marketplace. In those circumstances, the settlement agreement often includes a non-disparagement clause. The Supreme Court of Connecticut strongly upheld such a clause on March 25 in *TES Franchising, LLC v. Feldman*, 2008 WL 726293 (Conn. March 25, 2008). The court enjoined Feldman from any further violation of the settlement agreement and remanded to the trial court to determine how much he would have to pay for his past violations. The court found that the non-disparagement clause was important to the agreement because it not only prevented negative comments to potential new franchisees, but it protected confidential information shared by the parties during their former relationship.

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Minneapolis, MN Office

John W. Fitzgerald, Co-Chair (612-632-3064)
Megan L. Anderson (612-632-3004)
Wade T. Anderson (612-632-3005)
Phillip W. Bohl (612-632-3019)
Jennifer C. Debrow (612-632-3357)
Elizabeth S. Dillon (612-632-3284)
* Collin B. Foulds (612-632-3388)
* Michael R. Gray (612-632-3078)
Laura J. Hein (612-632-3097)
* Kelly W. Hoversten (612-632-3203)
Franklin C. Jesse, Jr. (612-632-3205)
Cheryl L. Johnson (612-632-3271)
Jeremy L. Johnson (612-632-3035)
Gaylen L. Knack (612-632-3217)

Kirk W. Reilly, Co-Chair (612-632-3305)
Gregory R. Merz (612-632-3257)
* Craig P. Miller (612-632-3258)
Bruce W. Mooty (612-632-3333)
John W. Mooty (612-632-3200)
* Kevin J. Moran (612-632-3269)
* Max J. Schott II (612-632-3327)
Daniel R. Shulman (612-632-3335)
* Jason J. Stover (612-632-3348)
Michael P. Sullivan, Sr. (612-632-3351)
Michael P. Sullivan, Jr. (612-632-3350)
Henry Wang (612-632-3370)
Lori L. Wiese-Parks (612-632-3375)
* Quentin R. Wittrock (612-632-3382)

Washington, D.C. Office

Robert Zisk, Co-Chair (202-295-2202)
* Jimmy Chatsuthiphan (202-295-2217)
* Ashley M. Ewald (202-294-2221)
Jeffrey L. Karlin (202-295-2207)
* Iris F. Rosario (202-295-2204)

Stephen J. Vaughan (202-295-2208)
* Katherine L. Wallman (202-295-2223)
* David E. Worthen (202-295-2203)
Eric L. Yaffe (202-295-2222)

**** Wrote or edited articles for this issue.***

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GRAY, PLANT, MOOTY, MOOTY & BENNETT, P.A.

500 IDS Center
80 South Eighth Street
Minneapolis, MN 55402-3796
Phone: 612-632-3000
Fax: 612-632-4444

2600 Virginia Avenue, N.W.
Suite 1111 – The Watergate
Washington, DC 20037-1905
Phone: 202-295-2200
Fax: 202-295-2250

franchise@gpmlaw.com

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