The Franchise Memorandum | By Lathrop GPM

To: **Our Franchise and Distribution Clients and Friends**

From: **Lathrop GPM's Franchise and Distribution Practice Group**
Maisa Jean Frank, Editor of *The Franchise Memorandum by Lathrop GPM*
Richard C. Landon, Editor of *The Franchise Memorandum by Lathrop GPM*

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Welcome to *The Franchise Memorandum by Lathrop GPM*. Below are summaries of recent legal developments of interest to franchisors.

Antitrust

Two Illinois Federal Courts Deny Class Certification in Anti-Poaching Class Actions Against Franchisors

Two federal courts in Illinois have rejected motions to certify classes of employees who worked in franchised McDonald's and Jimmy John's restaurants. These employees claimed that they suffered antitrust injury attributable to anti-poaching provisions formerly contained in the franchise agreements for those systems. *Deslandes v. McDonald's USA, LLC*, 2021 WL 3187668 (N.D. Ill. July 28, 2021); *Conrad v. Jimmy John's Franchise, LLC*, 2021 WL 3268339 (S.D. Ill. July 30, 2021). The decisions, which follow years of discovery, represent the likely end to attempts to claim system-wide monetary damages for the periods in which these provisions were in effect.

The decision in the Jimmy John's case in the Southern District of Illinois was unsurprising because, as reported in Issues 263 and 266 of *The Franchise Memorandum*, the court had excluded the expert that the plaintiff class sought to rely upon with respect to critical issues. More generally, however, the court found numerous flaws in the plaintiffs' theory of the case and attempt to meet the Rule 23 requirements for class certification. Among other issues, the putative class representative admitted that he had never sought employment at another Jimmy John's restaurant; thus, he was never prevented from changing jobs by the provision at issue. The terms of the anti-poaching provision also changed over time, and enforcement was spotty at best and varied locally. For these and other reasons, the court could not conclude that class-wide issues would predominate over issues requiring individualized determinations. Finally, although the court had left open the possibility of applying per se illegality or the quick-look doctrine in denying a motion to dismiss, the court ultimately determined that a full rule of reason analysis would be required, leading to additional issues that could not be determined on a class-wide basis. In this regard, the court noted that the plaintiffs' attempt to define a single-system labor market was refuted by evidence that Jimmy John's restaurants competed for labor with other QSR restaurants as well as other local employers.

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The court in the McDonald's case in the Northern District of Illinois reached the same result, for somewhat different reasons. The court first concluded that a full rule of reason analysis would be required, notwithstanding its prior decision holding out the possibility of a quick-look analysis. The court noted that, in the context of a franchise system, anti-poaching provisions could serve pro-competitive purposes and should not be condemned without full examination. The court also focused on the fact that labor markets, particularly for QSR restaurants, are inherently localized. Thus, there were hundreds or potentially thousands of relevant markets in which the effects, if any, of the anti-poaching provision would need to be evaluated. In markets where there were other competitors for labor, a single-system restraint could have little effect. Thus, the plaintiffs' $2.74 billion damages calculation, which had been premised on alleged nationwide suppression of wages, could not be sustained. In view of its analysis, the court criticized as "self-interested" the decision by plaintiffs' counsel to present the case only as a nationwide class action with no rule of reason claim.

Arbitration

First Circuit Affirms No Waiver of Right to Arbitrate

The First Circuit Court of Appeals has affirmed a district court's confirmation of an arbitration award, concluding that franchisor Toddle Inn Franchising had not waived its contractual right to arbitrate by initially seeking injunctive relief in court. *Toddle Inn Franchising, LLC v. KPJ Assocs., LLC*, 2021 WL 3524057 (1st Cir. Aug. 11, 2021). In 2006, Toddle Inn entered into a franchise agreement with KPJ Associates, which KPJ unilaterally sought to terminate in 2018. KPJ informed Toddle Inn it intended to continue operating a daycare service at the same location with the same employees but under a different name, which prompted Toddle Inn to immediately file suit seeking injunctive relief under the Lanham Act. The court denied the relief requested, but later granted Toddle Inn's motion to compel arbitration. Toddle Inn subsequently won its claims in arbitration. Toddle Inn then successfully petitioned the district court to confirm the arbitration award, and also won additional attorneys' fees incurred in the action to confirm. KPJ appealed, but the First Circuit affirmed the lower court decision on all grounds.

On appeal, KPJ raised three theories for reversal. First, KPJ alleged the district court did not have subject matter jurisdiction despite the Lanham Act claim because the case was wholly insubstantial and frivolous. The court was not persuaded at all and pointed out only the most extreme cases fail the substantiality test. Toddle Inn alleged that KPJ was providing the same services in the same location with the same employees, which the court believed was not even close to a frivolous basis for bringing a Lanham Act claim. Second, KPJ argued the district court erred in not finding Toddle Inn had waived its right to arbitrate by bringing the district court action for injunctive relief. The First Circuit rejected that argument by focusing on the very broad arbitration provision in the franchise agreement that, while requiring arbitration of all disputes, expressly granted Toddle Inn the additional right to seek injunctive relief in court. Finally, KPJ claimed under the arbitration provision of the franchise agreement that only the arbitrator, and not the court, had discretion to award attorney's fees. Again, the First Circuit disagreed, quoting from the agreement that attorneys' fees were recoverable, not only in the arbitration proceeding, but also "in any legal proceeding" including "appeals" and "post judgment proceedings."

On Motion for Reconsideration, Pennsylvania Federal Court Finds Franchisor's Arbitration Agreement Invalid

A federal court in Pennsylvania granted a former franchisee's motion for reconsideration of its order staying proceedings holding the franchisor's arbitration agreement invalid. *Takiedine v. 7-Eleven, Inc.*, 2021 WL 3223070 (E.D. Pa. July 29, 2021). In 2017, Azmi Takiedine, a 7-Eleven franchisee for over 40 years, brought suit in district court alleging that 7-Eleven failed its duties regarding vendor negotiating practices as required by the parties' franchise agreement. The contract included an arbitration agreement requiring disputes arising under the arbitration agreement to be handled by the "Franchise Selection Committee" through a "Third Party Reviewer." Finding Takiedine's claims subject to the arbitration agreement, the court imposed a stay to allow the parties to resolve the dispute through arbitration. However, over two years later, Takiedine filed a motion to lift the stay arguing, in part, that the arbitration agreement did not give him an effective way to pursue his claims. In response, 7-Eleven argued that arbitration was the exclusive procedure under the franchise agreement for resolving vendor negotiating practices disputes, Takiedine could, but failed to, pursue his claims through arbitration, and Takiedine's motion was untimely. Finding the unique nature of the arbitration agreement left Takiedine in perpetual legal limbo, the district court concluded that the arbitration agreement was invalid, granting Takiedine's motion for reconsideration and lifting the stay.

The core issue in this dispute was whether the arbitration agreement was enforceable. Takiedine argued it was unenforceable because he lacked a meaningful choice in signing the agreement, and it was unconscionable as it left him with no effective way to vindicate his cause of action. The court found that Takiedine had no meaningful choice when entering into the arbitration agreement as he faced extreme financial pressure. Further, the court found that 7-Eleven's unique arbitration agreement was unenforceable as it left franchisees in perpetual limbo without a means to pursue their cause of action. In particular, the arbitration agreement mandated that the Committee handle disputes. However, franchisees were left with no means of influencing the self-elected and insulated Committee members. In fact, a former member testified that the Committee never used the arbitration dispute resolution procedures in the decade he was on the Committee. In effect, the procedures left Takiedine with no means of arbitrating. The court concluded that its previous order staying proceedings was in clear error because it was based on the assumption that Takiedine would be able to arbitrate. The court therefore held the arbitration agreement was unenforceable and its previous order was manifestly unjust.

Oregon Federal Court Enforces Arbitration Provision Against Franchisees' Employees but Strikes Forum Selection Provision and Limitation on Damages

A federal court in Oregon held that plaintiff franchisee employees were bound by the arbitration provision of relevant franchise agreements and could be compelled to arbitrate by affiliates of the franchisor, even though none of them were parties to the franchise agreements. However, the court struck the provision's forum selection and limitation on damages clauses as unconscionable. *Escobar v. Nat'l Maint. Contractors, LLC*, 2021 WL 3572652 (D. Or. Aug. 12, 2021). Escobar, along with other franchisees and their employees, sued janitorial and building maintenance services company National Maintenance Contractors, its affiliated franchisor entity, another affiliate, and several key employees of those entities (together, NMC), asserting various violations of federal and state laws, including wage and hour laws. NMC moved to compel arbitration based on the arbitration agreement in the relevant franchise agreements. The plaintiffs opposed arbitration on several grounds, including that the franchisees' employees and the franchisors' affiliates were not parties to the franchise agreements, and that the arbitration provision was unconscionable.

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The court held that the franchisees' nonsignatory employees were estopped from repudiating the franchise agreements' arbitration provision, having knowingly and affirmatively benefited from the franchise agreements by being employed and receiving compensation by the franchisees. Furthermore, the court held that the nonsignatory NMC parties could enforce the arbitration provision because the claims they faced were "intertwined with and directly relate[d] to the franchise agreement." The court, however, agreed with the plaintiffs' arguments that the arbitration provision's forum selection and limitation of damages clauses were unconscionable—the forum selection clause because, by requiring the predominantly low-income Oregon- and Washington-based plaintiffs to arbitrate in Minneapolis, it effectively denied them an opportunity to arbitrate, and the punitive damages waiver because it would have resulted in the plaintiffs foregoing statutorily granted rights. Finally, the court held that it could sever the unconscionable provisions while still enforcing the arbitration agreement because the agreement provided for the severability of such provisions, and they were not so pervasive as to permeate the entire agreement with unconscionability.

Fraud/Misrepresentation

Illinois Federal Court Allows Franchisor to Proceed, in Part, with Its Claims Regarding Underreported Gross Sales

A federal court in Illinois declined to dismiss franchisor 360 Painting's claims against franchisee R. Sterling Enterprises for underreporting of gross sales but dismissed its claims for fraudulent misrepresentation. *360 Painting, LLC v. R Sterling Enters., Inc.*, 2021 WL 3603626 (N.D. Ill. Aug. 13, 2021). 360 terminated its franchise agreement with Sterling after an audit showed underreporting by the franchisee. 360 subsequently entered into a settlement with the Illinois Attorney General requiring it to offer rescission to franchisees who had not executed an Illinois-specific franchise agreement amendment. However, the settlement included specific language allowing 360 to hold Sterling accountable for its alleged misconduct. Sterling accepted 360's offer of recission, and then 360 brought claims for breach of contract and fraudulent misrepresentation based on Sterling's underreported gross sales.

Sterling moved to dismiss 360's breach of contract claim, arguing that 360 could not recover for breach of a rescinded contract. The court disagreed, declining to resolve whether it was improper for 360 to offer to rescind a terminated agreement and whether the franchise agreement was executed in violation of the Illinois Franchise Disclosure Act, indicating determination of the obligations of the parties post-termination and determination of whether the franchise agreement was in fact void would require resolution of factual disputes "for another day." Sterling also requested dismissal of 360's claims for fraudulent misrepresentation arguing 360 failed to plead its claims with particularity. The court agreed, finding 360's complaint contained no details about what documents were provided, when and by whom, the content of the documents, whether they all contained underreporting or only some, or how 360 determined that Sterling underreported gross sales by over $100,000. As such, though the court allowed 360 to proceed with its claim under the franchise agreement, its claims for fraudulent misrepresentation were dismissed.

Franchise Sales/Transactions

California Court Affirms Ruling that Contingent Offer to Purchase Franchise Was Not a Valid, Bona Fide Offer, Triggering Franchisor's Right of First Refusal

A California appellate court affirmed a trial court's ruling that a third party's offer to purchase a franchise was not a valid, bona fide offer under the terms of a franchise agreement because the purchase price was contingent on the franchise's future revenues. *IJLSF, LLC v. It's Just Lunch International, LLC*, 2021 WL 3012850 (Cal. Ct. App. July 16, 2021). It's Just Lunch International is the franchisor of the It's Just Lunch franchise system, which involves dating and matchmaking services. An It's Just Lunch franchisee received and intended to accept an offer to sell its franchise to a third party, but the final purchase price was based on the franchise's revenue over the upcoming year. The franchisor sought to exercise its right of first refusal and purchase the franchise on the same terms. The franchisee and the third party objected to the franchisor's decision and the parties sued each other.

At summary judgment, the trial court held the third party's offer was a not valid, bona fide offer under the franchise agreement. The parties appealed, and the appellate court affirmed. The appellate court interpreted the plain language of the franchise agreement—which required that any offer include a "purchase price . . . in a dollar amount"—and concluded that it required more definite terms than those offered by the third party. The court reasoned that the requirement that the offer include a set dollar amount provides the franchisor with information it needs to evaluate whether to exercise its right of first refusal. The court further held that the offer was vague because the purchase price would change depending on who operated the franchise and their performance. Finally, the appellate court also held the trial court erred in holding that the franchisor had waived its right under the franchise agreement to reject the purchase offer and remanded for further proceedings on that issue.

Data Privacy and Security

EU Issues New Standard Contractual Clauses for Data Transfers

In response to the uncertainty caused by the European Court of Justice questioning whether Standard Contractual Clauses (last amended in 2004) provide sufficient data protections in the "*Schrems II*" opinion, the European Commission recently adopted new SCCs. The new SCCs should increase the confidence of American businesses in the GDPR-compliant transfer of personal data of EU residents to servers in the U.S., provided those businesses know when and how to use them. Lathrop GPM data privacy and security attorneys Michael R. Cohen and Tedrick A. Housh, III discussed these changes more thoroughly here.

Along with the attorneys on the next page, litigation associates Brooke Robbins and Kristin Stock contributed to this issue.

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Lathrop GPM Franchise and Distribution Attorneys:

	Name	Phone		Name	Phone
	Liz Dillon (Practice Group Leader)	612.632.3284		Gaylen L. Knack	612.632.3217
*	Eli Bensignor	612.632.3438	*	Richard C. Landon	612.632.3429
	Sandra Yaeger Bodeau	612.632.3211		Mark S. Mathison	612.632.3247
	Phillip W. Bohl	612.632.3019		Craig P. Miller	612.632.3258
	Katie Bond	202 .295.2243		Katherine R. Morrison	202.295.2237
*	Samuel A. Butler	202.295.2246		Marilyn E. Nathanson	314.613.2503
	Emilie Eschbacher	314.613.2839	*	Thomas A. Pacheco	202.295.2240
	Ashley Bennett Ewald	612.632.3449		Ryan R. Palmer	612.632.3013
*	John Fitzgerald	612.632.3064	*	Justin L. Sallis	202.295.2223
*	Maisa Jean Frank	202.295.2209	*	Frank J. Sciremammano	202.295.2232
*	Alicia M. Goedde (Kerr)	314.613.2821	*	Michael L. Sturm	202.295.2241
	Neil Goldsmith	612.632.3401	*	Erica L. Tokar	202.295.2239
	Michael R. Gray	612.632.3078		James A. Wahl	612.632.3425
	Cameron C. Johnson	202.295.2224		Eric L. Yaffe	202.295.2222
	Mark Kirsch	202.295.2229		Robert Zisk	202.295.2202
	Sheldon H. Klein	202.295.2215		Carl E. Zwisler	202.295.2225
*	Peter J. Klarfeld	202.295.2226			

**Wrote or edited articles for this issue*

Lathrop GPM LLP Offices:

Boston | Boulder | Chicago | Dallas | Denver | Fargo | Jefferson City | Kansas City | Los Angeles | Minneapolis | Overland Park | St. Cloud | St. Louis | Washington, D.C.

Email us at: **franchise@lathropgpm.com**
Follow us on Twitter: **@LathropGPMFran**

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On January 1, 2020, Gray Plant Mooty and Lathrop Gage combined to become Lathrop GPM LLP.

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