The Franchise Memorandum | By Lathrop GPM

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

From: **Lathrop GPM's Franchise and Distribution Practice Group**
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Date: **May 6, 2021 — Issue # 265**

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

Fraud/Misrepresentation

Minnesota Federal Court Rules that Fraud and Misrepresentation Claims Against Franchise Broker Fail Because Alleged Misrepresentations Were Puffery

A federal court in Minnesota dismissed all claims against a franchise broker because the plaintiff failed to demonstrate that the broker made false statements about past or present facts or circumstances. *Mount Holly Kickboxing, LLC v. FranChoice, Inc.*, 2021 WL 117968 (D. Minn. Mar. 24, 2021). FranChoice was a franchise broker for the iLoveKickboxing.com (ILKB) franchise system and was involved in the sale of a franchise to the franchisee, Mount Holly. Mount Holly claimed that, during the sales process, FranChoice misrepresented whether the franchise was suitable for absentee or semi-absentee ownership, the estimated initial investment, the success of franchisees, and made financial performance representations that were not disclosed in ILKB's FDD. Mount Holly brought claims against FranChoice for fraud and misrepresentation and violations of statutory franchise sales and deceptive practices acts.

The court granted summary judgment for FranChoice and dismissed all claims with prejudice, holding that all but one of the alleged statements Mount Holly relied upon were based either upon puffery or on future events, which are not actionable fraud, and that it failed to present any evidence that those statements did not reflect past or present circumstances at the time the statements were made. The one alleged statement that was based upon a past fact was FranChoice's claim that no ILKB franchises had ever closed. However, because the statement was directly contradicted by the FDD that listed ILKB's closed franchises, the court concluded that Mount Holly could not demonstrate justifiable reliance on that statement.

Arbitration

Michigan Federal Court Declines to Extend Franchise Agreement Arbitration Provision to Subsequent Service Contract

A federal court in Michigan has denied a franchisor's motion to compel arbitration because the court determined that the dispute arose from a service contract that was outside the scope of the arbitration

provision in the separate franchise agreements. *NH Learning Sols. Corp. v. New Horizons Franchising Grp., Inc.*, 2021 WL 1212578 (E.D. Mich. Mar. 31, 2021). Plaintiffs NH Learning Solutions and 5P NH Holding Co. are longstanding, multi-unit franchisees of New Horizons, offering instructor-led live training in the use of business applications. In 2019, they entered into participation agreements with New Horizons to deliver instruction online. Almost immediately, disputes arose regarding the franchisees' ability to determine course offerings, instructor staffing, and class size. The franchisees allege that these issues were foreseeable to New Horizons, given commitments it had made to another franchisee regarding the online platform in a previous participation agreement. After operating on the platform for ten months, the franchisees withdrew their participation and sued New Horizons for fraudulent misrepresentation and breach of the participation agreements. New Horizons moved to compel arbitration pursuant to each franchise agreement's provision for arbitration of "any dispute . . . arising out of or relating to this Agreement." The franchisees opposed the motion, arguing that the parties' disputes concerned the participation agreements — which have no arbitration provision — and assurances provided by New Horizons related to those agreements.

The court sided with the franchisees, rejecting New Horizons' argument that the franchise agreements control the entire relationship between the parties. The court pointed out that the scope of the arbitration provision is limited to disputes arising out of the franchise agreements, and the participation agreements do not incorporate the dispute resolution provisions of those franchise agreements. In fact, the participation agreements expressly supersede previous agreements through their integration provision. The court reasoned that the franchisees were not challenging New Horizons' performance under the franchise agreements but under the participation agreements. Because the franchisees did not need to refer to the franchise agreements to make out their claims for fraud or breach of the participation agreements, the franchisees were permitted to continue pursuing those claims in court.

Illinois Federal Court Compels Arbitration of Putative Class Action Claims Related to the Pandemic

A federal court in Illinois dismissed certain putative class action claims related to pandemic closures of Planet Fitness franchises, compelling arbitration against one named plaintiff while dismissing claims of another for failure to name the franchisee. *Williams v. Planet Fitness, Inc.*, 2021 WL 1165101 (N.D. Ill. Mar. 26, 2021). On March 17, 2020, Planet Fitness and its franchisees assessed membership fees against many of its members for the period of March 17 through April 17, 2020. Then, on March 18, in response to the COVID-19 pandemic, Planet Fitness closed its corporate facilities indefinitely and urged its franchisees to do the same. On March 30, Planet Fitness suspended operations of its franchise locations as well. However, Planet Fitness refused to offer refunds to its members for the period of March 17 through April 17; instead, it offered to credit the members' bill or extend their memberships. Two named plaintiffs filed class action lawsuits against Planet Fitness and its franchising subsidiaries, seeking refunds. Planet Fitness moved to compel arbitration of the first named plaintiff's claims pursuant to an arbitration provision in his membership agreement, but moved to dismiss the claim of the second named plaintiff for failing to join the franchisee with whom he executed his membership agreement.

The first plaintiff argued that the agreement's arbitration clause was procedurally and substantively unconscionable. But the court disagreed, noting that the arbitration provision was in the same font-size and color as the rest of the contract terms and included a "Dispute Resolution" heading; additionally, the court found that the provision's failure to fully explain the arbitration process did not render it substantively unconscionable. Thus, the court dismissed the first named plaintiff's claims and compelled arbitration.

Planet Fitness then argued that the second named plaintiff's claims should be dismissed for failing to join the franchisee with whom he had executed his contract. The court agreed and dismissed the suit because the franchisee was not subject to personal jurisdiction in Illinois.

Pennsylvania Federal Court Compels Individual Arbitration of Claims Asserted by 90 Franchisees

Similarly, a federal court in Pennsylvania has dismissed a lawsuit brought by 90 hotel franchisees, enforcing the arbitration provisions in their franchise agreements and ordering all 90 franchisees to arbitrate their claims individually. *Jai Sai Baba LLC v. Choice Hotels Int'l Inc.*, 2021 WL 1049994 (E.D. Pa. Mar. 19, 2021). The franchise agreements entered into between Choice Hotels and its franchisees contained binding arbitration provisions, which, among other things, prohibited prehearing discovery. Most of the franchise agreements also included a class action wavier, but some agreements were silent as to class arbitration. Despite the arbitration and waiver provisions, 90 franchisees filed suit together against Choice Hotels, alleging a variety of federal and state law claims. Choice Hotels moved to compel arbitration.

The court rejected the franchisees' arguments that these agreements to arbitrate were unenforceable. The court found that neither the arbitration provisions' limitation of discovery nor the additional costs of arbitration prevented the franchisees from effectively vindicating their federal statutory rights. Nor did these factors render the arbitration provisions unconscionable in this business setting. Finding the arbitration provisions in the franchise agreements were enforceable, the court compelled arbitration. It further found that it lacked the basis to compel class arbitration and ordered individual arbitration for all the franchisees.

Joint Employer

New York Federal Court Holds Franchisor is not a Joint Employer

A federal court in New York recently dismissed a franchisee's employee's discrimination claim against a franchisor because the franchisor was not her joint employer. *Rivers v. Int'l House of Pancakes*, 2021 WL 860590 (S.D.N.Y. Mar. 8, 2021). The employee — a server at an IHOP franchise in Manhattan — sued the franchisee and IHOP for pregnancy discrimination. IHOP moved to dismiss and argued that the franchisee, not IHOP, was Rivers' employer. Rivers argued that while the franchisee was her direct employer, IHOP was also considered her employer based on the control it exercised over the franchisee.

The court agreed with IHOP and held that Rivers failed to plead that IHOP exercised formal or functional control over the franchisee sufficient to make it a joint employer. As to formal control, the court reasoned that Rivers did not allege that IHOP played a role in the franchisee's hiring and firing decisions, or that it controlled the franchisee's work schedules or supervised the franchisee's work conditions beyond semi-annual inspections. The court further reasoned that there were no allegations suggesting that IHOP influenced the franchisee's compensation policies or maintained the franchisee's employment records. As to functional control, the court reasoned that Rivers failed to allege that she used IHOP's — as opposed to the franchisee's — premises or equipment, or that the material aspects of her work environment would remain unchanged were she to gain employment with a different IHOP franchisee. The court further reasoned that Rivers only alleged marginal supervision on behalf of IHOP, which was plainly insufficient to plead IHOP's functional control over the franchisee's employees.

Vicarious Liability

Texas Federal Court Denies Motion for Summary Judgment Regarding Franchisor's Vicarious Liability in Wrongful Death Claim

A federal court in Texas recently denied franchisor Kiddie Academy Domestic Franchising's motion for summary judgment, rejecting the argument that Kiddie Academy bore no liability under its franchise agreement for the negligence of one of its franchisees. *McNeel v. Kiddie Academy Domestic Franchising, LLC*, 2021 WL 920108 (S.D. Tex. Mar. 10, 2021). In August 2018, a three-month-old baby was found dead, face down, in her crib in the care of a Kiddie Academy franchisee. The parents brought suit in state court for negligence against both the franchisee and Kiddie Academy, arguing that the franchisor should have exercised contractual rights to prevent and remedy the franchisee's missteps. After the lawsuit was removed to federal court, Kiddie Academy moved for summary judgment, arguing it was not vicariously liable for its franchisee's negligence. The district court denied the motion.

Looking to the degree of control that Kiddie Academy had the right to exert over its franchisee, the court concluded that the franchise agreement afforded Kiddie Academy so much control over the franchisee that its negligence could be imputed to Kiddie Academy. The court agreed that a franchisor retaining supervisory rights in the franchise agreement generally would not rise to a degree of control high enough to impute liability. However, Kiddie Academy retained the right under its franchise agreement to control the "operative details" of the franchisee, such as the right to inspect the facility, provide plans and specifications, train the franchisee's childcare directors, and require the franchisee to follow certain operating procedures — including a Safe Sleep Policy establishing safe practices for infants. The court concluded, therefore, that Kiddie Academy could be held vicariously liable for the actions of the franchisee even if it was not exercising control over its franchisee at the time of the accident. Moreover, because Kiddie Academy has the power under its franchise agreement to enter upon the premises in the event of a default (which could have included adherence to the Safe Sleep Policy) and "exercise complete authority with respect to the operation and administration of the franchised business" until the default was cured, the court concluded that Kiddie Academy exposed itself to vicarious liability for its franchisee's negligence.

Tennessee Federal Court Rules Franchisor Lacks Day to Day Control over Franchisee, Defeating Vicarious Liability Claim Against Franchisor

In another vicarious liability case, a federal court in Tennessee granted summary judgment in favor of Country Inn & Suites By Radisson, dismissing claims that it was liable for the alleged actions of its franchisee's employee*. Faulkner v. Country Inn & Suites By Radisson, Inc.*, 2021 WL 1143856 (M.D. Tenn. Mar. 24, 2021). Lathrop GPM is counsel to Country Inn & Suites (CI&S). The lawsuit alleged Kevin Faulkner was assaulted by an employee of a CI&S franchisee, and sought to hold CI&S directly and vicariously liable for battery, assault, and intentional infliction of emotional distress arising out of the assault.

In considering CI&S's motion for summary judgment, the court concluded that CI&S's License Agreement demonstrated it did not have control over the day-to-day activities of the franchisee's hotel, and therefore, could not be vicariously liable for the franchisee's employees. In an attempt to circumvent these arguments, Faulkner argued CI&S was liable through apparent agency stemming from the use of CI&S's marks at the franchisee's hotel. The court held that the facts, instead, demonstrated merely a franchisee-franchisor relationship between the parties and highlighted a previous observation from the Middle District of Tennessee that if branding could create apparent authority, this "would effectively transform every

franchisor-franchisee relationship into an agency relationship" — an unworkable notion. The court further relied on a Tennessee statute explicitly stating employees of franchisees are not employees of franchisors, negating any contention CI&S could be directly liable for the actions of its franchisee's employees.

Preliminary Injunctions

Illinois Federal Court Denies Temporary Restraining Order Seeking to Prevent Termination While Litigation Was Pending

A federal court in Illinois denied a motion to temporarily restrain franchisor Seva Beauty from terminating franchise agreements based on the franchisee's failure to pay weekly royalty payments while a dispute with the franchisor was pending. *Sashital v. Seva Beauty, LLC*, 2021 WL 1222895 (N.D. Ill. Mar. 31, 2021). The plaintiffs, who were current and former Seva franchisees, filed a class action lawsuit alleging that the franchisor fraudulently induced them to purchase franchises by withholding financial information and misrepresenting aspects of the business. Because the franchisees were struggling to pay the minimum royalty payments required under their franchise agreements, they asked the district court for an injunction preventing Seva from terminating the franchisees based on nonpayment of royalties during the litigation.

The court denied the motion, concluding that the franchisees failed to show that they would suffer irreparable harm absent an injunction — if the franchise agreements were terminated, it was not clear that money damages would be an insufficient to remedy. The franchisees argued that without an injunction, they were at risk of losing their businesses while pursing litigation. The court, however, rejected this argument, noting that it was inconsistent with the franchisees' claim that their franchises were destined to fail from the start due to Seva's misrepresentations. The court reasoned that the franchisees didn't provide evidence that keeping the franchises open offered some intangible value that could not be remedied by money damages, and because money damages could remedy the alleged harm, injunctive relief was unnecessary. Additionally, the court determined that one franchisee lacked standing to pursue the motion because the franchisor had previously terminated this franchisee's franchise agreement, therefore, that franchisee would not receive any relief from the injunction.

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