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: **February 11, 2021 — Issue # 262**

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

Employment

California Supreme Court Applies Independent Contractor Standard Retroactively; Does Not Reach Applicability to Franchises

The California Supreme Court has held that its *Dynamex* decision applies retroactively, answering a question certified to it by the Ninth Circuit in *Vazquez v. Jan-Pro Franchising Int'l, Inc.*, --- P.3d ---, 2021 WL 127201 (Cal. 2021). Although the case involved a franchise relationship, the court explicitly declined to address the applicability of *Dynamex* to franchise relationships. Jan-Pro is a franchisor whose franchisees offer cleaning and janitorial services. It licenses its marks to master franchisees, who in turn license unit franchisees. In 2008, a group of unit franchisees sued Jan-Pro, alleging that they had been improperly classified as independent contractors and were entitled to employee rights such as minimum wages and overtime. Following changes of plaintiffs and venue, Jan-Pro prevailed on summary judgment. That decision was vacated by *Vazquez v. Jan-Pro Franchising*, 923 F.3d 575 (9th Cir. 2019) (summarized in Issue 242 of the GPMemorandum). There, the Ninth Circuit concluded that California courts would apply retroactively the California Supreme Court's adoption in *Dynamex Operations W. v. Superior Court*, 416 P.3d 1 (Cal. 2018) of the "ABC test" to distinguish independent contractors from employees in the wage and hour context. Jan-Pro successfully petitioned the Ninth Circuit for panel rehearing, the court withdrew its earlier decision and certified the retroactive application question to the California Supreme Court.

The basic holding of *Dynamex* was that the ABC test should be used to determine whether a worker is an independent contractor exempt from the wage and hour laws or an employee subject to them. To show that a worker is an independent contractor, the hiring entity must show that the worker (A) is free from the control of the hirer in performing the work, both under the contract for the work and in fact; (B) performs work that is outside the usual course of the hiring entity's business; and (C) is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity. Before the California Supreme Court, Jan-Pro argued that *Dynamex* should not apply retroactively because it had reasonably relied on the broader, balancing-of-factors test established for the workers' compensation context in *S. G. Borello & Sons, Inc. v. Dep't of Indus. Relations*, 769 P.2d 399

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(Cal. 1989), and could not have anticipated application of the ABC test in the wage and hour context. Jan-Pro also said that public policy, fairness concerns, and due process precluded retroactive application. The court rejected these arguments, pointing to the difference in regulatory context between *Dynamex* and *Borello* and the difficulty of reasonable reliance on a complex balancing test involving numerous factors — which itself includes the three ABC test elements. Further, various intervening California Supreme Court decisions had observed that the question of the appropriate test in the wage and hour context remained open. The court further concluded that *Dynamex* was consistent with the history and purpose of California's wage orders, that it did not establish new law but merely interpreted the "suffer or permit to work" language used in the wage orders, and that the deeper unfairness was to employees who would be deprived of the protections of the wage orders were *Dynamex* not to apply retroactively.

Unfair Competition

California Federal Court Denies Franchisor's Motion to Dismiss California Unfair Competition Law Claims Arguably Barred by Statute of Limitations

A federal court in California granted in part a franchisor's motion to dismiss a franchisee's California Unfair Competition Law (UCL) and business interference claims, while denying the motion as to other aspects of the unfair competition claims and the covenant of good faith and fair dealing claim. *Ronald Cohn, Inc. v. Sprouts Farmers Market, Inc.*, 2021 WL 120896 (S.D. Cal. Jan. 13, 2021). Ronald Cohn entered into a Trademark License Agreement (TLA) with Boney's Services, Inc. in 1990 and then a second TLA in 1995. Boney's was subsequently purchased by Sprouts Farmers Market in 2011, and Sprouts amended the TLA. Ronald Cohn alleged that Sprouts prevented Ronald Cohn from accessing promotional and discounted pricing, failed to provide advanced notice of certain advertising, diverted customers to corporate-owned stores because Ronald Cohn was not listed on Sprouts' website, and conducted online sales within Ronald Cohn's protected area. Sprouts moved to dismiss five of the six claims, including three distinct claims under the UCL.

UCL claims may be asserted under its "unlawful" prong, its "unfair" prong, or its "fraudulent" prong, and Ronald Cohn brought claims under all three. The court denied Sprouts' motion to dismiss under the "unlawful" and "unfair" theories and granted the motion on the "fraudulent" claim. Ronald Cohn asserted that Sprouts failed to register the franchise under the California Franchise Investment Law (CFIL), which served as a predicate for showing "unlawful" and "unfair" actions under the UCL. Sprouts contended that the claim was time-barred by the four-year statute of limitations of both the CFIL and UCL, but Ronald Cohn argued that the claims were not time-barred because Sprouts had made "material modifications to the franchisee-franchisor relationship" in 2017, which overcomes the limitations bar. The court agreed with Ronald Cohn, determining that the limitations period began in 2017 when the complaint alleged Sprouts had materially modified the franchisor-franchisee relationship, and thus the "unlawful" and "unfair" claims were not time-barred. Ronald Cohn's "fraudulent" claim under the UCL, however, did not rely on the CFIL predicate and instead alleged that Sprouts misled consumers about the availability of certain products. The court concluded that Ronald Cohn failed to show reliance on Sprouts' misrepresentations because Ronald Cohn did not allege its own reliance on Sprouts' misrepresentations and was not a member of the consumer class alleged to have been deceived. As a result, the court dismissed the fraudulent prong of Ronald Cohn's UCL claim.

Preliminary Injunction

New Jersey Federal Court Denies Injunction to Franchisee Arguing that Franchisor Imposed Terms of Agreement in Defiance of Local Law

A federal court in New Jersey has denied a franchisee's motion for an emergency temporary restraining order. *Sat Agiyar, LLC v. 7-Eleven, Inc.*, 2021 WL 147110 (Jan. 15, 2021). In September 2015, Agiyar signed a franchise agreement to operate a 7-Eleven store 24-hours per day in Princeton, New Jersey. At that time, Princeton prohibited the operation of retail food establishments from 2 a.m. to 5 a.m. The prohibition was set to expire in 2017 unless the city council extended it. To account for the local ordinance, Agiyar and 7-Eleven agreed to permit Agiyar to operate the location for less than 24 hours without having to pay additional royalties until 2017, when Agiyar would have to pay additional royalties for the number of hours each day that Agiyar did not operate. In 2017, the local ordinance was made permanent, and 7-Eleven increased Agiyar's royalty to account for the hours Agiyar was not operating the location. In response, Agiyar sued 7-Eleven arguing that 7-Eleven unilaterally amended the franchise agreement to increase the royalty amounts solely on the basis that Agiyar was not operating 24 hours each day, and that 7-Eleven was requiring Agiyar to operate 24 hours per day in defiance of the local law. Agiyar sought a temporary restraining order arguing 7-Eleven breached the covenant of good faith and fair dealing and the New Jersey Fair Practices Act (NJFPA).

The court denied Agiyar's motion. First, the court determined that Agiyar was not likely to succeed on the merits of its good faith and fair dealing claim because the franchise agreement clearly permitted 7-Eleven to increase the royalties after two years if Agiyar did not operate the location 24 hours a day. Second, the court determined that Agiyar was not likely to succeed on the merits of its NJFPA claim because it was not unfair or unreasonable for 7-Eleven to act in conformance with the terms of the franchise agreement and charge the additional fees, and 7-Eleven had no obligation to extend the amendment of the franchise agreement after the two years expired.

Vicarious Liability

New Jersey Federal Court Finds Hilton Not Liable for Accidental Drowning at Franchised Hotel

A federal court in New Jersey granted the motion for summary judgment filed by Doubletree hotel franchisor, Hilton Franchise Holdings, LLC, and its affiliate (collectively "Hilton"), finding that Hilton was not liable for the tragic accidental drowning of a child in a franchised Doubletree hotel's pool. *Burnet v. Hilton*, 2021 WL 118924 (D.N.J. Jan. 13, 2021). The victim's family claimed that Hilton, the third-party hotel management company, and the Hilton franchisee were all negligent in causing the child's death. At summary judgment, the family argued that Hilton was both directly negligent and vicariously liable for the franchisee's negligence. Hilton filed a cross-motion for summary judgment contending that it could not be vicariously liable for the child's death because it had no agency relationship with the franchisee. Hilton also argued that it could not be directly liable because it neither owned nor possessed the hotel.

In granting Hilton's motion, the court held that it was "evident" that no agency relationship existed between Hilton and the franchisee. Examining whether an "actual" agency relationship might have existed, the court noted that the governing franchise agreement specifically disclaimed the existence of an agency relationship between the parties. It further held that Hilton's brand standards, and the biannual audits that Hilton conducted to enforce those brand standards, did not evidence an agency relationship

because Hilton did not have control over the day-to-day operations of the hotel. The court also did not find any evidence of an "apparent" agency relationship. Although the plaintiff alleged that guests rely on the "badge of Hilton" as indicia of the safety of the premises, the court found no evidence that the hotel brand had lured the victim to the hotel. Finally, the court found that Hilton could not be directly liable for the drowning because it was not the landowner and, therefore owed the victim no duty of care. Accordingly, the court granted the motion for summary judgment in favor of Hilton.

Delaware Court Finds Plaintiff Sufficiently Pled a Plausible Claim for Relief Against Franchisor for Acts of Franchisee's Former Employee

However, in another vicarious liability case, a Delaware Superior Court denied franchisor Hand and Stone's motion to dismiss, allowing vicarious liability claims based on the alleged sexual misconduct of its franchisee's former employee to go forward. *Jane Doe v. Massage Envy Franchising, LLC*, 2021 WL 62643 (Del. Super. Ct. Jan. 7, 2021). The plaintiff alleged she was sexually assaulted while receiving a massage by Massage Envy employee, Christopher Dorman. She further alleged that Dorman was previously employed by a franchisee of Hand and Stone, that Dorman had engaged in unreported sexual misconduct while employed by Hand and Stone's franchisee, and that Hand and Stone recommended Dorman to Massage Envy for employment.

In its motion to dismiss, Hand and Stone argued that, as the franchisor, it was not liable for the acts of Dorman, an employee of its franchisee, because it did not control his day-to-day job responsibilities. Hand and Stone further argued that it could not be liable for the alleged conduct of Dorman occurring when he was no longer employed by its franchisee. Emphasizing the low standard needed to defeat a motion to dismiss, the court found it possible for an agency relationship to exist between Hand and Stone and Dorman as the plaintiff sufficiently pled that Hand and Stone had a role in the daily operations of its franchisee. Further, the court found that, even though the alleged sexual assault of the plaintiff did not occur while Dorman was employed by Hand and Stone's franchisee, the plaintiff's allegations that Hand and Stone failed its duty to report the sexual misconduct of Dorman, and that Hand and Stone recommended Dorman for employment at Massage Envy, could be "reasonably assumed to be consenting to Dorman's actions and ratifying Dorman's conduct."

Choice of Law

New Jersey Federal Court Enforces Contractual Choice of Law in Franchise Agreements, but Not in Related Lease Agreements

A federal court in New Jersey has dismissed certain state-law claims against the franchisors of Circle K gas stations based upon choice-of-law provisions in the parties' franchise agreements, but ruled that related lease agreements had narrower choice-of-law language that did not apply to tort claims. *Universal Prop. Servs. Inc. v. Lehigh Gas Wholesale Servs., Inc.*, 2021 WL 118940 (D.N.J. Jan. 13, 2021). Plaintiffs acquired the rights to operate 17 Florida-located gas stations from Defendants Circle K Stores, Inc. and TMC Franchise Corp. Plaintiffs alleged that during negotiations, Circle K and TMC provided inaccurate financial information, misrepresented growth projections, and failed to disclose declining profit data. Plaintiffs brought claims under Florida's Deceptive and Unfair Trade Practices Act, the Florida Franchise Act, and asserted common law fraud and contract claims.

Circle K and TMC moved to dismiss the claims arising under Florida statutes and common law fraud. The defendants argued that the parties' eases and supply agreements (entered into by Circle K) and franchise agreements (entered into by TMC) contained choice-of-law provisions that designated Pennsylvania and Arizona, respectively, as the applicable law. Considering first the choice-of-law provision in the leases and supply agreements, the court concluded that provision was limited to contract claims arising from the agreements and did not apply to the tort-related claims rooted in franchisors' fraudulent conduct. The court nevertheless decided that Florida law did not have the most significant relationship to the allegations in the complaint, but determined that additional briefing was required before deciding whether the tort claims were governed by New Jersey or Pennsylvania law under New Jersey's most significant relationship test. With regard to the franchise agreements entered into by TMC, the court found that the choice-of-law provisions were broader than those in the leases and supply agreements, and that the provisions required the franchisee to plead its common law claims under Arizona law. Therefore, it dismissed the claims against TMC without prejudice.

Texas Federal Court Partially Grants Franchisor's Motion to Dismiss California Franchise Law Claims

A federal court in Texas granted in part and denied in part a franchisor's motion to dismiss a franchisee's counterclaims under California state law. *Jack in the Box Inc. v. San-Tex Rests., Inc.*, 2021 WL 148058 (W.D. Tex. Jan. 14, 2021). Jack in the Box entered into franchise agreements for 49 Texas restaurant locations with Atour Eyvazian and Anil Yadav, who, on the same day, assigned the franchise agreements to San-Tex Restaurants. The franchise agreements contained a choice of law provision contemplating the application of California law to claims "regarding the making, entering into, performance or interpretation" of the franchise agreement. Following San-Tex's alleged operational and financial deficiencies, Jack in the Box terminated the franchise agreements. When San-Tex continued to operate the restaurants, Jack in the Box sued San-Tex for breach of the franchise agreements and leases and copyright infringement. In its counterclaim, San-Tex alleged, among other claims, that Jack in the Box violated the California Franchise Relations Act (CFRA) and the California Unfair Practices Act (CUPA).

While the court granted Jack in the Box's motion to dismiss as to the CFRA claim, it denied the motion with regard to the CUPA claim. The court recognized coverage under the CFRA is limited to franchisees domiciled in California and franchised businesses presently or formerly operating in California. The court noted the CFRA was not designed nor intended to regulate claims of non-residents arising from conduct occurring entirely outside California. Although Yadav, an original franchisee, was domiciled in California, there was no allegation of Yadav's ownership interest in San-Tex and therefore no basis to apply the protections of the CFRA to San-Tex. As none of the relevant San-Tex restaurants had ever operated in California, the court found San-Tex could not meet the CFRA's jurisdictional requirement and dismissed San-Tex's CFRA claim. The CUPA, however, lacks a similar jurisdictional requirement and reaches out to non-residents when the allegedly fraudulent conduct occurred in California. As Jack in the Box's headquarters were in California, a reasonable inference could be drawn that misconduct occurred in California. The court found this inference, coupled with the parties' contemplation of the application of California law, was sufficient to afford San-Tex the protections of the CUPA.

Department of Labor

President Biden Freezes DOL Final Rule on Independent Contractor Classification

In his first few days in office, President Biden has set out to reverse a number of Trump-era labor policies. One such reversal involves the DOL final rule on independent contractor classification (the “Final Rule”), which was published on January 7, 2021, and would have set new standards for determining when a worker is an employee or an independent contractor under the Fair Labor Standards Act. Notably, the Final Rule implemented a more employer-friendly “economic realities” test, which focused on (1) the nature and degree of the worker’s control over the work, and (2) the worker’s opportunity for profit or loss as the primary factors guiding the analysis of whether a worker should be classified as an employee or independent contractor. The Final Rule was set to take effect on March 8, 2021.

On January 20, 2021, just hours after his inauguration, President Biden sent a memorandum to all agency heads directing them to freeze all regulatory activity pending review by the new administration. This action effectively killed the Final Rule before it could take effect. Notably, President Biden has stated that he aims to work with Congress to pass a federal independent contractor law that mirrors the “ABC” test some states use, including California through AB-5. Therefore, it is likely that the next regulation or piece of legislation we see on this issue will contain more worker-friendly language, moving away from the “economic realities” test. Given the potential effect of AB-5 on franchising in California, franchisors should closely monitor this development at the federal level.

Legislation and Rulemaking

New Laws in Belgium and Netherlands Impact Franchise Regulations

Laws that just became effective in Belgium and Netherlands may have a major impact on how franchisors conduct business there. On December 1, 2020, Belgium’s Unfair Contract Terms law, which regulates B2B and franchise contracts, among others, went into effect. Unfair contract terms are divided into those on a “black list,” which are *per se* void and unenforceable, and “gray list” terms, which carry a rebuttable presumption of unfairness. Black list terms include limitations on remedies available to a franchise in a dispute with its franchisor, as well as terms that give a franchisor discretion to perform its obligations to a franchisee while requiring a franchisee to perform regardless of the franchisor’s performance.

The Netherlands franchise law became effective January 1, 2021. It requires preparation of an FDD, which must include specified information, and all other information that a franchisee might consider important to making a franchise investment. Franchisors must disclose limitations on their right to increase fees or investments franchisees must make during the term of the franchise agreement. Additional fee and investment requirements are not enforceable unless a majority of franchisees agree to the changes. The regulation of additional fees and investments will apply to all new and existing agreements on January 1, 2023.

Lathrop GPM’s latest issue of Global Franchise Regulation Update, which can be accessed here, also contains information about recently enacted laws in Ecuador and Romania, and surveys all known franchise regulations proposed or adopted since January 2019.

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