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

Employment

Missouri Federal Court Holds Franchisor Controls Sufficient to Survive Motion to Dismiss Joint Employer Claim

A federal court in Missouri recently denied a motion by McDonald's to dismiss an employment discrimination claim brought against it by a franchisee's former employee. *Johnson v. McDonald's Corp.*, 2021 WL 2255000 (E.D. Mo. June 3, 2021). Barbara Johnson briefly worked at a McDonald's franchise before quitting after allegedly being sexually harassed and assaulted. In her subsequent employment discrimination complaint, she alleged that she was an employee of the franchisor McDonald's, describing her franchisor-issued application form, franchisor inspections of franchisee operations, and training provided by McDonald's to the franchisee that included the topics of sexual harassment prevention and reporting. McDonald's moved to dismiss the complaint on the basis that she failed to plead facts sufficient to establish that McDonald's was her joint employer or that the franchisee acted as its agent.

The court rejected McDonald's arguments in an extremely brief decision. After discussing and distinguishing three cases in which McDonald's was not found to be a joint employer, the court held that Ms. Johnson's allegations were sufficient to survive a motion to dismiss. Without ruling on the appropriate standard to apply to the joint employer issue, the court labelled it "a close case," holding Ms. Johnson's allegations sufficient to show some level of interrelated operations, common management, centralized control of labor relationships, and centralized management. While the brevity of the decision prevents great insight into the court's reasoning, the court's conclusion appears driven by an overall impression of the controls typically exercised by a franchisor over a franchisee, in addition to the particular controls exercised by McDonald's — including the specific decision to require sexual harassment prevention and reporting training.

Terminations

Arizona Federal Court Grants Temporary Restraining Order for Franchisor That Terminated Franchise Agreement Without Opportunity to Cure

A federal court in Arizona recently granted a temporary restraining order for franchisor Rebath against one of its franchisees even though ReBath gave no opportunity to cure the defaults and had previously sent a notice of default with opportunity to cure for a similar issue. *ReBath LLC v. Foothills Serv. Sols. Co.*, 2021 WL 2352426 (D. Ariz. June 9, 2021). On April 26, 2021, ReBath initially sent Foothills a notice of default for past-due royalty payments and past-due product purchase payments, providing 30 days to cure the default. Foothills paid the past-due royalty payments in full on May 6, 2021. ReBath sent a notice of termination on that same day, stating, among other things, that Foothills was in default for failure to pay fees due three times in 12 months, in violation of the franchise agreement. This notice provided Foothills with no opportunity to cure. Foothills repaid the past-due product purchase payments a week later and notified ReBath that Foothills would not cease operation of its franchise. ReBath and Foothills both filed separate suits, which were later consolidated. ReBath brought claims for trademark infringement, unfair competition, trade secret violations, and breach of contract for post-termination obligations and breach of the covenant not to compete. Foothills asserted an equitable action for injunctive relief preventing termination of the Agreement, declaratory relief that Foothills was in compliance with the Agreement, breach of contract based on termination, and breach of implied covenant of good faith and fair dealing. Both parties sought temporary restraining orders. The Arizona district court granted ReBath's temporary restraining order in part and denied Foothill's.

The key issue was whether ReBath had the right to terminate the franchise agreement and the district court determined that ReBath had a likelihood of success of showing that its actions were proper under the franchise agreement. Under the language of the franchise agreement, ReBath had a right to terminate immediately if Foothills failed to pay fees due three or more times in 12 months. Even though the reasons for termination were similar to the reasons for the initial default, the reasons for termination were invoked under a different section of the franchise agreement. In addition, in its initial notice of default, ReBath preserved its right to invoke other remedies under the franchise agreement. The district court held that ReBath therefore showed a likelihood of success on the merits and granted in part its temporary restraining order.

Jurisdiction and Procedure

New York Federal Court Dismisses Suit Against Franchisor and its Successor-in-Interest for Lack of Personal Jurisdiction and Failure to State a Claim

A federal court in New York has dismissed contract, fraud, and negligent misrepresentation claims brought by a former iLoveKickboxing franchisee. *ILKB, LLC v. Singh*, 2021 WL 2312951 (E.D.N.Y. June 7, 2021). ILKB operated the iLoveKickboxing franchise system of kickboxing studios and Ardamandeep Singh entered into a franchise agreement with ILKB in July 2015 to operate an iLoveKickboxing franchise. In his claims, Singh alleged that ILKB made multiple representations to induce him into entering the franchise agreement, including that he would break even in weeks or months, that franchisees of the system were able to retain other employment and participate in the franchise as absentee owners, that the system's marketing would generate 100 trial members per month, and that the membership conversion rate was in the 70-80% range. Singh alleged that he relied on those representations, which were false, when he entered into the franchise agreement with ILKB. In 2020, ILKB Too, a Florida LLC, assumed the assets of ILKB through an asset purchase agreement.

ILKB, former CEO Michael Parrella, and ILKB Too each sought dismissal of Singh's claims, but ILKB Too specifically argued that the court lacked personal jurisdiction over it. The court agreed, explaining that ILKB Too was a Florida limited liability company and Singh failed to allege any facts showing ILKB Too had continuous contact with New York. Instead, Singh alleged that because ILKB Too was the successor-in-interest to ILKB, the court had jurisdiction over both entities. In determining whether successor liability attached to ILKB Too, the court looked to whether ILKB Too expressly or implicitly assumed its predecessor's liability, whether there was a merger of seller and purchaser, whether the purchaser was a continuation of the seller, and whether the transaction was entered into fraudulently to escape certain obligations. ILKB Too had expressly assumed only certain liabilities of its predecessor and none that were related to Singh's claims. As to whether there was a merger or continuation of the seller, the key factor identified by the court was the lack of continuity of ownership. Parrella was required to resign as part of the acquisition by ILKB Too, and he retained no interest or management role whatsoever in the successor company. Lastly, the asset purchase agreement contained a provision which stated ILKB would indemnify ILKB Too, which the court understood to mean that the asset purchase agreement was not entered into under pretenses to defraud. Taken together, successor-in-interest liability did not attach to ILKB Too, and the New York court did not have jurisdiction over the successor company. The court also dismissed the claims against ILKB and Parrella on the basis that the fraud claim was not specific or detailed enough to meet the requisite pleading standard, that the franchisor-franchisee relationship was not a "special relationship" under New York law for purposes of stating a claim for negligent misrepresentation, that Parrella was not a party to the franchise agreement and therefore could not have breached the contract, and that ILKB did not fail in its marketing obligations simply because they were not as effective as Singh had hoped they would be.

Preliminary Injunctions

Colorado Federal Court Holds Former Franchisee in Contempt and Awards Attorneys' Fees to Franchisor for Violations of Preliminary Injunction

A federal court in Colorado found a former franchisee of Core Progression Franchise in contempt and awarded sanctions for violations of the terms of a preliminary injunction. *Core Progression Franchise, LLC, v. O'Hare*, 2021 WL 2566890 (D. Colo. June 23, 2021). Core Progression terminated its former franchisee, Chris O'Hare, when he began defaulting on monetary obligations shortly after opening his Core Progression franchise. When Core Progression learned that O'Hare was operating a competing business in the same location, it filed an action for breach of contract and trademark infringement against O'Hare. The court granted a preliminary injunction prohibiting O'Hare from operating a fitness business at his former franchise location and from using Core Progression's trademarks and client data. Because of O'Hare's continued violations of the preliminary injunction, however, Core Progression moved for sanctions and sought its attorneys' fees associated with enforcement of the preliminary injunction.

It was undisputed that after issuance of the preliminary injunction, O'Hare hosted training sessions at his former franchised locations and used Core Progression's trademarks on websites such as Facebook, Yelp, and Google My Business. O'Hare claimed that he was unsure at first whether subleasing the space to independent trainers would violate the order, he eventually stopped when he realized it fell within the scope of the order. O'Hare therefore argued his conduct was not worthy of sanctions because he had eventually ceased the violative conduct. The court declined to disregard O'Hare's violation; however, utilizing its equitable discretion, it awarded half of the attorneys' fees requested taking into account O'Hare's reasonable efforts to comply with the preliminary injunction after the initial violative conduct.

Post-Termination Injunctions: Noncompete Covenants

Louisiana Federal Court Applies Virginia State Law to Extend Post-Termination Covenants Beyond Period of Non-Compliance

A federal court in Louisiana granted a preliminary injunction against a former franchisee for breaching post-termination covenants, and the court extended the covenants for 20 months following the date of the injunction. *JTH Tax, LLC v. Johnson*, 2021 WL 2379541 (E.D. La. June 10, 2021). JTH Tax is the franchisor of Liberty Tax Services, a nationwide income tax preparation service center. In 2013 and 2014, defendant Angel Johnson, entered into a five-year franchise agreement to operate two Liberty Tax locations in Louisiana. As part of the arrangement, Johnson agreed to post-termination covenants that prevented her from competing or soliciting JTH customers within 25 miles of the territory for two years after termination or expiration of the agreement and required her to return all proprietary materials. On April 17, 2019, JTH terminated the franchise agreement with Johnson. Johnson, however, continued to operate out of one franchised location, and continued to use JTH's proprietary customer lists to solicit customers. JTH filed its complaint on April 13, 2021, asking for injunctive relief and damages. Applying Virginia law, the court found in favor of JTH, extending the post-termination covenants for 20 months after the injunction date.

Both parties agreed that Johnson breached the franchise agreement by continuing to operate the tax service while soliciting JTH's customers. Johnson argued, however, that the post-termination covenants ended on April 17, 2021, negating the need for an injunction. The court disagreed, finding that despite nearly two years passing between the termination of the franchise agreement and the filing of the complaint, Virginia law allowed equitable extension of covenants from the date of an injunctive order, and noting that JTH's claim otherwise met the factors needed for a preliminary injunction. Thus, the court reasoned that declining to extend the covenants would directly reward Johnson for her breach of contract and encourage prolonged litigation. However, the court reduced the extension from two years to 20 months because JTH waited four months to file suit after it became aware of Johnson's breach.

Contracts

Louisiana Appellate Court Affirms Decision Enforcing Provisions of Lost or Stolen Franchise Agreement

The Louisiana Court of Appeals affirmed a trial court's finding that there was a signed franchise agreement between the parties even though the franchisor could not produce the signed original. *Miss Bee's Snoworld, LLC v. Guidry*, 2021 WL 2493348 (La. Ct. App. June 18, 2021). Brooke and Michael Hyde owned and operated a snowball business in Louisiana since 2008, and in 2014 they decided to franchise the business. While their franchise documents were in the works, Brooke Hyde reconnected with a friend, Kaci Guidry, and explained the franchise opportunity. Guidry was interested in the business and over the next few months she and her sister invested many hours to learn about the business. Guidry even found and purchased a location for the prospective franchise business. In May 2015, Guidry was provided a copy of the completed FDD. While Hyde and an employee testified that they received a signed copy of the franchise agreement and stored it at the snowball business, Guidry testified that she never signed the agreement. On June 7, 2015, Guidry's sister allegedly took the file with the signed copy of the franchise agreement after getting into an argument with Hyde and the staff. By June 15, 2015, Guidry and her sister opened a competing snowball business at the location Guidry purchased for the proposed franchised business.

The franchisor, Miss Bee's Snoworld, brought suit against Guidry for unlawful use and disclosure of confidential information and breach of contract. After a bench trial, the court ruled in favor of Miss Bee's when it found that even though Hyde could not produce the signed copy of the franchise agreement, other evidence, including testimony, could prove the existence of a contract if the original was lost, stolen, or destroyed. The trial court found Hyde's and her employee's testimony satisfactory to determine Guidry did execute the franchise agreement, that her sister took the agreement, and that Guidry's subsequent actions of operating a competing business was a breach of contract and the unlawful use and disclosure of confidential information. The Louisiana Court of Appeals affirmed the trial court's decision and held the trial court did not act manifestly erroneously when it found the franchise agreement was executed and subsequently lost, stolen, or destroyed.

Along with the attorneys on the next page, summer associates Li Lu, Maya Sanaba, Rosalie Swingle, Andi Darden, Andrew Biddison and Brandon Mickelsen contributed to this issue.

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