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*, formerly known as *The GPMemorandum*. Below are summaries of recent legal developments of interest to franchisors.

Forum Selection Clause

Colorado Federal Court Applies Forum Selection Clause to Non-Signatory Entities Controlled by Former Franchisees

A federal court in Colorado held that entities controlled by former franchisees were bound by the forum selection clauses in the franchisees' terminated franchise agreements. *Fitness Together Franchise, LLC v. EM Fitness, LLC,* 2020 WL 6119470 (D. Colo. Oct. 16, 2020). EM Fitness and related franchisee-defendants operated several Fitness Together franchises in Ohio under franchise agreements that contained post-termination noncompetition and Colorado forum selection clauses. The franchisee-defendants negotiated the early termination of their franchise agreements, but, at the same time, formed new entities through which they began operating competing businesses at the same locations previously occupied by the franchised businesses. Fitness Together sued its former franchisees and the newly formed entities in federal court seeking to enjoin them from breaching the post-termination noncompetition provisions of the franchisee-defendants' agreements. The new entities challenged the court's personal jurisdiction over them, arguing that they were not signatories to the franchise agreements and therefore should not be bound by their forum selection clauses.

The court held that the new entities were bound by the forum selection clauses in the terminated franchise agreements under the "closely related" doctrine, as well as under traditional doctrines of estoppel, successor liability, and principal-agent liability. The "closely related" doctrine provides that non-signatories are subject to contractual restrictions if they are closely related to the contractual relationship. Here, it was undisputed that the new entities were controlled by the former franchisees and received customer lists and business information from the former franchisees. The court held that because the new entities knowingly undertook activities that the closely related franchisee-defendants had agreed would be subject to the forum selection clauses, the new entities effectively consented to the forum selection clauses themselves. The court also granted Fitness Together's motion for a preliminary injunction, enforcing the noncompetition provisions of the respective franchise agreements against both the franchisee-defendants and the new entities.

Post-Termination Injunctions: Noncompete Covenants

Missouri Federal Court Grants Temporary Restraining Order Against Former Licensee for Violation of Noncompete Covenant

A federal court in Missouri granted, in part, a franchisor's motion for a temporary restraining order against a former licensee. *Imo's Franchising, Inc. v. Kanzoua, Inc.*, 2020 WL 5534425 (E.D. Mo. Sept. 14, 2020). Imo's Pizza entered into a licensing agreement with Kanzoua, which allowed Kanzoua to operate an Imo's Pizza restaurant at its gas station/convenience store location. In July 2020, Imo's Pizza terminated the agreement. Imo's Pizza alleged that after termination, Kanzoua continued to sell pizza, hold itself out as an Imo's-affiliated restaurant, and use Imo's Pizza's confidential information in contravention of the terms of the licensing agreement. Imo's Pizza sought a temporary restraining order alleging, *inter alia*, breach of the noncompetition covenant in the licensing agreement.

The court found that Imo's Pizza demonstrated that it was likely to succeed on the merits of its complaint, which asserted Kanzoua violated the licensing agreement by continuing to sell pizza at its gas station/convenience store. The court interpreted the noncompete provision in the licensing agreement as prohibiting Kanzoua from selling *any* pizza at its location for a period of 18 months, not just Imo's Pizza. The court noted that "Imo's Pizza's reputation, goodwill, and brand recognition were just as threatened where one of its former licensees de-affiliates but continues to make a similar product under their own name as they are when the same former Imo's licensee enters a new license with an independent pizza manufacturer that has its own distinctive recipes and branding." Moreover, the court found that the risks of confusion, reputational harm, and muddled brand recognition were actually higher in a situation like this case than when a former licensee switches entirely to another recognizable rival pizza brand. Therefore, the court concluded, there was no reason to think that Imo's Pizza meant anything other than what the plain text of the agreement indicated — that a former licensee may not "engage in . . . any food business which sells any type of pizza." Accordingly, the court granted Imo's Pizza's motion for a temporary restraining order on these grounds.

Injunctive Relief

Ohio Federal Court Denies Area Representative's Request to Enjoin the Nonrenewal of Agreement

A federal court in Ohio denied an area representative's request to enjoin the nonrenewal or termination of two of its area representative agreements. *KAM Development, LLC v. Marco's Franchising, LLC*, 2020 WL 6146482 (N.D. Ohio Oct. 10, 2020). In 2010, Marco's granted KAM two area representative agreements in which KAM agreed to solicit potential franchisees and service existing franchisees in Charlotte, North Carolina, and Columbia, South Carolina, for ten years. Each agreement provided up to four renewal periods of five years each, so long as KAM satisfied certain requirements, including the satisfaction of development obligations. In May 2020, KAM provided notice of its intent to renew the Columbia Agreement, but Marco's advised that KAM was ineligible because of performance deficiencies. After further correspondence, KAM filed a motion for a temporary restraining order against Marco's regarding the Columbia agreement, which was granted on September 11, 2020. On September 15, 2020, Marco's sent KAM a notice of default of the Charlotte agreement. KAM then filed a motion for preliminary injunction against Marco's. The court held a multi-day evidentiary hearing to consider the motion with regard to both agreements.

When considering a preliminary injunction, a plaintiff must establish that it is likely to succeed on the merits of the case, that it would suffer irreparable harm without the injunction, that the balance of equities favors the plaintiff, and that an injunction is in the public interest. As to the first factor, the court found KAM was unlikely to prevail on the merits. KAM had failed to meet the development requirements set forth under the Charlotte agreement and it was unlikely that it could meet those before December 31, 2020. Because the Columbia agreement required KAM to be in compliance with all agreements between the parties, KAM also was not eligible for renewal of the Columbia agreement. As to the second factor, the court reversed its prior finding of irreparable harm in its temporary restraining order. The court found KAM would not suffer an irreparable loss of goodwill because, if KAM prevailed in the litigation, it could inform its unit franchisees of its victory and any goodwill would be restored; further, KAM did not put forth evidence of any loss it would suffer from failing to service franchisees. Any loss to KAM would also be compensable by money damages. Third, the court stated it is "cautious when it comes to forcing parties whose relationship has soured to continue contracting with one another" and found the balance of equities favored not granting the injunction. Finally, because the parties did not focus on the public interest argument, that factor was not heavily weighted in either direction. Therefore, given that KAM was unlikely to succeed on the merits, would not likely suffer irreparable harm, and the balance of equities favored not forcing parties to contract with each other once the relationship had soured, the court denied KAM's motion for preliminary injunction and permitted Marco's not to continue the agreements.

Contracts

New York Federal Court Allows Franchisor to Pursue Breach of Contract Claim Against Guarantor of Loan Related to Franchise

Wyndham Hotel Group International's claim for monetary damages against a guarantor of an $850,000 note related to a franchise agreement has survived a motion to dismiss. *Wyndham Hotel Grp. Int'l v. Silver Entm't LLC*, 2020 WL 5517519 (S.D.N.Y. Sept. 14, 2020). Wyndham sued its franchisees Silver Entertainment and Veneto Hotel & Casino and was awarded monetary damages for their breach of the franchise agreement. Wyndham then sought to recover against Silverman, the personal guarantor of a note related to the franchise agreement. Silverman moved to dismiss the claims on the basis that the personal guaranty agreement he signed lacked consideration and was ambiguous.

The court disagreed with both of Silverman's arguments. The court held that a provision in the loan note, which forgave ten percent of the loan on each anniversary of the opening date of the franchisee's hotel, constituted consideration for the guaranty. Although the provision was a part of Veneto's loan terms and was not in the personal guaranty, the favorable terms were only received after the personal guaranty was executed by Silverman. Additionally, Silver Entertainment transferred the franchise to Veneto, and as part of the transfer Silverman's obligations as the primary obligor of the franchise loan were discharged, which the court also found to be consideration for guaranteeing Veneto's loan. The court then rejected Silverman's vagueness argument, finding that language to the effect of "Guarantor agrees to be bound by the terms and provisions of this Note" was sufficiently clear to bind Silverman as guarantor.

Americans with Disabilities Act (ADA)

California Federal Court Finds No Unlawful Discrimination in Franchise System's Late-Night Drive-Thru-Only Service

A federal court in California found that a restaurant does not violate the Americans with Disabilities Act or the California Unruh Civil Rights Act when it provides late-night service exclusively through its "drive-thru." *Szwanek v. Jack in the Box, Inc.*, 2020 WL 5816752 (N.D. Cal. Sept. 30, 2020). Plaintiffs Judy Szwanek and James Lopez II are California residents and patrons of Jack in the Box fast food restaurants within walking distance of their homes. Visual impairments prevent each from driving. They brought a putative class action against the franchisees who operate the restaurants they frequent, as well as the franchisor, after they were refused late-night service at the restaurants. The restaurants provide late-night service exclusively through their drive-thrus, which pedestrians are not permitted to use. The franchisor, joined by the franchisees, argued that the action should be dismissed because the drive-thru-only policy does not discriminate on the basis of disability, and because the plaintiff's claims were based not on their visual impairments, but on their inability to drive. The court agreed with each argument and granted the motion to dismiss.

As to the first argument, the court noted that the burden imposed by the restaurants' drive-thru-only policy was imposed on those who cannot drive for any number of reasons. As a result, this policy did not burden the visually impaired any differently or greater than it affected pedestrians who are not disabled. Therefore, there was no proof that the plaintiffs were excluded due to their disability. As to the second argument, the definition of a "disability" under the ADA requires the limitation of a "major life activity" as a result of the impairment. The court concluded that driving — specifically, driving to access a drive-thru for the purpose of enjoying a late-night hamburger — is not a major life activity. In reaching its decision, the court was also guided by two recent decisions from the Northern District of Illinois rejecting similar claims of discrimination flowing from restaurants providing only drive-thru-only service. Because the court held that the plaintiffs were not disabled under the meaning of the ADA, it granted the motion to dismiss.

Renewals

Illinois Federal Court Partially Dismisses Counterclaims Arising out of Expired Area Developer Agreement

A federal court in Illinois has dismissed three of four counterclaims asserted against Liberty Tax by one of its former area developers and franchisees, David Rocci. *JTH Tax LLC v. Grabowski*, 2020 WL 6203355 (N.D. Ill. Oct. 22, 2020). Liberty first sued Rocci for allegedly continuing to operate competing businesses using Liberty's trademarks and other property following the expiration of his area development agreement and the termination of his franchise. Rocci counterclaimed, arguing that Liberty breached the area development agreement because it failed to offer him a renewal after he provided notice of his intent to renew. He also claimed that Liberty breached the agreement by failing to provide a lawful franchise system; violated the Illinois Franchise Disclosure Act (IFDA) by failing to renew his area development agreement without giving him adequate notice and compensation for the value of his business; and violated the Massachusetts Consumer Protection Act by, among other things, failing to renew the area development agreement.

The court denied Liberty's motion to dismiss Rocci's contract claim based on nonrenewal because, on a motion to dismiss, it had to take as true his allegations — which were that he was not offered a renewal

despite giving written notice. The court would not consider Liberty's arguments concerning facts outside the pleading as to why Rocci may not have been entitled to renew. However, the court dismissed Rocci's claim that Liberty failed to provide and maintain a lawful franchise system because the contract provision that he cited in support of the claim imposed requirements on him, not Liberty. The court also held that Rocci could not state a claim under the IFDA because the Act's renewal requirements concern the renewal of a franchise of a franchised business, not an area development agreement like Rocci's. Lastly, the court determined that Rocci's fourth counterclaim under the Massachusetts Consumer Protection Act was barred by the area development agreement's choice-of-law provision designating Illinois law as the governing law.

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