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.

Class Actions

Ninth Circuit Reverses Class Action Settlement Approval and Fee Award

The Ninth Circuit Court of Appeals has reversed the approval of a $10 million voucher settlement and a $2.6 million attorneys' fee award in a class action over increased membership fees charged by Massage Envy franchises. *McKinney-Drobnis v. Oreshack*, --- F.4th ---, 2021 WL 4890277 (9th Cir. Oct. 20, 2021). The plaintiffs claimed the franchisor of the Massage Envy franchise system told customers their Massage Envy membership rates would not change after they signed up, and that they could cancel their memberships at any time. However, the company allegedly raised membership rates and intentionally made it hard for customers to cancel their memberships. The parties reached a settlement before a class was certified. Under the settlement, in exchange for the release of all claims against Massage Envy, class members could submit claims for vouchers for Massage Envy products and services. The trial court approved the settlement over the challenge of one objector, who appealed.

The Ninth Circuit agreed with the objector. First, the appellate court held that the trial court erred in finding the vouchers not to be "coupons" under the Class Action Fairness Act. As a result, the trial court evaluated the settlement under a less exacting standard and relied on an incorrect settlement value (the total settlement value, rather than the value of the redeemed coupons) in awarding attorney fees. Second, the Ninth Circuit held that the trial court abused its discretion by failing to adequately investigate and substantively grapple with some of the potentially problematic aspects of the relationship between the attorney-fee award and the benefits to the class. To that end, the Ninth Circuit held that the district court failed to apply the requisite heightened scrutiny for pre-class certification settlements.

Choice of Forum/Venue

Sixth Circuit Holds Forum Selection Clause Unenforceable

The Sixth Circuit Court of Appeals ruled that a forum selection clause in a franchise agreement was unenforceable. *Lakeside Surfaces, Inc. v. Cambria Co., LLC*, --- F.4th ---, 2021 WL 4807182 (6th Cir. Apr. 20, 2021). As reported in Issue 253, Lakeside and Cambria entered into a franchise agreement in which Lakeside would sell fabricated countertops manufactured by Cambria. Lakeside met its contractual targets for a number of years, but Cambria terminated the franchise agreement after discovering that Lakeside carried a different manufacturer's product. Lakeside sued Cambria alleging, in part, that Cambria violated the Michigan Franchise Investment Law, and Cambria moved to dismiss on the basis of the franchise agreement's designation of Minnesota law and forum. The trial court agreed and dismissed the case, and Lakeside appealed.

The Sixth Circuit reversed. First, the appellate court clarified its precedent regarding the deference afforded to the plaintiff's choice of forum and held that an enforceable forum selection provision presumptively controls where a litigation must occur. The Michigan Franchise Investment Law, however, represents strong Michigan public policy and voids any out-of-state forum selection provision. Cambria argued that the Franchise Investment Law did not apply because of the Franchise Agreement's choice of Minnesota law. The appellate court would not permit the use of a choice of law provision to circumvent a strong public policy. The appellate court was skeptical that the Michigan legislature would create such a simple loophole to what it otherwise rendered quite explicit: that out-of-state forum selection clauses were not enforceable in franchise agreements. The Ninth Circuit therefore reversed and remanded the decision back to the district court.

Arbitration

Massachusetts Federal Court Dismisses Individual's Claims Related to Ongoing Arbitration Against Franchisee

A federal court in Massachusetts dismissed a franchisee's declaratory judgment, consumer protection, and fraud claims against a franchisor, two of its employees, and its outside counsel and enforced the arbitration clause in the parties' franchise agreement. *Restuccia v. H&R Block Tax Services LLC, et al.* 2021 WL 4658734 (D. Mass. Oct. 7, 2021), Restuccia converted his accounting firm into an H&R Block franchise through a series of agreements he entered into in 2015. Block subsequently provided assistance in his acquisition of another accounting business, in exchange for an ownership interest in the new business. When a dispute arose concerning royalties due for the newly acquired business, Restuccia's firm initiated arbitration against Block. It then filed for bankruptcy, and Block moved to join Retuccia as an individual. Restuccia then sued Block and several individuals in federal court to avoid being added to the arbitration and alleging claims of fraud and consumer protection violations. Block moved to dismiss.

The court first considered and determined that it did not have personal jurisdiction over Block's outside counsel and its employees. Block's outside counsel only had offices in Kansas and Missouri, and its only contact with Massachusetts was the Missouri-venued arbitration with the franchisee, a Massachusetts company. Similarly, the Block employees' only contacts with Massachusetts occurred within the scope of their employment with Block. Next, the court considered Restuccia's argument that he was not personally bound by the arbitration provision in the franchise agreement. The court disagreed, as Restuccia agreed

to the provision individually as the franchisee's principal. Further, the arbitration agreement's incorporation of the AAA's Commercial Arbitration Rules constituted clear and unmistakable evidence the parties intended to arbitrate the issue of arbitrability. Therefore, the court dismissed Restuccia's claims against Block and compelled arbitration.

Damages

New Jersey Federal Court Denies Franchisee Judgment on the Pleadings on Future Royalties Claim

A federal court in New Jersey denied a franchisee defendant's motion for judgment on the pleadings on franchisor Golden Corral's breach of contract claims for lost future royalties and marketing fees of $1,168,368. *Golden Corral Franchising Systems, Inc. v. Scism*, 2021 WL 4490233 (D.N.J. October 1, 2021). Golden Corral alleged that the franchisee breached the franchise agreement by ceasing to operate its restaurant halfway through a fifteen-year term and sought lost future royalty and marketing fees.

The franchisee sought to avoid the damages by arguing that (1) the franchisor's termination of the agreement ended the franchisee's obligation to pay the fees; (2) fees were based on sales, which were $0 after the restaurant ceased to operate; (3) no franchise agreement provision awards future lost royalties; (4) the initial franchise fee recompenses the franchisor for future lost profits; and (5) New Jersey law precludes recovery of lost future royalties where the franchisor terminates the franchise agreement. The court rejected each of these arguments, finding that New Jersey law permits (and the franchise agreement does not preclude) the recovery of lost profits as a result of a breach of contract under appropriate circumstances. Whether those circumstances are present in this case depends on issues of fact that the court could not appropriately decide at such an early stage of the litigation.

State Franchise and Dealer Laws

California Federal Court Denies Summary Judgment on Franchisee's CFIL Claim

A federal court in California denied a gasoline station and convenience store franchisee's motion for summary judgment on its claim that there was an unlawful material modification to its franchise agreement under the California Franchise Investment Law (CFIL). *BP Prods. N. Am.*, *Inc. v. Grand Petroleum, Inc.,* 2021 WL 4804275 (N.D. Ca. Oct. 14, 2021). After franchisee Grand Petroleum, Inc. entered into two franchise agreements with BP, BP instituted two optional programs and provided Grand with a disclosure about the programs under the CFIL. Each ultimately became mandatory and, after Grand failed to comply with them, BP terminated the franchise agreements. When BP filed suit to enforce the termination, Grand counterclaimed that the programs were material modifications to the franchise agreements in violation of the CFIL. The parties filed cross motions for summary judgment on their respective claims.

The court denied Grand's motion for summary judgement as to its CFIL claim on the grounds that there were material questions of fact as to the meaning of the disclosure that BP provided, and the question of whether the programs rose to "material modifications." The court noted that parties pointed to different sections of the disclosure to bolster their interpretation; the scant record and lack of briefing on the interpretation prevented the court from determining whether the mandatory programs were unlawful material modifications. The court also rejected BP's argument that the material modification requirements

of the CFIL were preempted by the Petroleum Marketing Practices Act – citing the Ninth Circuit's holding that that state law concerning fraud in the formation of contracts is not preempted because it does "not implicate the grounds for, procedure for or notification requirements of termination and nonrenewal under the [PMPA]."

Americans with Disabilities Act

Illinois Federal Court Grants Summary Judgment Dismissing Claim that Franchisor Violated ADA by Not Serving Pedestrians at a Drive-Through

A federal court in Illinois granted summary judgment to McDonald's on an ADA claim, finding the franchisor did not "operate" the franchised restaurants. *Magee v. McDonald's USA, LLC*, 2021 WL 4552411 (N.D. Ill. Oct. 5, 2021). The court also found that the policy of not serving pedestrians at a drive-through did not discriminate against Scott Magee, who is legally blind and does not drive. Magee alleged that McDonald's discriminated against him in violation of the ADA. He also alleged that three franchised restaurants violated the ADA by excluding disabled, nondriving persons like himself from late-night food service, because they refused to serve him as a pedestrian in the drive-through lane.

The core issue on McDonald's summary judgment motion was whether it exercised sufficient control over the restaurants in question to operate them, within the meaning of the ADA. The court found in McDonald's favor, holding that it delegated late-night operational decisions to the franchisees, as neither the Franchise Agreement nor Operations and Training Manual mandated late-night service. Further, the court concluded that, even if McDonald's could be deemed an operator of the restaurants, Magee was not discriminated against on the basis of his disability because all pedestrians, not just blind pedestrians, were unable to receive service through the late-night drive-through lane.

Preliminary Injunctions

Nebraska Federal Court Denies Preliminary Injunction to Licensor Because of Delay in Seeking Injunctive Relief

A federal Court in Nebraska has recently denied a licensor's request to enjoin a terminated licensee, concluding that there was no likelihood of irreparable harm where the licensor delayed in seeking injunctive relief. *Stone Strong, LLC v. Stone Strong of Texas, LLC*, 2021 WL 4710449 (D. Neb. Oct. 28, 2021). Stone Strong, LLC designs and sells retaining wall blocks under what it calls the Stone Strong System. Stone Strong entered into a Dealer and License Agreement with Stone Strong of Texas, under which the licensee paid a fee for the right to provide goods and services under the trademarked system. After Stone Strong of Texas failed to pay large amounts of past due fees, Stone Strong terminated the license agreement and eventually sought a preliminary injunction to prevent Stone Strong of Texas from using its trademarks. The district court refused to enjoin Stone Strong of Texas, however, because it determined that Stone Strong failed to demonstrate that it would be irreparably harmed in the absence of a preliminary injunction.

In denying the request, the court reasoned that, although Stone Strong was likely to prevail on the merits of its claims, any concern about the harm and customer confusion caused by the licensee's continued use of the marks was negated by Stone Strong's delay in seeking a preliminary injunction. Stone Strong waited nearly ten months after Stone Strong of Texas stopped paying its license fees to terminate the

parties' agreement and gave Stone Strong of Texas two additional months to wind down operations. The court also determined that money damages were sufficient to compensate Stone Strong for concerns about customer goodwill. Lastly, the court also concluded that the balance of harms between the parties and the public interest weighed against granting a preliminary injunction, and therefore denied Stone Strong's motion.

International

Global Franchise Regulation Update

The Global Franchise Regulation Update (GFRU) is a well-known Lathrop GPM Franchise & Distribution publication that is updated and re-published around 3 times annually, most recently on September 30, 2021. The comprehensive Update on international regulatory developments is compiled from publications and correspondence with franchise counsel from throughout the world. For the first time, editor of the GFRU and Senior Counsel Carl Zwisler and Franchise & Distribution Practice Group Leader and Partner Liz Dillon presented the updated GFRU in webinar format on September 29, 2021. A recording of the webinar and accompanying materials are accessible here.

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

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