GRAY PLANT MOOTY

The GPMemorandum

TO: OUR FRANCHISE CLIENTS AND FRIENDS

FROM: GRAY PLANT MOOTY'S FRANCHISE AND DISTRIBUTION PRACTICE GROUP

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This section of *The GPMemorandum* addresses non-judicial developments, trends, and best practices of interest to franchisors. Reports of recent judicial developments begin on page 2.

IDENTITY THEFT

MAY 1, 2009, DEADLINE LOOMS FOR COMPLIANCE WITH FTC "RED FLAGS RULE"

The new federal "Red Flags Rule" requires certain businesses to establish written programs to detect, identify and respond to signs of possible identity theft. The rule is aimed at reducing identity theft by making it more difficult for identity thieves to use stolen identity information to purchase goods or services. The Federal Trade Commission will begin enforcing this new rule on May 1, 2009.

Franchisors and the Red Flags Rule. The Red Flags Rule applies to "creditors" with "covered accounts." Franchisors are considered "creditors" under the rule if they regularly extend credit, for example, by deferring royalty payments owed by franchisees, by allowing franchisees to purchase supplies on credit, or by arranging or providing financing to franchisees. Under the rule, however, franchisors are required to have a written identity theft program (as discussed in the "Compliance" section below) only if they have "covered accounts."

One type of "covered account" is an account primarily for personal, family, or household purposes that involves or permits multiple payments or transactions. Because franchisor/franchisee relationships are for *business* purposes, even when the franchisee is an individual, credit extended to franchisees likely does not comprise a "covered account." But franchisors and franchisees may have "covered accounts" in other parts of their businesses. For example, franchise systems that provide services that are billed monthly, such as household cleaning or lawn care services, are likely "covered accounts" under the rule. Franchise systems that provide goods to customers on payment plans would be another example of "covered accounts" that would subject a franchisor and/or franchisees to the rule.

Another type of "covered account" is any account with a reasonably foreseeable risk to customers from identity theft. In the franchisor/franchisee relationship there is generally not a reasonably foreseeable risk because the establishment of a franchise generally involves a high degree of due diligence. Each franchise system should assess the risk to it and its customers from identity theft in order to determine if compliance with the rule is necessary.

Compliance with the Red Flags Rule. If a business has covered accounts, the rule requires it to develop a written program to detect, prevent, and mitigate identity theft by noting "Red Flags" indicating possible theft. The warning signs may include forged or altered photo identifications or documents, invalid Social Security numbers, the use of an account that has been inactive for a long period, or signals of possible identity theft discovered during a credit check, such as fraud alerts, address discrepancies, and credit freezes. The rule is flexible in that businesses are tasked with implementing their own compliance programs tailored to the nature and risk of their businesses.

For information about whether your business is subject to the rule or if you have any questions, please contact Jennifer Debrow at Gray Plant Mooty at jennifer.debrow@gpmlaw.com or (612) 632-3357.

RECENT CASES

Here are summaries of recent cases of interest to franchisors.

POST-TERMINATION INJUNCTIONS/FRANCHISE ASSOCIATIONS

COURT RULES AGAINST FORMER FRANCHISEES AND ASSOCIATION ON CHALLENGE TO FRANCHISOR'S EXPANSION PLANS IN DETROIT

What started as a routine post-termination injunction case brought by a franchisor turned into a more fundamental dispute when a franchisor terminated the franchise agreements of two of its franchisees for non-payment of royalties and other fees in *Dunkin' Donuts Franchised Restaurants LLC v. Shrijee Investment, Inc.*, 2008 WL 5384077 (E.D. Mich. Dec. 23, 2008). Dunkin' Donuts, represented by Gray Plant Mooty, began the case by suing the franchisees for their continued use of Dunkin' trademarks after termination. The franchisees, in turn, sued Dunkin' for allegedly breaching its duty of good faith and fair dealing (claiming Dunkin's alleged expansion plan for Detroit was designed to drive them out of business) and tortiously interfering with their attempts to sell their franchises. The franchisees argued that alleged prior breaches nullified the terminations, but the court rejected that argument and ruled that Dunkin's alleged breach is immaterial to the court's evaluation, thus the franchisor's motion for a post-termination injunction was granted.

Raising what may be a more significant issue for franchisors, Dunkin' moved to dismiss the claims of the Detroit Dunkin' Donuts Franchisee Association (DDFA) for lack of associational standing. In order to sue on behalf of its members, the DDFA needed to establish that its members would otherwise have standing to sue in their own right, the interests at stake are germane to the organization's purpose, and neither the claim asserted nor the relief requested requires the individual participation of the individual members. Like the individual franchisee parties, the DDFA alleged that Dunkin's alleged expansion plan for Detroit was designed to remove small networks of shops in favor of large, multi-unit operators. The court concluded that the breach claims made by the DDFA could be evaluated only with the participation of each individual franchisee, and therefore it dismissed the DDFA from the suit.

RICO

CLAIM AGAINST FRANCHISOR SURVIVES MOTION TO DISMISS

In *HT of Highlands Ranch, Inc. v. Hollywood Tanning Systems, Inc.*, 2008 WL 5109745 (D. N.J. Dec. 1, 2008), four unrelated franchisees joined together to sue their system's franchisor and its related entities, setting forth several causes of action, including a claim under the Racketeer Influenced and Corrupt Organizations Act (RICO). The plaintiffs' RICO claim was based on their allegation that the franchisor fraudulently created vague equipment leases, which it then used as a basis to invoice the plaintiffs for equipment that did not exist or for used equipment that was passed off as new.

To sustain a RICO claim, a plaintiff must plead the existence of "predicate racketeering acts" that are related to each other and which "amount to or pose a threat of continued criminal activity." On a motion to dismiss by the defendants, the court found the plaintiffs' allegations, if proved, would qualify as related racketeering acts in furtherance of a crime. Further, relying on prior RICO cases, the court found that the plaintiffs' allegations satisfied the "continuity" analysis—both because the acts continued in time for a period of 12 months or more and because the plaintiffs had alleged that the fraudulent leases constituted the "regular way of conducting defendant's ongoing legitimate business."

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PROCEDURE

FRANCHISEE NOT ALLOWED TO CALL FRANCHISOR'S COUNSEL AS TRIAL WITNESS

In *AAMCO Transmissions, Inc. v. Baker*, 2008 WL 5245768 (E.D. Pa. Dec. 16, 2008), 2008 WL 5272781 (E.D. Pa. Dec. 18, 2008), and 2008 WL 5412026 (E.D. Pa. Dec. 24, 2008), a federal district court in Pennsylvania handed down three decisions concerning pretrial motions filed by the parties. The case arose following the termination of Baker's franchise in Tallahassee, Florida, after an investigation by AAMCO showed that Baker was not dealing with the public fairly and honestly. Baker filed counterclaims against AAMCO for, among other things, breach of contract and intentional interference.

The December 18 decision should be of the most interest to franchisor trial lawyers, as the court granted AAMCO's motion to prohibit its general counsel, James A. Goniea, and the vice president and general counsel of Cottman Transmissions Systems, William Jameson, from being forced to testify at trial. Early in the case, AAMCO had moved to have Goniea admitted to appear as counsel. Baker opposed the motion on the grounds that Goniea would likely be a witness at trial. As a compromise, a magistrate judge allowed Baker the right to renew his objection within a short period after Goniea's deposition. Baker never renewed his objection. A year later, on the eve of trial, Baker listed Goniea and Jameson on his own witness list. The court agreed with AAMCO that both witnesses should be excluded in light of the substantial prejudice and conflict of interest that would result to AAMCO if these witnesses were forced to testify. Baker also failed to establish that Jameson was an necessary witness.

In the other two rulings last month, the same court denied AAMCO's motion to exclude the testimony of Baker's expert witnesses on damages and liability, and the court disallowed as evidence certain audio-recordings and other writings concerning AAMCO's investigation into Baker's operation. As to the experts, the court found that both were qualified, and the court held that whether the losses were overstated by the damages expert was an issue for trial. As to Baker's hearsay-based motion to exclude evidence, the challenge was to AAMCO's investigatory recordings and memoranda of statements by Baker's customers shortly after they visited Baker's shop. AAMCO argued these items should be allowed into evidence because they constituted business records and contained present sense impressions of the shoppers. The court disagreed on the grounds that the recordings and memoranda were made after the customers visited Baker's franchise and therefore were not the present sense impressions. Nor were they business records. The court held that admitting this hearsay at trial would prejudice Baker since he would not be able to confront the customers on the witness stand.

FRANCHISEES MUST SET FORTH ALLEGED STATEMENTS WITH PARTICULARITY BEFORE REQUIRING FRANCHISOR TO PRODUCE DEPONENT

In *Brunet v. Quizno's Franchise Company LLC*, 2008 WL 5378140 (D. Colo. Dec. 23, 2008), a United States Magistrate Judge for the District of Colorado issued a discovery ruling notable for its requirement that the plaintiff-franchisees create a detailed list of particular statements they claim were made by the defendant-franchisor before the franchisor would be required to produce a corporate representative to testify regarding the statements. The franchisees had demanded that the franchisor produce the corporate representative(s) most knowledgeable regarding "all representations made to Franchise Owners in the United States by the Franchisor relating to its efforts to lower the costs of food, supplies, equipment, and services in operating a Quiznos restaurant" for the past ten years. The court agreed with the franchisor that this request was too unspecific. As part of the court's order that the franchisees prepare a list of the statements they claim were made, the franchisees were directed to: (1) identify the speaker who allegedly made the statement; (2) the date of the statement; (3) the place of the statement; (4) the event at which it took place; and (5) the paraphrased content of the statement. Only then would the franchisor be required to produce a corporate representative to testify about the statements.

ARBITRATION

CALIFORNIA COURT GRANTS FRANCHISOR'S MOTION TO DISMISS ACTION AND COMPEL ARBITRATION

In *Bencharsky v. Cottman Transmission Systems, LLC*, 2008 WL 5411500 (N.D. Cal. Dec. 29, 2008), the United States District Court for the Northern District of California enforced an arbitration clause in a franchise agreement, but with some significant limitations. The franchisee had filed the lawsuit alleging breach of contract, fraud, negligent misrepresentation, interference with contract, and violation of the California Franchise Investment Law (CFIL). The factual basis for the action was that, among other things, the franchisor had refused to renew the franchise agreements at their current locations under the Cottman brand name. When Cottman moved to dismiss and to compel arbitration, the franchisees contended that the arbitration clause was unconscionable and thus unenforceable under California precedent.

In granting Cottman's motion, the court found that it (rather than the arbitrator) would determine the validity of the arbitration clause because the franchisee was merely challenging the arbitration provision instead of seeking to invalidate the entire franchise agreement. The court then held that the franchise agreements' choice of law provision (which would have applied Pennsylvania law to the question the enforceability of the arbitration provision) was invalid because California law affords greater protections to franchisees than Pennsylvania law—especially because the CFIL gives franchisors a narrower range of defenses to misrepresentation claims than Pennsylvania recognizes.

The court then determined that the arbitration clause was substantively unconscionable in that it only allowed Cottman to seek injunctive relief in court, even for trademark infringement claims; that it barred punitive and exemplary damages and set out a one-year limitations period on filing the arbitration; and that it limited the power of the arbitrator to alter or modify any provision of the franchise agreements. The court, however, noted that the arbitration clause was not significantly unconscionable procedurally because the franchisees had been the ones to initiate contact with Cottman about becoming part of the system, that they had consulted with an attorney before signing the franchise agreement, and that the arbitration was distinctly identified in the text of the contract.

Concluding that it would uphold the arbitration provision while severing the unconscionable portions, the court granted Cottman's motion to dismiss the action and compel arbitration. The court also held that it did not have jurisdiction to compel the parties to arbitrate in their contractually-selected forum state of Pennsylvania.

DISTRICT COURT UPHOLDS ARBITRATION AWARD FOR FRANCHISOR DESPITE ONE FRANCHISEE'S CLAIMED LACK OF NOTICE

A Pennsylvania federal court has confirmed an arbitrator's award for the franchisor despite one of the co-franchisees' claims that he did not receive notice of the arbitration. In *AAMCO Transmissions, Inc. v. Sally*, 2008 WL 5272449 (E.D. Pa. Dec. 17, 2008), two individuals signed the franchise agreement together, but one franchisee left the day-to-day business operations entirely to his co-franchisee son-in-law. Soon thereafter, AAMCO discovered that the franchisees collectively had underreported sales and committed other breaches of the franchise agreement. Consequently, it served a single arbitration demand at the contractually agreed-upon location of the franchise. The son-in-law, however, failed to notify his father-in-law about the arbitration demand. Instead, the son-in-law hired a lawyer to represent both of them at the arbitration. Ultimately, the arbitrator found in favor of AAMCO and awarded damages in excess of $260,000. When AAMCO filed its petition to confirm the arbitration award in federal court, the son-in-law, for the first time, notified his father-in-law of the arbitration and award and filed a petition to vacate or modify the award, or in the alternative, for a rehearing.

The court held that AAMCO complied with the notice requirements of the franchise agreement and the American Arbitration Association's Commercial Arbitration Rules by sending a single arbitration demand to the business address of the franchise. The court also noted that AAMCO's counsel and the arbitrator both made repeated attempts to contact the father-in-law personally. Further, the court held that even if the father-in-law failed to receive notice, this was not the fault of AAMCO or the arbitrator and, therefore, it could not be said that the arbitrator exceeded his powers or otherwise engaged in "misconduct" or "misbehavior" warranting an order to vacate the award.

Additionally, in response to the franchisees' claims that they had meritorious defenses to present to the court, the district court held that its role was not to "re-weigh" the evidence; the proper forum for those defenses was the arbitration.

DAMAGES

COURT ENFORCES TERMS OF PERSONAL GUARANTY ATTACHED TO FRANCHISE AGREEMENT

In *Howard Johnson Int'l., Inc. v. Inn Development, Inc.*, 2008 WL 5378247 (D.S.D. Dec. 22, 2008), the court granted summary judgment to a plaintiff franchisor on its claim brought under a personal guaranty signed by the corporate franchisee's principals. Howard Johnson had terminated the franchisee's license agreement for failure to comply with quality standards. The franchisee's principals had signed a personal guaranty by which they promised to pay all amounts owed under the license agreement. The parties also executed an addendum that replaced a liquidated damages provision with a separate provision calling for the franchisee and personal guarantors to pay "any and all damages which [Howard Johnson] [has] sustained or may sustain" as a result of a breach of the license agreement.

The franchisor filed suit against the guarantors seeking to recover amounts owed under the license agreement and an accompanying promissory note. The guarantors defended by arguing that the franchisee had not breached the license agreement. The court noted, however, that the franchisee corporation had defaulted in the lawsuit, and thus had admitted the allegations of Howard Johnson's complaint. For that reason, the court found the guarantors liable for all amounts owed under the license agreement and promissory note. By contrast, the court rejected Howard Johnson's argument that it was entitled to liquidated damages, finding the franchisor had agreed through the license agreement to forgo such damages. The court further held that Howard Johnson had presented insufficient evidence in the summary judgment papers to permit the court to quantify the actual damages, so the court ordered an evidentiary hearing at which Howard Johnson could present further evidence.

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