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

Second Circuit Affirms Dismissal of Franchisees' Minimum Wage and Unjust Enrichment Claims

A divided panel of the Second Circuit Court of Appeals has concluded that claims of improper wage deductions and unjust enrichment against a franchisor were properly dismissed because the plaintiffs agreed to deductions in exchange for valuable franchise rights. *Mujo v. Jani-King Int'l, Inc.*, --- F.4th ---, 2021 WL 4096577 (2d Cir. June 2, 2021). The plaintiffs were current and former franchisees of Jani-King, a commercial cleaning service franchisor. Jani-King sources cleaning customers, who enter into service agreements with the franchisees. The customers pay Jani-King, who deducts agreed-upon franchise fees and transmits the remainder on to the franchisees. In the lawsuit, the franchisees alleged that this structure made them employees rather than independent contractors and that the franchise fee deduction constituted an improper withholding of wages under the Connecticut Minimum Wage Act and unjustly enriched Jani-King. After a lower court dismissed the statutory claim and granted summary judgment on the unjust enrichment claim, the franchisees appealed.

The Second Circuit held that the franchisees failed to state a claim under the wage statute even assuming they were employees. The statute prohibits employers from diverting an employee's wages except as agreed to by the employee or as required by law. However, the majority reasoned that the so-called wage in question was not the entire revenue paid by the customer, but the amount that remained after Jani-King deducted its agreed-upon fees. The panel majority also concluded that Jani-King had not been unjustly enriched under Connecticut law, because it had conferred valuable rights in return for the franchise fees received and the fee provisions of the franchise agreement were agreed upon and enforceable. This was true even assuming that, as permitted under Connecticut law, the franchisees were considered to be both employees and franchisees. Accordingly, the majority affirmed the dismissal of all claims. In dissent, Judge Calabresi asserted that the relevant issues were not clear under Connecticut law, and that the case should be certified to the Connecticut Supreme Court for clarification.

California Federal Court Holds Franchisees Are Not Employees of Franchisor

A federal court in California has recently ruled that a group of former 7-Eleven franchisees were not employees of 7-Eleven. *Haitayan v. 7-Eleven, Inc.*, 2021 WL 4078727 (C.D. Cal. Sept. 8, 2021). Four former 7-Eleven franchisees brought wage and hour claims against 7-Eleven claiming that 7-Eleven owed them millions of dollars in unreimbursed expenses because they were employees and not independent contractors of 7-Eleven. 7-Eleven denied the claims on the basis of the franchise relationship and a two-day bench trial was held.

Following trial, the court concluded that the former franchisees were independent contractors and not employees. Under applicable California law, the key factor was the level of control 7-Eleven retained over the franchisees. The court found the evidence at trial established that the former franchisees exercised their own judgment in determining, among other things: what products they would carry and their pricing; how to organize the store; what promotions to take part in; the scheduling, hiring, and firing of employees; and their own schedules and pay at their stores. The court further observed that the former franchisees held themselves out as business owners; they were not subject to the control of a 7-Eleven field consultant; their success was directly tied to their business savvy in operating their franchises; their income was entirely dependent on the profits they generated in operating their franchises; and 7-Eleven's core business is franchising, not operating convenience stores. Based on the foregoing, the court concluded that the circumstances weighed in favor of finding the former franchisees were independent contractors and not employees of 7-Eleven, and the court ruled in favor of 7-Eleven on all claims.

Post-Termination Injunctions: Noncompete Covenants

Indiana Federal Court Enforces Noncompete Against Former Steak N Shake Franchisee

A federal court in Indiana recently granted a motion by Steak N Shake to temporarily restrain a former franchisee from operating a competing business. *Steak N Shake Enters. v. iFood, Inc.*, 2021 WL 3772012 (S.D. Ind. Aug. 25, 2021). After its Steak N Shake franchise agreements and area development agreement were terminated, iFood and its principals converted their former franchises to "Sean's Shack" restaurants (the anglicized version of one of the principal's names), which allegedly offered similar menu items as Steak N Shake. Steak N Shake sued and moved for a temporary restraining order enjoining iFood from infringing on Steak N Shake's trademarks and from violating the franchise agreements' post-termination noncompete provision. While iFood initially failed to fully de-brand the restaurants, the court noted that the trademark issue was likely moot because iFood subsequently completed the de-branding process.

The court granted the motion based upon the alleged breach of the noncompete provision. In doing so, it rejected iFood's argument that the noncompete was overbroad and unenforceable and concluded that Steak N Shake had a protectable interest in refranchising the territory, even though there were no Steak N Shake restaurants in the region at the time. The court further found that Steak N Shake would suffer irreparable harm from iFood's breach of the noncompete as a result of the loss of customer goodwill, unfair competition, and the threat to the stability of the franchise system if the noncompete could not be enforced. This harm outweighed the loss of income that iFood stood to suffer from an injunction. Finally, the court held that the public's interest in the enforcement of contractual commitments also weighed in favor of granting the motion.

Trade Secrets

Illinois Federal Court Rules Circumstantial Evidence of Franchise Developer's Misappropriation of Trade Secrets Precludes Summary Judgment

A federal court in Illinois denied a franchise developer's motion for partial summary judgment seeking to dismiss a franchisor's allegations that he misappropriated trade secrets. *JTH Tax LLC v. Grabowski*, 2021 WL 3857794 (N.D. Ill. Aug. 30, 2021). In 2008, Liberty Tax Service and David Rocci executed a ten-year area development agreement. Rocci had a right of renewal, so long as he was in compliance with the agreement's terms and conditions, including the agreement's development benchmarks. Rocci failed to meet the benchmarks but nevertheless requested renewal. Liberty did not respond, and the agreement expired. After expiration, Liberty discovered that Rocci had formed a competing business during the agreement's term and continued to operate that business after his agreement with Liberty ended. Liberty alleged that Rocci had also used Liberty's trade secrets in the process and accordingly sued Rocci for breach of the Defend Trade Secrets Act, unlawful competition, and breach of the agreement's in-term and post-term covenants not to compete. Rocci counterclaimed for breach of contract based on Liberty's failure to renew the agreement. After discovery, Liberty moved for summary judgment on Rocci's counterclaim, and Rocci filed a counter-motion for summary judgment on both his claim and Liberty's claims.

The court agreed with Liberty that there existed sufficient circumstantial evidence of Rocci's misappropriation of Liberty's trade secrets to permit a reasonable jury to find for Liberty on its trade secrets claim. During the term of the agreement, Liberty identified an electronic filing identification number associated with Rocci that was used to file tax returns outside of the Liberty system. Rocci's business partner also testified that he tried to train her on a new software to file tax returns for customers without having to pay royalties. Finally, when the agreement expired, Rocci failed to return the franchise customer list. This circumstantial evidence warranted denying Rocci's summary judgment as to the trade secret claim, as well as Liberty's two other claims. The court did conclude, however, that Rocci's failure to satisfy any of the agreement's development benchmarks precluded him from enforcing the agreement's renewal provision, and therefore dismissed his counterclaim.

Damages

New Jersey Federal Court Awards $7 Million in Damages for Franchisees' Breach

After a two-day bench trial, a federal court in New Jersey found franchisees breached real estate franchise agreements and awarded the franchisor over $7 million in damages. *Coldwell Banker Real Estate, LLC. v. Bellmarc Group LLC*, 2021 WL 4129492 (D.N.J. September 9, 2021). In 2013, Bellmarc, a group of real estate franchisees, entered into franchise agreements with Coldwell Banker. Under those agreements, Bellmarc was required to: (1) report all transactions to Coldwell Banker; (2) maintain accurate financial statements and records to periodically provide to Coldwell Banker; and (3) pay Coldwell Banker royalty fees and marketing fees. Beginning in their first month of operations, Bellmarc was late remitting payments to Coldwell Banker, and remained delinquent with payments for much of the next year and a half. Ultimately, in December 2014, Coldwell Banker terminated the franchise agreements for monetary default and filed suit for breach of contract.

At trial, Bellmarc was found to have breached the franchise agreements by failing to pay royalty payments, failing to repay promissory notes to Coldwell Banker, and failing to convey to Coldwell Banker

collateral required under a security agreement. The court awarded damages with 18% interest, per the terms of the franchise agreements, based on unpaid royalty and marketing fees, liquated damages based on the monthly average amount of fees owed multiplied by 36 months, and unpaid promissory notes. The court also awarded Coldwell Banker an accounting of all unreported transactions, and $50,000 for Bellmarc's trademark infringement following termination, for a total award of $7,593,262.80, plus reasonable attorneys' fees and costs.

Franchisor's Claim for Liquidated Damages Survives Motion to Dismiss

A federal court in Georgia denied a franchisee's motion to dismiss a franchisor's claim for liquidated damages. *Holiday Hosp. Franchising, LLC v. N. Riverfront Marina & Hotel, LLLP*, 2021 WL 3798561 (N.D. Ga. Aug. 26, 2021). Holiday Hospitality entered into a license agreement with Northern Riverfront permitting Northern Riverfront to develop and operate a hotel under its brand but, in spite of numerous extensions, Northern Riverfront failed to commence construction on the hotel. Holiday Hospitality terminated the agreement and sued Northern Riverfront, seeking nearly $5 million in liquidated damages.

Northern Riverfront moved to dismiss the lawsuit for two reasons. First, it argued that Holiday Hospitality waived its rights under the agreement by waiting nearly four years to file the lawsuit. The district court disagreed, holding that waiver was a fact issue to be decided by a jury. Second, Northern Riverfront argued that the liquidated damages provision was unenforceable under Georgia law because (1) it included damages incurred over an excessive time period and (2) the calculation was based on the average daily revenue of other hotel locations within the brand, which amounted to an unreasonable estimate of potential losses. The court rejected this argument as well, concluding that a determination of the reasonableness of the liquidated damages sought is based upon facts alleged in the complaint, which alleged sufficient facts to satisfy the elements of the enforceability of a liquidated damages provision. In addition, the court noted that the Eleventh Circuit and Georgia Court of Appeals had already determined that the exact liquidated damages provision at issue was reasonable under Georgia law.

Virtual Education Speaker Series

Increasing Diversity in Franchising

On October 28, 2021, Lathrop GPM will launch its *Increasing Diversity in Franchising* virtual educational speaker series with a presentation by Dr. Marcia Chatelain, Professor, History and African American Studies, Georgetown, and Pulitzer Prize-winning author of *Franchise: The Golden Arches in Black America*. Dr. Chatelain will discuss "Diversity in Franchising – Where Are We & How Can We Improve?" Click here to learn more and to register for this important discussion.

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.

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