

The Franchise Memorandum

| By Lathrop GPM

To: Our Franchise and Distribution Clients and Friends

From: Lathrop GPM's Franchise and Distribution Practice Group

Maisa Jean Frank, Editor of *The Franchise Memorandum by Lathrop GPM*

Richard C. Landon, Editor of *The Franchise Memorandum by Lathrop GPM*

Date: June 4, 2020 — Issue # 254

Welcome to *The Franchise Memorandum by Lathrop GPM*, formerly known as *The GPMemorandum*. Below are summaries of recent legal developments of interest to franchisors.

Given the widespread and evolving impact of the COVID-19 pandemic, this issue also includes recent developments and resources related to COVID-19.

Arbitration

Third Circuit Concludes “Unsophisticated Party” Cannot Avoid Arbitration Provision; Remands Issue of Franchisor’s Ability to Invoke Arbitration Provision in a Contract to Which It Is Not a Party

The Third Circuit Court of Appeals has held that Coverall franchisees must submit their employee misclassification claims against a subfranchisor to arbitration, but remanded the question of whether the franchisor can invoke the same arbitration provision even though it is not a party to the plaintiffs’ franchise agreements. *Richardson v. Coverall N. Am., Inc.*, 2020 WL 2028523 (3rd Cir. Apr. 28, 2020). Plaintiffs Richardson and Silva signed subfranchise agreements with Sojul, LLC in 2016 and 2005, respectively, to operate Coverall commercial cleaning franchised businesses. The agreements both contained requirements to arbitrate certain claims. In 2017, Richardson and Silva filed a class action against Sojul and Coverall on the basis that they had been misclassified as independent contractors. Sojul and Coverall removed the matter to federal court and moved to stay the action until arbitration had concluded. In its decision, the lower court considered whether the agreements delegated the question of arbitrability to an arbitrator and whether Coverall could enforce the arbitration clause. The court held that because Silva was an “unsophisticated party,” the mere incorporation of the American Arbitration Association (AAA) Commercial Arbitration Rules in Silva’s agreement did not constitute the clear and unmistakable evidence required to find delegation. Although Richardson’s claims were subject to arbitration, the court held that because Coverall was not a party to the franchise agreement, it could not enforce the agreement’s arbitration provision. The parties appealed.

Reviewing the decision *de novo*, the Third Circuit reversed both conclusions by the lower court. First, the court found that no evaluation of the parties’ sophistication is needed when the arbitration clause clearly requires disputes to be resolved under the “then-current Commercial Arbitration Rules of the AAA.” The court found that the arbitration clause was clear and unmistakable, and therefore delegated the question

of arbitrability to the arbitrator. Second, the court determined that there was insufficient information in the record regarding Coverall's ability to invoke the arbitration provision as a third-party beneficiary. Because the issue would benefit from discovery between the parties, the appellate court remanded the issue for further fact-finding.

Ohio Federal Court Upholds Franchise Agreement Clause Mandating Arbitration in New Jersey

A federal court in Ohio held that an arbitration provision in a franchise agreement was enforceable despite arguments that the agreement was rescinded or that it was contrary to Ohio law. *Scarso Enters., Inc. v. Honor Yoga Mgmt., LLC*, 2020 WL 2496941 (N.D. Ohio May 14, 2020). Plaintiff Scarso is a former franchisee that operated a yoga studio under the trade name of franchisor Honor Yoga. Scarso entered a development agreement with Honor Yoga to develop three studios and a franchise agreement for the first studio. When that studio underperformed, Scarso sought to renegotiate the agreements. When that failed, Scarso purported to rescind the agreements pursuant to Ohio's Business Opportunity law and sued Honor Yoga and BodeTree, LLC, through which Honor Yoga sold the franchise. Scarso alleged that Honor Yoga and BodeTree had misrepresented the financial viability of the franchise. After removing the case to federal court, Honor Yoga sought to enforce the arbitration provisions of the agreements with Scarso and asked the court to stay the case pending arbitration. Scarso responded that, because it had rescinded the agreements, their arbitration provisions could not be enforced, and that the provisions' New Jersey venue was void under the provision of the Ohio Business Opportunity law, which barred contract provisions that mandated dispute resolution outside of Ohio.

The court held that Scarso's purported rescission did not constitute a challenge to the validity of the arbitration provisions, and the issue of the validity of the agreements themselves was reserved to the arbitrator. Scarso did not deny that the parties' dispute fell within the broad scope of the arbitration clauses, which covered all "disputes and claims" relating to the agreements. The court further held the arbitration provision was enforceable, as there had been no allegations of fraud or duress specific to the clause, nor allegations that the New Jersey forum would be ineffective, unfair, or seriously inconvenient. The court rejected Scarso's argument that Ohio law voided the venue provision because Scarso had agreed in the contract that New Jersey law, not Ohio law, would control disputes arising out of the contract. However, because the court lacked authority to compel arbitration outside of its district, it ruled only that the action would be stayed pending the outcome of arbitration. Defendant BodeTree was not a party to the agreements between Scarso and Honor Yoga, and therefore was not subject to the arbitration provisions of those agreements. But because the arbitration between Scarso and Honor Yoga would necessarily affect the claims against BodeTree, Scarso's suit was stayed as to that defendant as well.

Damages

Michigan Federal Court Enters a Default Judgment Against Franchisee and Awards Liquidated Damages and Attorneys' Fees to Franchisor

A federal court in Michigan recently entered a default judgement against a former Little Caesars franchisee and its principals, which included contractual liquidated damages in the amount of \$474,144.14, as well as all attorneys' fees and costs requested. *Little Caesar Enterprises, Inc., v. Reyes 1, Inc.*, 2020 WL 2395206 (E.D. Mich. May 11, 2020). After Reyes repeatedly failed to operate its

restaurants in accordance with Little Caesar's standards, Little Caesar terminated its franchise agreements and filed a lawsuit, which quickly resulted in a settlement agreement between the parties. The settlement agreement required Reyes to, among other things, sell or deidentify its franchises and pay Little Caesar a specified settlement amount. Reyes promptly breached the settlement agreement, causing Little Caesar to replead its claims, including a claim for breach of the settlement agreement.

After Reyes failed to respond to the lawsuit, the court readily found in favor of Little Caesar, entered a default judgment, and focused its analysis on the award of damages — more specifically — the validity of the liquidated damages provision contained in the franchise agreements and the reasonableness of the attorneys' fees and costs requested. The liquidated damages provision contained in the franchise agreements calculated damages based on the franchisee's average monthly royalty and advertising fees (over the 12-month period immediately preceding termination), multiplied by the lesser of 36 months or the number of months remaining in the term of the franchise agreement. The court found the provision enforceable because the parties had contractually agreed to the uncertainty of damages resulting from termination and the amount provided for under the provision was reasonable with relation to the possible injury suffered. The court also found that the attorneys' fees sought were reasonable, taking into account that Little Caesar's counsel "brought significant experience and expertise in th[e] matter" and "the results achieved in th[e] matter [were] significant in order to enforce the basic tenants of the parties' Franchise Agreement." The court awarded all attorneys' fees and costs requested. Little Caesar was represented by Lathrop GPM in this matter.

Court Permits Franchisee to Seek Punitive Damages Against Franchise Broker

In another recent damages case, a federal court in Minnesota has granted in part a franchisee's motion to add a claim for punitive damages, holding that the Federal Rules of Civil Procedure supersede state rules with respect to a franchisee amending its complaint to assert a claim for punitive damages. *JTKB, LLC v. FranChoice, Inc.*, 2020 WL 2192337 (D. Minn. May 6, 2020). JTKB became a franchisee of ILKB kickboxing studios after engaging the services of franchise broker FranChoice. JTKB filed suit against FranChoice, alleging claims of fraud and misrepresentations regarding the ILKB franchise system. Because the case was in federal court under diversity jurisdiction, JTKB later moved to amend its complaint to seek punitive damages under Minnesota's Rules of Civil Procedure. JTKB sought punitive damages on grounds that FranChoice, among other things, allegedly knew that ILKB's founder was involved in bankruptcy proceedings over 10 years ago, that ILKB engaged in illegal marketing techniques, and that FranChoice misrepresented certain aspects about the ILKB franchise system, such as financial performance representations, the high end initial investment, that the business was a semi to fully absentee owner business, and the membership conversion rate was based upon ILKB's marketing activities.

As an initial matter, the court applied the Federal Rules of Civil Procedure, rather than Minnesota's rules, in analyzing whether to grant JTKB's motion to amend. The Supreme Court has held that a federal court exercising diversity jurisdiction should not apply a state law if a federal rule "answer[s] the same question," and would not violate the Rules Enabling Act. The court held that because Minnesota's procedural law attempts to answer the same question as the federal law regarding when an amendment should be permitted, the federal rule shall apply as it would not violate the Rules Enabling Act. Under those rules, the court concluded that JTKB's motion should only be granted with respect to the allegation that FranChoice made misrepresentations about the franchise system. The claims for punitive damages failed to allege sufficient facts, which if taken as true, would survive a motion for summary judgment. The

court further explained that a showing of mere negligence is insufficient for punitive damages. However, the court found that JTKB alleged sufficient facts regarding FranChoice's alleged misrepresentations about the system to be entitled to seek punitive damages on such grounds.

Americans with Disabilities Act

New York Federal Court Dismisses Deaf Customer's Claim that Subway Violated the Americans with Disabilities Act

A federal court in New York has dismissed a claim that Doctor's Associates LLC, the franchisor of Subway restaurants, violated the Americans with Disabilities Act (ADA) because the plaintiff failed to allege that Doctor's Associates operated the Subway restaurant at which the discrimination took place. *Sullivan v. Doctor's Assocs. LLC*, 2020 WL 2319295 (S.D.N.Y. May 8, 2020). Sullivan, a "profoundly deaf individual," attempted to order a steak sandwich from a Subway restaurant. He alleged that, while trying to order, a Subway employee became angry with him, using hostile hand gestures and aggressive body language, which ultimately resulted in Mr. Sullivan being unable to order his sandwich. Mr. Sullivan alleged that Doctor's Associates, as the franchisor of Subway restaurants, had "actual control and responsibility over all Subway restaurants' compliance, adherence to laws, franchise training, and the way the franchise owners conduct their business," and, therefore, was ultimately responsible for any violations of the ADA and analogous state and city law provisions. Sullivan claimed that such laws required each and every Subway restaurant to install technology that would allow hearing-impaired individuals to place orders through a touch-screen interface.

The court concluded Sullivan had failed to plausibly allege that Doctor's Associates owned, leased, or operated the Subway restaurant at issue. The court noted that supervisory authority, provision of an operating manual, and a training program for employees, without more, are insufficient to demonstrate that a franchisor "operates" a franchisee's establishment. The court further noted that Doctor's Associates' authority to enforce and modify any Subway restaurant's policies, practices and procedures under the franchise agreement was unpersuasive, and that the franchise agreement conferred only general supervisory authority to Doctor's Associates. Therefore, since Sullivan failed to adequately plead that Doctor's Associates operated the Subway restaurant at issue, the court dismissed Sullivan's ADA claims and the related claims under New York state law. Even if Sullivan had adequately alleged that Doctor's Associates operated its franchisees, the court noted that the ADA does not require Subway restaurants to install technology that would allow hearing-impaired individuals to place orders through a touch-screen interface. The requirement to offer auxiliary aid and services to individuals with disabilities is flexible, and can include notetakers, written materials, and exchange of written notes. The court held that Sullivan's claim would ultimately fail because the ADA clearly did not require Doctor's Associates to force its franchisees to adopt specific technological solutions, so long as the franchisees can ensure that their employees can communicate effectively with hearing-impaired individuals. Additionally, even though Sullivan alleged he was denied service because an employee failed to communicate effectively during his visit to a Subway restaurant, the court held that Doctor's Associates is not responsible for the alleged discriminatory interaction, absent a sufficient allegation of specific control, over the Subway restaurant at issue. Therefore, while the franchisee may be held liable for its employee's interaction with Sullivan, Doctor's Associates may not. Sullivan was given an opportunity to amend his complaint.

Choice of Forum/Venue

Connecticut Federal Court Denies Motion to Dismiss for Improper Venue

A federal court in Connecticut has ruled that a franchisor's successor-in-interest cannot invoke a choice of venue provision in an agreement that refers to its predecessor's principal place of business. *Purugganan v. AFC Franchising, LLC*, 2020 WL 2494718 (D. Conn. May 13, 2020). Purugganan entered into the Master Development Agreement with AFC's predecessor-in-interest, Doctors Express Franchising LLC, to obtain exclusive rights to develop franchises in two New York counties and one county in Connecticut. Purugganan alleged AFC was not honoring the Master Development Agreement by attempting to purchase franchises belonging to him and brought suit to prevent the sale of the franchises and to enforce the agreement. Purugganan initiated the lawsuit in Connecticut federal court, and AFC sought to transfer venue to Alabama, which is where its principal place of business is located. The Master Development Agreement included a forum selection clause which formed the basis of AFC's motion to dismiss for improper venue.

The court denied AFC's motion to dismiss. Although the Master Development Agreement included an inconspicuous forum selection clause, the provision was worded such that the suit should be brought in the "state or judicial district in which we have our principal place of business." The "we" and "our" only referred to Doctors Express and did not include or contemplate a possible successor-in-interest to the rights of the Master Development Agreement. The purpose of a forum selection clause is to provide certainty to parties regarding where they can expect to participate in legal proceedings, and the forum selection clause did not put Purugganan on notice of the possibility of a lawsuit in the principal place of AFC's business. The fact that the Master Development Agreement did generally include a provision permitting the possibility of an assignment of rights was not sufficient to overcome the absence of a specific discussion of assignees or successors-in-interest in the forum selection clause.

Contracts

Ohio Federal Court Allows One Breach of Contract Claim to Proceed Against Hotel Franchisor; Dismisses Others

A federal court in Ohio granted in part, and denied in part, a motion for summary judgment filed by hotel franchisor Red Roof Franchising, LLC on certain breach of contract and other claims that Red Roof filed against a former franchisee. *Red Roof Franchising, LLC v. Riverside Macon Group, LLC*, 2020 WL 2494462 (S.D. Ohio May 14, 2020). Red Roof terminated its franchise agreement with Riverside because the franchisee had failed to pay certain fees when due and failed to make required improvements to the premises of the franchised hotel. Riverside continued to operate the franchised hotel after receiving Red Roof's notice of termination. Red Roof responded by filing a suit that alleged trademark infringement, breach of contract, and unjust enrichment, among other claims, and sought a temporary restraining order and an injunction. Riverside filed counterclaims alleging that Red Roof committed breach of contract, fraudulent misrepresentation, fraudulent concealment, tortious interference with business relationship, and civil conspiracy, among other claims. Red Roof moved for summary judgment on some of its claims, including its breach of contract claim, and all of Riverside's counterclaims.

With regard to its contractual counterclaims, Riverside specifically argued that Red Roof breached the parties' franchise agreement when it terminated Riverside's access to Red Roof's reservation system without giving Riverside an opportunity to cure its defaults. The court agreed that the relevant provisions

of the Franchise Agreement — which it described as “poorly drafted” — seemed to require Red Roof to provide Riverside time to cure before it could rescind access to the reservation system. Thus, the court denied summary judgment on that counterclaim. The court also looked closely at the language of the franchise agreement to find that the *force majeure* clause did not automatically give Riverside additional time to complete the required improvements, but rather required Red Roof to expressly consent to an extension of time. So the court granted summary judgment on that claim. Finally, the court declined to conclude that Red Roof had agreed to modify its contract to provide Riverside with additional time for the improvements and granted summary judgment on that claim as well. Red Roof’s motion for summary judgment was granted in part, and denied in part, on the remaining claims.

Legislation and Rulemaking

Federal Trade Commission Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule

As part of its periodic adjustment for inflation, the Federal Trade Commission has announced in a press release the new monetary thresholds for certain exemptions from disclosure under the FTC’s Franchise Rule. Although the Franchise Rule generally requires a franchisor to disclose key information to a prospective buyer before selling a franchise, 16 C.F.R. § 436.8 contains various exemptions, including three based on monetary thresholds for the sale. As of July 1, 2020, disclosure to a prospective buyer is not required under the Franchise Rule if:

- The buyer pays less than \$615 for the franchise (the previous threshold was \$570);
- The sale requires a large investment where the franchisee pays at least \$1,233,000, excluding the cost of unimproved land and any franchisor (or affiliate) financing (the previous threshold was \$1,143,100); or
- The sale is to a large entity (such as multi-unit franchisees, airports, hospitals) that has been in business at least five years and has a net value of at least \$6,165,500 (the previous threshold was \$5,715,500).

The Rule requires that the FTC adjust these thresholds every four years based on the Consumer Price Index.

COVID-19 Pandemic

COVID-19 Resources for Franchisors and Distributors

Lathrop GPM continues to provide clients with alerts, articles, and other resources to help clients navigate important legal information regarding the COVID-19 pandemic. Some of the following may be of particular interest to franchisors and distribution-based businesses:

- **Restaurant Alert:** [Guidance for Reopening Restaurants](#) by Thomas Pacheco and Samuel Butler
- **Privacy Alert:** [CCPA Enforcement Remains on Track Despite COVID-19 Pandemic](#) by Tedrick Housh, Michael Cohen, Amanda McAllister and Reid Day

- **M&A Update:** "[CorePower Yoga Lawsuit One to Watch for Failed M&A Deals During COVID-19](#)," **Franchise Times** article by Mark Williamson
- **Webinar:** [Preparing for Franchisee Bankruptcies in a COVID-19 World](#) by Phillip W. Bohl, Robert J. Haupt, Lauren O'Neil Funseth, and James A. Wahl
- **Webinar:** [Guidance for Employers on Reopening and Returning to Work](#) by Megan Anderson, Mark Mathison, Bridget Romero, and Brian Woolley

These updates and resources from Lathrop GPM's cross-disciplinary team are available at the [Lathrop GPM COVID-19 Client Resource website](#).

Lathrop GPM Franchise and Distribution Attorneys:

Liz Dillon (Practice Group Leader)	612.632.3284	Mark S. Mathison	612.632.3247
* Eli Bensignor	612.632.3438	Craig P. Miller	612.632.3258
* Sandra Yaeger Bodeau	612.632.3211	Bruce W. Mooty	612.632.3333
Phillip W. Bohl	612.632.3019	Katherine R. Morrison	202.295.2237
* Samuel A. Butler	202.295.2246	Marilyn E. Nathanson	314.613.2503
Michael A. Clithero	314.613.2848	Lauren O'Neil Funseth	612.632.3077
* Emilie Eschbacher	314.613.2839	* Thomas A. Pacheco	202.295.2240
Ashley Bennett Ewald	612.632.3449	Ryan R. Palmer	612.632.3013
Christopher T. Feldmeir	314.613.2502	Kirk Reilly	612.632.3305
* John Fitzgerald	612.632.3064	Eric R. Riess	314.613.2504
* Hannah Holloran Fotsch	612.632.3340	* Justin L. Sallis	202.295.2223
* Maisa Jean Frank	202.295.2209	* Max J. Schott, II	612.632.3327
Olivia Garber	612.632.3473	* Frank J. Sciremammano	202.295.2232
* Alicia M. Goedde (Kerr)	314.613.2821	Michael L. Sturm	202.295.2241
Michael R. Gray	612.632.3078	* Erica L. Tokar	202.295.2239
Mark Kirsch	202.295.2229	Stephen J. Vaughan	202.295.2208
Sheldon H. Klein	202.295.2215	* James A. Wahl	612.632.3425
Peter J. Klarfeld	202.295.2226	Eric L. Yaffe	202.295.2222
Gaylen L. Knack	612.632.3217	Robert Zisk	202.295.2202
* Richard C. Landon	612.632.3429	* Carl E. Zwisler	202.295.2225

**Wrote or edited articles for this issue*

Lathrop GPM LLP Offices:

Boston | Boulder | Chicago | Dallas | Denver | Fargo | Jefferson City | Kansas City | Los Angeles | Minneapolis | Overland Park | St. Cloud | St. Louis | Washington, D.C.

Email us at: franchise@lathropgpm.com

Follow us on Twitter: [@LathropGPMFran](https://twitter.com/LathropGPMFran)

For more information on our Franchise and Distribution practice and for recent back issues of this publication, visit the Franchise and Distribution Practice Group at <https://www.lathropgpm.com/services-practices-Franchise-Distribution.html>.

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

The Franchise Memorandum is a periodic publication of Lathrop GPM LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult your own franchise lawyer concerning your own situation and any specific legal questions you may have. The choice of a lawyer is an important decision and should not be made solely based upon advertisements. Lathrop GPM LLP, 2345 Grand Blvd., Suite 2200, Kansas City, MO 64108. For more information, contact Managing Partner Cameron Garrison at 816.460.5566.