RAISING THE BAR

IFA LEGAL SYMPOSIUM

MAY 5-7, 2019 | WASHINGTON, DC

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No-Poaching Provisions in Franchise Agreements

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NO-POACH CLAUSES-WHAT'S THE ISSUE?

- Antitrust Issue – "No Poaching" and "Wage Fixing"
- In addition to competition among sellers in an open marketplace, antitrust laws also apply to **competition among companies to hire employees**
- *PER SE* ILLEGAL IF they are not reasonably necessary to any separate, legitimate business collaboration between the employers

WHY IS THIS AN ISSUE NOW?

- No change in law
- DOJ / FTC Guidance - October 2016
  - Increased scrutiny of No-Poach Clauses in general
  - Criminal enforcement threatened
- April 2018 – settlement announced
  - No criminal charges. Yet
- Not franchise-related

FRANCHISE INDUSTRY BECOMES TARGET

- Focus on Franchises – Why?
  - Study found No-Poach Clauses in 58% of franchisor agreements; some cite higher numbers
  - Possible cause of wage stagnation in lower-income jobs, like those in the fast food industry
  - Politics? (just a guess)
    - Good political talking point
    - Joint Employer / No-Poach Contradiction

THREE AREAS OF ACTIVITY

- State Enforcement and Litigation
- Federal Enforcement
- Private Class Actions

STATE ENFORCEMENT ACTION

- Washington State Attorney General
  - Settlements beginning in July 2018 that started with QSR industry but has since expanded
  - As of March 2019 over 50 franchisors have agreed to cease use and enforcement of No-Poach Clauses nationwide
- Combined State Attorneys General Actions
  - Targeted Arby's, Burger King, Dunkin', Five Guys, Little Caesars, Panera Bread, Popeyes, Louisiana Kitchen and Wendy's
  - March 2019 – Settlement with Dunkin', Arby's, Five Guys and Little Ceasars
- *State of Washington v. Jersey Mike's Franchise Systems, Inc.* (Kings County Superior Court)
  - Motion to Dismiss summarily denied

FEDERAL ENFORCEMENT ACTION

- End Employer Collusion Act
- United States Senators Warren and Booker

United States Senate
WASHINGTON, DC 20510

July 12, 2018

Dear [Insert CEO Name]

We write to seek information on your use of so-called "no-poach" clauses (also known as "no-hire" or "no-switching" agreements), a harmful practice in which employers agree not to hire each other's employees. These agreements harm workers by preventing them from moving freely across the labor market and translating their value into higher wages.

A recent study by Princeton economists Alan Krueger and Orley Ashenfelter found that 58 percent of major franchisors' franchise agreements include a no-poach provision that prohibits their franchisees from hiring each other's workers.[1] Use of these provisions is up 20 percent from two decades ago and now covers approximately 340,000 franchise units and millions of low-wage workers.[2]

We are concerned that restrictions on worker mobility, including through no-poach clauses and

PRIVATE CLASS ACTIONS

Cases Still Pending	Cases Dismissed
McDonald's	Cinnabon (4-23-19)
H&R Block	Dunkin'
Burger King	Jackson Hewitt
Jimmy John's	Pizza Hut
Little Ceasars	Auntie Anne's, Carl's Jr. and Arby's

NO-POACH CLAUSE AS ANTITRUST VIOLATION

- Elements of Antitrust Claim
  - an agreement, conspiracy, or combination between two or more entities
  - that is an ***unreasonable*** restraint of trade under either a *per se* or rule of reason analysis
  - that affects interstate commerce

UNREASONABLE RESTRAINT OF TRADE ELEMENT

Standards of Review	Factors/Exceptions
Per Se – applies to those restraints with "manifestly anticompetitive effects" that "lack any redeeming virtue"	**Horizontal** - between competitors at the same level of the market; horizontal agreements among competitors to fix prices or divide markets are prime examples of restraints that are *per se* unlawful
Rule of Reason – "accepted standard" for testing whether practice is unreasonable restraint; to find a violation, must meet high burden of showing defendant has "market power"	**Vertical** - between parties that operate at different levels of the supply chain or market
Quick Look - available when it is clear that the restraint "would have an anticompetitive effect on customers and markets, but there are nonetheless reasons to examine the potential procompetitive justifications"	**Ancillary Restraints Doctrine** - a horizontal agreement that would otherwise be found *per se* unlawful may be permissible if it is ancillary to a separate, legitimate venture between the competitors

ARGUMENTS IN FRANCHISE CASES

- Concerted Action Element
  - Can franchisors and franchisees conspire?
  - Interbrand v. Intrabrand competition
- Unreasonable Restraint of Trade Element
  - Horizontal v. Vertical*?*
  - *Per Se* v. Rule of Reason v. Quick Look

DECISIONS ON MOTIONS TO DISMISS

- DENIED-McDonald's, Cinnabon, Jimmy John's and Jersey Mike's
- Concerted Action Element - rejected argument that franchisors and franchisees cannot conspire as a matter of law
- Unreasonable Restraint of Trade Element
  - while franchise agreements are vertical, there are horizontal elements
  - No-Poach Clauses are not *per se* unlawful
  - Quick Look review (McDonald's and Cinnabon)
    - Jimmy John's – too early to decide a standard of review

DOJ Statement of Interest

- Filed in private actions in Washington (since dismissed)
- Rejects argument that franchisors and franchisees cannot conspire as a matter of law
- Even if horizontal elements, ancillary restraint doctrine applies
  - No hub and spoke conspiracy
- Rule of reason is appropriate standard
  - Rejects quick look analysis and explicitly disagrees with the decisions in McDonald's and Cinnabon holding quick look review should apply

Joint Employer Liability

Robert Einhorn

Managing Partner
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Joint Employer Liability

- Sources of Authority
- A Glance At 2018 Through 2019
- Closing Remarks

Sources of Authority

- National Labor Relations Board
- U.S. Department of Labor
- Common law
- Legal precedent

Cruz v. MM 879, Inc., No. 115CV01563TLNEPG, 2019 WL 266458 (E.D. Cal., Jan. 18, 2019)

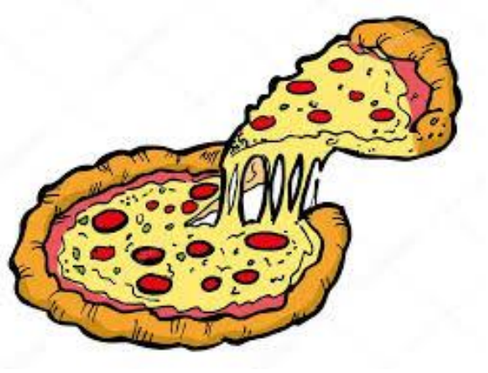
- Plaintiffs, former employees of a Merry Maids franchisee, brought hour and wage claims against the franchisee and franchisor, among others.
- *Martinez* 3-prong test

Cruz v. MM 879, Inc., No. 115CV01563TLNEPG, 2019 WL 266458 (E.D. Cal., Jan. 18, 2019)

- Defendants' motion for summary judgment granted as to the lack of a joint employer relationship but denied as to plaintiffs' ostensible agency theory.

In re Domino's Pizza Inc., 16CV2492AJNKNF, 2018 WL 4757944 (S.D.N.Y. Sept. 30, 2018)

- Plaintiffs filed a putative class action on behalf of employees of several Domino's franchises owned by several related Defendants, alleging wage violations under FLSA and New York law. Circuit standard
- Second Circuit
  - Formal control factors
  - Functional control factors



In re Domino's Pizza Inc., 16CV2492AJNKNF, 2018 WL 4757944 (S.D.N.Y. Sept. 30, 2018)

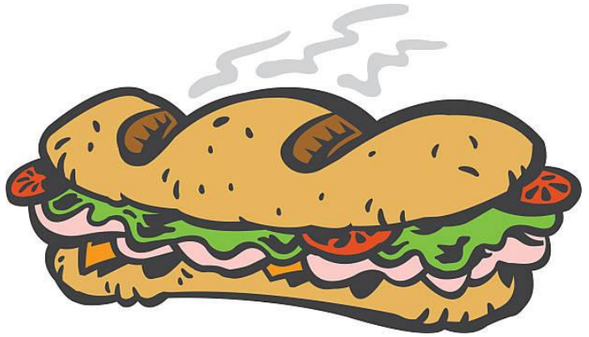
- Domino's summary judgment granted as to joint employer liability and ostensible agency.

Bonaventura v Gear Fitness One NY Plaza LLC., 17 CIV. 2168 (ER), 2018 WL 1605078 (S.D.N.Y. Mar. 29, 2018)

- Plaintiff, general manager of a franchised fitness club and medical spa, of which Retrofitness, LLC was the franchisor. Plaintiff alleged that he worked without pay for nine months and asserted an FLSA claim, among others, against the franchisor and franchisee entities.
- "Economic reality" test
- Retrofitness' motion to dismiss denied.

In re Jimmy John's Overtime Litigation, No. 14 C 5509, 2018 WL 3231273 (N.D. Ill. June 14, 2018)

- Plaintiffs consisted of former assistant store managers of several Jimmy John's franchisees, who brought FLSA claims against the franchisee and franchisor entities.



In re Jimmy John's Overtime Litigation, No. 14 C 5509, 2018 WL 3231273 (N.D. Ill. June 14, 2018)

- Four-factor test:
  - "(1) the power to hire and fire employees; (2) supervision and control of employee work schedules or conditions of payment; (3) determination of rate and method of payment; and (4) maintenance of employment records."
- Defendants' motion for summary judgment granted.

A.H. by and through Hunt v. Wendy's Company, No. 3:18-CV-0485, 2018 WL 4002856 (M.D. Pa., Aug. 22, 2018)

- Plaintiff filed employment discrimination claims against the franchisee and franchisor entities.
- Third Circuit joint employer factors
- Defendants' motion to dismiss denied as to joint employer liability and alternative agency theory.

Disclosure Violations

Andra Terrell

VP & Deputy General Counsel
Church's Chicken


ROUND 1

Failure to Provide Translation

***Luis Plaintiff Castillo v. CleanNet USA, Inc.*, 358 F. Supp. 3d 912, 2018 U.S. Dist. LEXIS 213073, 2018 WL 6619986.**

- Failure to provide a translated document can violate disclosure regulations
- If you provide a translation:
  - make sure the translation is complete
  - Encourage the contracting party to seek advice or counsel

Failure to Properly Provide Disclosure

***Trident Atlanta, LLC, et al. v. Charlie Graingers Franchising, LLC, et al.*, 2019 U.S. Dist. LEXIS 17295, 2019 WL 441187.**

- Inclusion of a written release of disclosure violations is not effective to extinguish improper disclosure

Failure to Register or Provide Current Disclosure Documents

***Kenneth Schulenberg and Moonlight101 v. Handel's Enterprises, Inc., Leonard Fisher, Jim Brown and DOES 1-25*, 2018 U.S. Dist. LEXIS 153129, 2018 WL 4282637**

- If your FDD is amended before the franchise agreement is signed and fees paid, you must redisclose

Failure to Register, con't

Bennion And Deville Fine Homes Inc., et al. v. Windermere Real Estate Servs. Co., 2018 U.S. Dist. LEXIS 222458.

- Failure to register an FDD does not necessarily cause constructive termination of a franchise agreement

Failure to Properly Disclose a Franchisee

***United Studios of Self Defense, Inc. v. Kristopher Rinehart, South Bay Self Defense Studios, LLC, Los Angeles Studios of Self Defense LLC, Brent Murakami and SB Ninja LLC*, 2019 U.S. Dist. LEXIS 37993.**

- Any business arrangement that satisfies the definition of a franchise must adhere to Federal and State laws

Failure to Determine Exemption At Time of Disclosure

Window World of Baton Rouge, LLC, et al. v. Window World, Inc., Window World International, LLC and Tammy Whitworth, 2018 NCBC LEXIS 218, 2018 NCBC 130.

- Determination of whether a prospective franchisee meets the Large Franchisee Exemption can be determined when, and if, a claim of improper disclosure is made, not at the time of disclosure


ROUND 2

Failure to Disclose Transfer Restrictions

***Picktown Foods, LLC, QSR Enterprises, LLC, Hepta Foods, LLC, Triad Foods, LLC, Xexa Foods, LLC, v. Tim Hortons USA, Inc.*, 2017 U.S. Dist. LEXIS 186107**

- If a franchise agreement includes restrictions on transfer those restrictions must be disclosed in Item 17 of its Franchise disclosure Document, but the detailed disclosure of the restrictions is not necessary

Failure to Properly Disclose Does Not Give Private Right of Action

***JTH Tax, Inc., doing business as Liberty Tax Service v. Charles Hines*, 2017 U.S. Dist. LEXIS 218756.**

- Individuals and business entities do not have a private right of action for violations of the FTC Rule, but that such actions must be brought by the FTC itself, which is charged with enforcing the FTC Rule.

Failure to Bring Claim Within Statute of Limitations

Safe Step Walk In Tub Co. v. CKH Indus., 2018 U.S. Dist. LEXIS 161082, 2018 WL 4539656

- Statutes of limitations in Little FTC Acts may bar disclosure violations, but will not necessarily bar violations of other provisions of the Little FTC Acts, depending upon when the facts giving rise to the claim occurred.

Unapproved Franchise Transfer Cases

Meredith Barnes

Corporate Counsel
FOCUS Brands, Inc.

Samaca, LLC v. Cellairis Franchise, Inc.

Background

- Samaca purchased 4 franchise units from existing franchisee;
- Samaca executed 4 new franchise agreements with franchisor, Cellairis, and 4 sublicense agreements to license space in mall;
- All franchise agreements and sublicense agreements contained arbitration provisions;
- Existing franchisee, Samaca and Cellairis executed assignment and assumption agreement ("AA agreement"), which incorporated other agreements by reference;
- AA agreement contained venue selection clause;
- Mall informed Samaca that it would not renew license for spaces.

Samaca, LLC v. Cellairis Franchise, Inc.

Procedural History

- Samaca filed suit against Cellairis seeking to rescind franchise and sublicense agreements;
- Cellairis filed motion to dismiss and to compel arbitration;
- Samaca amended complaint to argue that the arbitration provisions in the franchise and sublicense agreements were superseded by the forum selection provision in AA agreement;
- Trial court granted Cellairis' motion;
- Samaca appealed to Georgia Court of Appeals.

Samaca, LLC v. Cellairis Franchise, Inc.

Analysis

- In order for an agreement to be superseded or discharged, the parties must enter into a subsequent agreement that covers exactly the same subject matter and is inconsistent with the first agreement;
- AA agreement was not subsequent but rather part of a series;
- AA agreement did not subsume but instead incorporated by reference;
- AA agreement was not inconsistent because forum selection could be interpreted to merely identify which state law to apply to disputes;
- Issue of arbitrability should be decided by arbitrator;
- Trial court did not err in dismissing complaint and compelling arbitration.

Byram v. Danner

Background

- Franchisee, Danner, entered into purchase agreement to sell ReMax franchise to Byram;
- Byram defaulted under purchase agreement;
- The parties entered rescission and release agreement.

Byram v. Danner

Procedural History

- Byram filed lawsuit alleging the purchase agreement contained misrepresentation that Danner had power to sell its rights under franchise agreement even though Danner did not have approval for the sale from franchisor;
- The trial court granted motion to dismiss and Byram appealed to Appellate Court of Illinois.

Byram v. Danner

Analysis

- Seller's Warranties provision stated Danner has good title to assets, "except as herein provided otherwise;"
- Section listing assets stated Danner agrees to sell rights under franchise agreement, but only if the franchisor accepts Byram as franchisee;
- Upheld trial court's decision.

Saenz v. Gomez

Background

- Saenz owned Pizza Patron franchises;
- He was introduced to Gomez and represented himself as franchisor's employee;
- Saenz and Gomez entered into agreement for Gomez to buy one location;
- Saenz provided fraudulent documentation in connection with Gomez's loan to buy the franchise;
- Saenz hide unauthorized transfer from franchisor and Gomez;
- Gomez handed business back over to Saenz.

Saenz v. Gomez

Procedural History

- Gomez filed lawsuit alleging fraud;
- Saenz filed bankruptcy;
- Gomez commenced adversary proceeding seeking exception to discharge;
- Bankruptcy court found in favor of Gomez and district court affirmed decision;
- Saenz appealed to 5th Circuit Court of Appeals.

Saenz v. Gomez

Analysis

- Saenz claimed insufficient evidence to support fraud claim;
- Gomez found to be more credible and his testimony regarding misrepresentations was supported by evidence;
- Gomez justifiably relied because Saenz “went to great lengths” to convince Gomez that he could transfer franchise;
- Gomez would not have suffered injury (took out loan to purchase restaurant) without Saenz’s misrepresentations.

Picktown Foods, LLC v. Tim Hortons USA, Inc.

Background

- 5 franchise agreements, each with separate franchisee.
- Sent APAs and request for consent to transfer to franchisor, Tim Hortons ("TH");
- Franchisees claimed TH had calculated different sales price using formula in franchise agreements. Franchisees assumed transfers denied but franchisor gave no reason;
- TH claimed Franchisees were aware that transfer was denied because sales price for 2 locations was higher than permitted by formula.

Picktown Foods, LLC v. Tim Hortons USA, Inc.

Procedural History

- Franchisees filed lawsuit against TH;
- TH filed motion to dismiss;
- Court dismissed all claims except breach of contract and tortious interference with contract;
- TH moved for summary judgment.

Picktown Foods, LLC v. Tim Hortons USA, Inc.

Analysis

- TH argued franchise agreements allowed denial of transfer if sales price exceeded valuation formula;
- Court permitted declarations from Franchisees despite prior deposition testimony where Franchisees stated valuation was correct;
- Court found that TH miscalculated sale prices using depreciated value of equipment formula, which raised genuine issue of material fact.

Picktown Foods, LLC v. Tim Hortons USA, Inc.

Analysis

- TH argued franchise agreements gave it sole discretion to deny transfer;
- Court found this provision was in conflict with provision allowing franchisee to ask court to compel consent;
- Court then looked to parties' intent to determine contract meaning;
- TH did not offer direct evidence of intent so ambiguity remained;
- Court denied SJ as to breach of contract claim.

Picktown Foods, LLC v. Tim Hortons USA, Inc.

Analysis

- TH argued it could not be subject to tortious interference because it was a party to the contracts;
- It was not an outsider to franchise agreement because its consent was required for Franchisees to sign APAs;
- Court found that there was no third party interference and granted SJ to TH on tortious interference claim.

Picktown Foods, LLC v. Tim Hortons USA, Inc.

Final Outcome

- Following trial, Court ruled in favor of TH on all of franchisees' claims;
- Since franchise agreements provided TH with sole discretion to approve transfers, it was free to reject the deals;
- TH could enforce provision that limited franchisee's ability to transfer locations except for the stipulated sales price formula, which was depreciated sales price formula;
- Franchisees' claims failed because proposed sales price exceeded limits of contractual formula.

Franchise Termination and Bankruptcy Cases

Keri McWilliams

Partner

Nixon Peabody

Termination

- When is a violation of franchisor's standards sufficient to support termination?
- ***IHOP Restaurants LLC v. Moeini Corporation*, 2018 U.S. Dist. LEXIS 19707, 2018 WL 76343, (S.D. Ala. Feb. 7, 2018).**

Key Facts

- Franchisee's restaurants received failing grades during multiple operational audits and received an above-average number of customer complaints.
- Franchisor terminated the franchise agreement for violations of system standards, after providing notice and an opportunity to cure.

Key Takeaways and Conclusions

- Repeated violations of food safety standards constitute a material breach of a restaurant franchise agreement.
- Franchisee would be harmed by an injunction requiring de-identification, but the reputational harm to the franchisor outweighed the harm to the franchisee.

Termination

- When is a failure to upgrade technology sufficient to support termination?
- ***Peterbrooke Franchising of America, LLC v. Miami Chocolates, LLC*, 312 F. Supp. 3d 1325 (S.D. Fla Feb. 28, 2018).**

Key Facts

- Following the franchisor's testing and determination that new hardware, software, or technology would be beneficial to franchisees, the franchisee agreed to install the updated technology, as franchisor directed in its "sole and exclusive discretion."

Key Takeaways and Conclusions

- Franchisor was not required to show existing technology was obsolete.
- Termination for refusal to upgrade was reasonable given franchisor's wide discretion under the franchise agreement.

Termination

- When is a cross-default provision sufficient to support termination?
- ***Dunkin' Donuts Franchising, LLC v. C3WAIN, Inc.*, U.S. Dist. LEXIS 167682 (D. N.J. Sept. 28, 2018)**

Key Facts

- During the development of an new location, an existing franchisee misrepresented his involvement with a competing concept.
- The Franchise Agreements permitted termination for violations of the non-competition provisions.
- The Franchise Agreements permitted cross-defaults for fraudulent statements to the franchisor.

Key Takeaways and Conclusions

- Termination of the new location was appropriate.
- Termination of all three franchises would have been disproportionate, and was unnecessary for deterrence.

Termination

- What franchise agreement provisions survive termination?
- ***Service Team of Professionals, Inc. v. Folks*, 2018 U.S. Dist. LEXIS 75899, 2018 WL 2051516 (W.D. Mo. May 2, 2018).**

Key Facts

- Settlement Agreement terminated the Franchise Agreement.
- The Settlement Agreement preserved certain post-termination obligations relating to confidentiality and de-identification, but terminated all other rights and obligations.

Key Takeaways and Conclusions

- As a general rule, dispute resolution provisions generally survive a contract's termination, but can be superseded by the parties' negotiations.
- Because the Settlement Agreement neither included a forum selection clause, nor preserved the forum selection clause in the franchise agreement, no forum selection clause applied.

Bankruptcy

- What notice is required to terminate franchise agreements prepetition?
- ***Dine Brands Global, Inc. v. RMH Franchise Holdings, Inc., (In re RMH Franchise Holdings, Inc.)*, 590 B.R. 655 (Bankr. D. Del. Sept. 18, 2018).**

Key Facts

- Franchisor's notices of default expressly stated that the Franchise Agreements would terminate without further notice at the end of the cure period.
- Franchisor's cure period extensions did not specifically mention termination.
- Franchisor's notices of forbearance delayed any actions to enforce the franchisor's rights.

Key Takeaways and Conclusions

- Termination of a contract must be unambiguous and convey an unmistakable purpose to rescind or forfeit the agreement.
- Neither the extensions nor the notice of forbearance provided sufficient notice of termination.
- Franchise Agreements were the assets of the bankruptcy estate.

Encroachment Cases

Deborah Coldwell

Partner

Haynes & Boone, LLP

ENCROACHMENT

- February 4, 2019
- Hi Deborah,
- By way of this email I would like to extend an invitation to you to participate in the Judicial Update at the 2019 IFA Legal Symposium, May 5 - 7, 2019 at the JW Marriott in Washington, DC.
- Would you be willing to speak on and write the paper for the following topic?
- **Encroachment cases.**
- Andie Snider, | IFA Senior Director, Conferences & Meetings

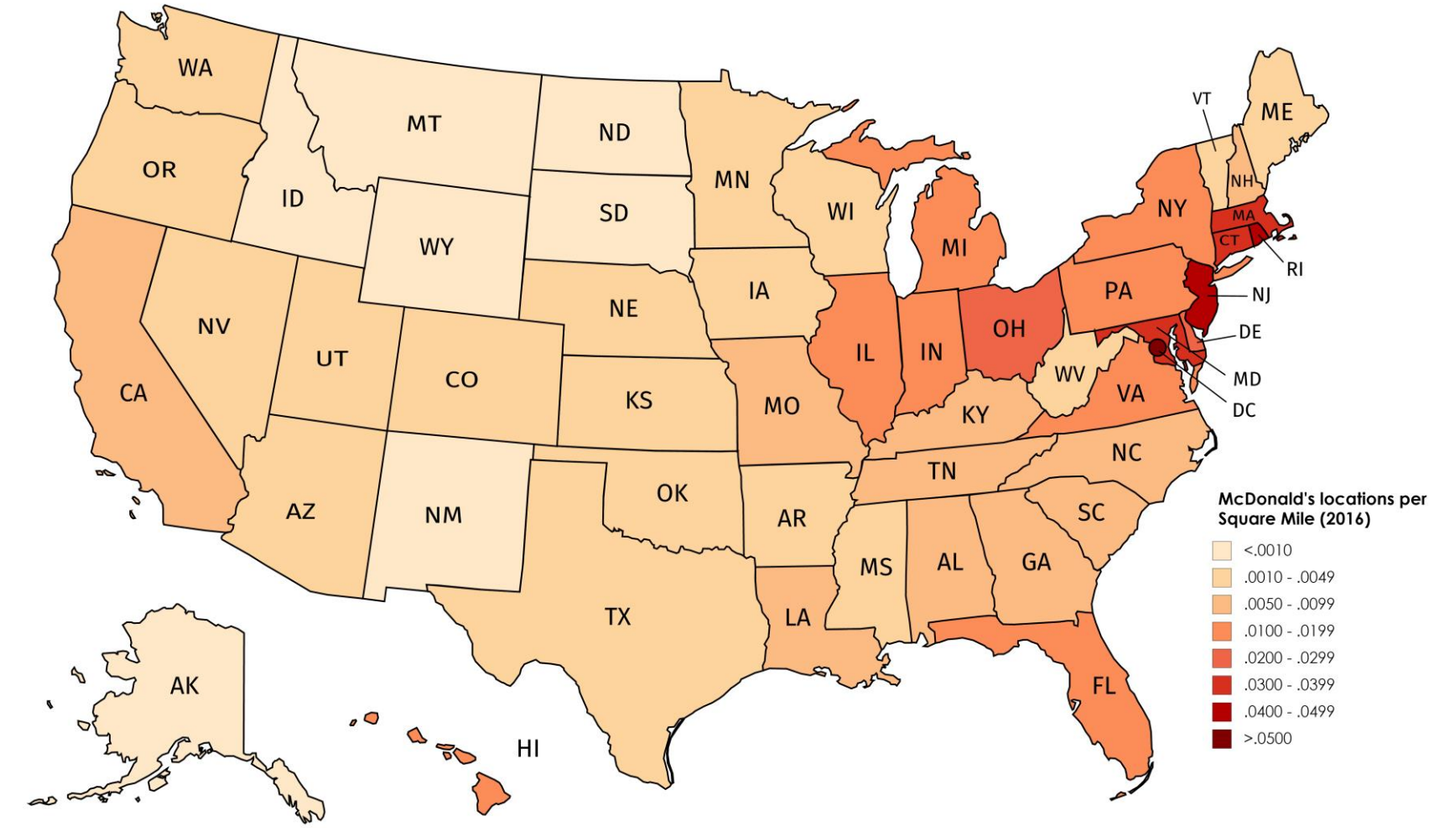
ENCROACHMENT

A Primer on Encroachment

There are multiple avenues through which encroachment may occur

Traditional Territorial Encroachment

- Traditional encroachment occurs when a franchisor approves a location for a new outlet sufficiently close to, or within the territory of, an existing outlet to draw customers away from the existing outlet.



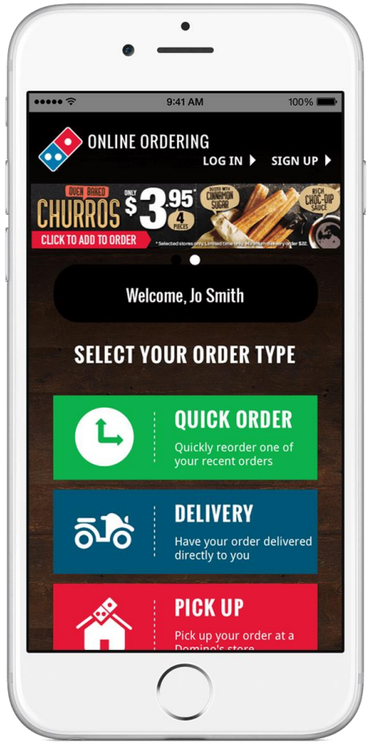
As you can see, the District of Columbia is a hotbed of franchise-related activity…

“Non-traditional” Territorial Encroachment

For example: a small kiosk across the street from a full-service franchise location.

Separate Channels of Distribution

Encroachment Through Direct Sales (particularly Online)



The Rise of the Implied Covenant of Good Faith and Fair Dealing

- "It is axiomatic that a contract includes not only its written provisions, but also the terms and matters which, though not actually expressed, are implied by law, and these are as binding as the terms which are actually written or spoken." ***Scheck v. Burger King Corp.***, 756 F.Supp. 543 (S.D. Fla. 1991).
- ***In re Vylene Enterprises, Inc.***, 90 F.3d 1472 (9th Cir. 1996): Despite acknowledging that franchisee "did not have any rights to exclusive territory under the terms of the franchise agreement, and we do not read any such rights into the contract[,]" the Ninth Circuit went on to hold that franchisor breached the implied covenant of good faith and fair dealing by building a competing restaurant—noting the "bad faith character" of franchisor's restaurant to potentially weaken the franchisee.

The Fall of the Implied Covenant of Good Faith and Fair Dealing

- ***Barnes v. Burger King Corp.***, 932 F. Supp. 1420 (S.D. Fla. 1996): the implied covenant of good faith and fair dealing does not apply where it would contravene the express terms of the agreement.
- ***Chang v. McDonald's Corp.***, 105 F.3d 664 (9th Cir. 1996) [applying Illinois law]: The franchise agreement foreclosed Chang's claims under the implied covenant because the contract "negates any inference that McDonald's actions were so far outside the parties' reasonable expectations as to constitute a breach of the implied covenant."
- ***Burger King Corp. v. Weaver***, 169 F.3d 1310 (11th Cir. 1999): The *Scheck* opinion's "attempt to separate the franchisee's right from the franchisor's duty" is "logically unsound[,]" adding that "if one party to a contract has no *right* to exclusive territory, the other party has no *duty* to limit licensing of new restaurants."

How do Franchisors Prevent Encroachment Claims?

- Drafting franchise agreements to expressly describe the rights and duties of the parties:
  - Expressly denying exclusive territorial rights, or otherwise specifying the scope of a franchisee's territory.
  - Using broad language to reserve a franchisor's right to develop nontraditional markets for goods and services—with particular emphasis on E-Commerce.

ENCROACHMENT

- *Michael D. Bryman, et al. v. El Pollo Loco, Inc.*, Case No. MC026045 (Cal. Super. Ct. Los Angeles Cnty. Aug. 1, 2018) (*appeal docketed*, *Handlers-Bryman, et al. v. El Pollo Loco*, Case No. B292585 (Ca. Ct. App. Feb. 5, 2019)).

ENCROACHMENT

The Bryman Plaintiffs' franchise location at 44402 Valley Central Way, Lancaster, California.

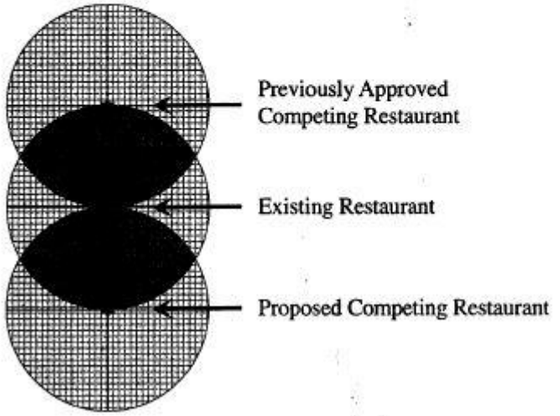
ENCROACHMENT

140. But what happens if the population within the Franchisee's Notification Radius is not evenly distributed, but instead is concentrated in the overlapping area? Assume for example, that one-half of the population within the Franchisee's Notification Radius is within the area of overlap. Now the Franchisee's lost sales has increased to 25% [80% of the 50,000 population is 40,000; 50% of 40,000 is 20,000; losing one-half to the competing restaurant is a loss of 10,000; which results in a loss of 25% of sales (10,000 is 25% of 40,000)].

141. This hypothetical is not an idle one. In fact, in the case at bar El Pollo Loco calculated a two mile Notification Radius ring for Plaintiffs' restaurant based upon a 2012 US Government Census sampling, which encompassed a population of 53,898. See, Ex. 687-001. El Pollo Loco built a competing company restaurant at the Costco Center just outside of Plaintiffs' Notification Radius at a distance of approximately 2.3 miles. El Pollo Loco calculated the population within a 2 mile radius around the Costco location in 2012 as 53,363; a nearly identical population.

The *El Pollo Loco* court went beyond the express provisions of the franchise agreement in scrutinizing the hypothetical impact of intra-brand competition on existing franchisees.

145. Taking the original hypothetical a step further, assume that the Franchisee has stood by and watched El Pollo Loco open the competing company restaurant immediately to the North of its restaurant, but just outside its Notification Radius circle. For the sake of simplicity, assume El Pollo Loco proceeds to open another competing company restaurant immediately to the South of Franchisee's restaurant. The resulting diagram would look like this:



The court even considered hypothetical future actions by the franchisor in evaluating unconscionability.

ENCROACHMENT

- The jury was clearly receptive to plaintiffs' arguments that they were entitled to lost profits due to competition with two corporate-owned restaurants within a five-mile radius which breached the **implied covenant of good faith and fair dealing.**

- Question No. 1: What is the total amount of damages suffered by the Brymans as a result of El Pollo Loco, Inc. breaching the implied covenant of good faith and fair dealing by constructing the corporate restaurant in the Costco Center located at Avenue L and 10th Street East (Impact Damages)? Answer: $2,634,622.00

- Question No. 2: What is the total amount of damages suffered by the Brymans as a result of El Pollo Loco, Inc. breaching the implied covenant of good faith and fair dealing by not offering the Costco Center location at Avenue L and 10th Street East to the Brymans when it became available (Lost Opportunity Damages)? Answer: $2,783,921.00

- Question No. 3: What is the total amount of damages suffered by the Brymans as a result of El Pollo Loco, Inc. breaching the implied covenant of good faith and fair dealing by constructing the corporate restaurant at Avenue J and 20th Street East (Impact Damages)? Answer: $1,721,978.00

- Question No. 4: What is the total amount of damages suffered by the Brymans as a result of El Pollo Loco, Inc. breaching the implied covenant of good faith and fair dealing by not offering the Avenue J and 20th Street East Location to the Brymans when it became available (Lost Opportunity Damages)? Answer: $1,697,285.00

ENCROACHMENT

- This, despite finding that El Pollo Loco's construction of a competing restaurant 2.3 miles away **did not invade plaintiffs' notification radius.**

- Question No. 1: What is the total amount of damages suffered by the Brymans as a result of El Pollo Loco, Inc. breaching the implied covenant of good faith and fair dealing by constructing the corporate restaurant in the Costco Center located at Avenue L and 10th Street East (Impact Damages)? Answer: $2,634,622.00

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ENCROACHMENT

- Startling Findings of Law from *El Pollo Loco*:
  - The court ruling, prior to trial, that express language allowing franchisor to build a company restaurant "in the immediate vicinity of or adjacent to" a franchisee location is "unenforceable as unconscionable."

ENCROACHMENT

- In addition to making these legal findings, the court granted **extremely broad injunctive relief**, enjoining El Pollo Loco from:
  - "Using any mechanism to calculate the population of the [protected] territory" that is "biased towards artificially increasing the population" so as to "decrease the Franchisee's protected territory[.]"

ENCROACHMENT

- In addition to making these legal findings, the court granted **extremely broad injunctive relief**, enjoining El Pollo Loco from:
  - Including in any franchise disclosure document or franchise agreement any provision that "purports to permit El Pollo Loco to place a corporate restaurant in the immediate vicinity of or adjacent to the restaurant of a Franchisee[.]"

ENCROACHMENT

So what was really going on here?

ENCROACHMENT

Is the *El Pollo Loco* case an anomaly or the wave of the future?

State Law Issues Not Covered by the Above

Mark Clouatre

Partner
Nelson, Mullins, Riley & Scarborough LLP

Mercedes-Benz USA, LLC et al. v. Carduco, Inc., 2019 WL 847845

- Texas Supreme Court decision analyzing, among other issues:
  - What is reasonable reliance for purposes of claims for fraud; and
  - Whether a fiduciary duty exists between a franchisee and franchisor.

Mercedes-Benz continued…

- Plaintiff negotiated for the purchase of a dealership in Harlingen, and discussed with Defendant a possible relocation to McAllen.
- Plaintiff's dealer agreement:
  - identified Harlingen as the only authorized location for the dealership;
  - prohibited Plaintiff from relocating the dealership without Defendant's written consent; and
  - permitted Defendant to add dealers into Plaintiff's market area at its discretion.

Mercedes-Benz continued…

- Defendant then entered into a dealer agreement with another entity for a new dealership in McAllen.
- Plaintiff submitted a request to relocate to McAllen.
  - Defendant denied Plaintiff's request.
- Plaintiff asserted claims for, among other things:
  - fraudulent inducement and
  - breach of fiduciary duty.

Mercedes-Benz continued…

- Jury found for Plaintiff against Defendant and three of its representatives and awarded:
  - $15.3 million in actual damages and
  - $115 million in punitive damages.
- Court of Appeals affirmed the jury's verdict but remitted punitive damages to $600,000.

Mercedes-Benz continued…

- Both parties appealed.
- Texas Supreme Court reversed and rendered a take nothing judgment against Plaintiff.

Mercedes-Benz continued…

- Claim for Fraudulent Inducement failed.
- No justifiable reliance that Plaintiff could relocate or be the only dealer in the area because the Dealer Agreement stated:
  - Plaintiff's area was "non-exclusive;"
  - Defendant could add dealers to Plaintiff's area at its discretion; and
  - Any relocation was subject to Defendant's approval.

Mercedes-Benz continued…

- The Court also provided guidance to future contracting parties:
  - "[T]he parties' relationship and sophistication required greater diligence than the execution of a written contract that directly contradicted [Plaintiff's] assumed bargain and assertion of fraudulent inducement."

Mercedes-Benz continued…

- The Court also rejected the claim for breach of fiduciary duty.
- The Court held: a franchisor and franchisee relationship is not special or fiduciary.
  - Although just in dicta, this was an expansion of prior caselaw.

Brooks Automotive Group, Inc. et al. v. General Motors LLC, 2019 WL 452494

- Franchisee operated a dealership in Connellsville and struck a deal to sell to a transferee.
- The transferee, who operated other GM dealerships, intended to relocate the dealership to Belle Vernon.
- Franchisee requested franchisor's approval as required.
- Franchisor denied the request because Belle Vernon was a less desirable location.
- Transferee agreed to stay in Connellsville and approval was granted.

Brooks Automotive continued…

- Franchisee sued because purchase price was less for the second, proposed transaction.
- Franchisee asserts claims for, among other things:
  - tortious interference with contract; and
  - breach of the duty of good fair and fair dealing.

Brooks Automotive continued…

- Like the Texas Supreme Court in *Mercedes-Benz*, the *Brooks* court looked to the parties' agreement.
- The Court found no interference with contract based on the parties' agreement which:
  - "governed changes in management and ownership;" and
  - gave Franchisor "sole discretion in its business judgment to execute its right to refuse consent to a transfer."

Brooks Automotive continued…

- The Court also found no breach of the covenant of good faith and fair dealing because the parties' agreement:
  - "flatly preclude[d] relocation absent GM's approval;" and
  - "[t]he contract does not limit the reasons upon which GM can base its relocation decisions."
- The Court added that the franchisee "can point to no portion of this contract creating 'reasonable expectations' that GM would grant such requests."

JJM Sunrise Automotive, LLC v. Volkswagen Group

- Franchisor encouraged franchisee to upgrade its facilities to modern franchise facility standards, as required by the parties' agreement.
- Franchisee purchased land and upgraded its facilities to comply with its agreement and franchisor's request.
- At same time, franchisor, based on studies of the market, decided to establish an additional location adjacent to franchisee.

JJM Sunrise continued…

- Franchisee sued for:
  - breach of contract;
  - breach of the implied covenant of good faith and fair dealing;
  - tortious interference with a contract;
  - intentional misrepresentation; and
  - negligent misrepresentation.
- Franchisee argued it would not have expanded/renovated if it had known of the new dealer in advance

JJM Sunrise continued…

- The Court disposed of franchisee's claims, again based on the parties' agreement, because the agreement:
  - gave franchisor unfettered discretion to open a new dealership; and
  - "does not give [franchisee] any exclusive right to sell or service Authorized Products in any area or territory."

RAISING THE BAR

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