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2022 Judicial Update

International

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Legal & Legislative Update – International[1]

I. Australia

a. Amendments to the Franchising Code of Conduct

In 2021 and 2022, significant amendments to the Australian Franchising Code of Conduct (the "Code") took effect, after many years of parliamentary inquiry, and as a response to the 2019 Fairness in Franchising Report.[2]

Disclosure - amendments to the Code which took effect with respect to disclosure obligations include:

- disclosure documents may be provided in printed or electronic form, or both
- an updated form of Information Statement setting out warnings relating to the contents of the franchise agreement and franchise relationship
- a prescribed form of a Key Facts Sheet setting out fundamental elements of the disclosure document
- disclosure documents must disclose considerable detail concerning supplier rebates received by the franchisor, including the nature of the rebates or other benefits, the name of each supplier, and the total amount of rebates or other benefits received in the previous fiscal year
- the disclosure document must disclose as much information as practicable regarding required capital expenditures, including: the rationale for the expenditure; the amount, timing and nature of the expenditure; the anticipated outcomes and benefits of the expenditure; and the expected risks associated with the expenditure. This information must be discussed with the franchisee before entering into, renewing or extending the franchise agreement, or, as an alternative, the franchisor can obtain majority consent from the affected franchisees.

Registration – each franchisor who has created a disclosure document under the Code and issued it within Australia before October 31, 2022 must register with the Australian government, and before November 14, 2022. Following that date, a franchisor must register at least 14 days prior to entering into a franchise agreement with a prospective franchisee in Australia. This registry will be publicly accessible at https://franchisedisclosure.gov.au/.

Termination of Franchise Agreements – the amendments to the Code permit a franchisee to terminate its franchise agreement within 14 days of receiving the lease agreement for the subject premises if the franchisor is the lessor of the premises and the lease was not disclosed in the disclosure document. Further, franchisees can now

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[1] The author would like to acknowledge the contributions to this paper by Julia Sergerie, articling student at Dale & Lessmann LLP.

[2] *Competition and Consumer (Industry Codes - Franchising) Amendment (Fairness in Franchising Regulations 2021* (Cth).

request the right to terminate the franchise agreement by providing the franchisor with a written proposal of termination. The franchisor is obligated to reply with its position regarding the notice to terminate, and if the franchisor denies the request, it must provide its reasons within 28 days. Franchisees can then follow up with the franchisor if its response to the notice to terminate is not satisfactory and ask for further justification. If the franchisor has provided further justification for why it is not satisfied with the termination of the franchise agreement and continue to deny the termination of the franchise agreement, the franchisee can escalate this dispute to the alternative dispute resolution ("ADR") mechanisms under the Code.

Penalties – the amendments to the Code have increased the monetary penalties which a franchisor can be liable to pay for violations of the Code.

Dispute Resolution – the dispute resolution amendments to the Code provide for further options and more flexibility to the ADR methods between franchisors and franchisees. Disputes are now permitted to be resolved through mediation and conciliation. The amendments also permit multiple party dispute resolution where two or more franchisees with similar disputes with the same franchisor can refer the disputes to a single dispute resolution process. In order to join the franchisees disputes against a single franchisor, the franchisees can receive consent from the franchisor, request permission of the Australian Small Business and Family Enterprise Ombudsman, or through the referral to an ADR practitioner. The confidentiality obligations under the franchise agreements are not applicable to discussions between franchisees deciding to resolve their disputes together.

Restraint of Trade – if immediately before the expiry of the franchise agreement, the franchisee was not in serious breach, any restraint of trade provisions would be of no effect.

b. Amendments to Australian Consumer Law

The Australian Government has proposed amendments to the existing Australian Consumer Law (the "ACL") to protect consumers and small businesses against unfair contract terms. On February 9, 2022, the amendments to the ACL were officially introduced to Parliament. These amendments may have an effect on certain franchise and distribution agreements. The eligibility requirements that will determine whether a franchise or distribution agreement is subject to these provisions will depend on whether the business has fewer than 100 employees, the business has an annual turnover threshold of fewer than AUD10 million, and whether the business had an effective opportunity to negotiate the contract.

The proposed amendments will provide the courts with more flexible remedies for contract terms that they deem unfair by allowing the court to determine the appropriate remedy rather than the unfair term being automatically void. Unfair contract terms will be considered illegal and will allow courts to impose civil penalties. It will also clarify that the remedies available for "non-party consumers" also apply to "non-party small businesses". There will be a rebuttable presumption provision for terms that are

substantially similar in effect to unfair contract terms, suggesting that contract terms that are the same or substantially similar in effect will also be considered to be unfair.

c. Elements of a Franchise

Freedom Foods Pty Ltd v. Blue Diamond Growers[3]

The primary issue in this case was whether a license agreement entered into for the manufacture, distribution and sale of almond milk products constituted a franchise agreement for the purposes set out in clause 5 of Australia's *Franchising Code of Conduct*.

The court found that the agreement did not meet the Code's test for a franchise, business system or marketing plan, as a number of elements required to satisfy this test were missing, including no provision for training, management structure or marketing plan.

II. Brazil

On March 26, 2020, the amendments to Brazilian Franchising Law were enacted.[4] The most notable changes include:

- parties to a franchise agreement may elect to have a dispute between them submitted to arbitration.
- disclosure documents must now state the rules of transfer or assignment of the franchise, the renewal conditions, and the situations where penalties, fines, or indemnities can arise and their respective amounts.
- the amendments make clear that neither a consumer nor employment relationship exist between franchisors and franchisees, or between franchisors and a franchisee's employees.
- franchisors can lease or sublease commercial spaces to franchisees and charge rent that exceeds the amount paid to the landlord.
- franchisors who not only fail to deliver disclosure documents to the franchisee 10 days prior to signing the franchise agreement, but omit information required by the rules or include false information in their disclosure documents will be subject to penalties.

III. Cambodia

As of January 13, 2020, in order for franchise agreements to be enforceable in Cambodia, the agreements must be registered with the Cambodian Ministry of Commerce. Otherwise, the agreement will have no effect against third parties.

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[3] *Freedom Foods Pty Ltd v. Blue Diamond Growers*, (2021) FCA 172.
[4] *Brazilian Franchising Law* (Law no. 13,996/2019).

IV. Canada

a. Amendments to Ontario's Franchise Legislation

On September 1, 2020, amendments to the *Arthur Wishart Act (Franchise Disclosure),* (the "Act") and its General Regulation came into effect in the Province of Ontario.[5] These changes largely operate to provide flexibility and clarity in connection with certain disclosure obligations and exemptions.

Exceptions to Cooling-Off Period – Consistent with the laws of the Provinces of Alberta and British Columbia, franchisors offering franchises to prospects in Ontario are now permitted to, at any time: (i) collect a fully refundable deposit of no more than 20% of the initial franchise fee; and (ii) enter into an agreement which provides for no more than a fully refundable deposit, franchisee confidentiality and use of information or material supplied, and the designation of a location or territory of the prospective franchised business (the franchise laws of the Provinces of Prince Edward Island, New Brunswick and Manitoba provide for the latter exception, though not the former). U.S. franchisors, in particular, may find these exceptions helpful in nurturing a strong franchise lead in Ontario while their franchise disclosure document is in the process of being adapted for use and compliance in Canada.

Review Standard for Financial Statements – of considerable frustration to many U.S. franchisors offering franchises in certain Canadian provinces has been a requirement to have the franchisor's financial statements prepared in accordance with Canadian GAAP, often resulting in the added expense and effort of engaging a Canadian accounting firm to reconcile the franchisor's financial statements to that standard. The recent amendments to the Act now permit the U.S. financial statements to be used in FDDs issued to prospects in Ontario, provided they meet the standards set out by the Auditing Standards Board of the American Institute of Certified Public Accountants, the Public Company Accounting Oversight Board of the United States, or the Financial Accounting Standards Board of the United States, as applicable.

Disclosure Exemptions – the minimum investment and large investment thresholds which exempt a franchise sale in Ontario from the requirement to issue an FDD have been revised to $15,000 and $3,000,000, respectively. The initial investment for both the minimum and large investment exemption is calculated by factoring in the actual amounts necessary to establish or acquire the franchise and by considering the estimated amounts that will be necessary to establish or acquire the franchise, including any deposits, franchise fees, inventory, leasehold improvements, equipment, leases, rentals and all other property. Further, the eligibility criteria for the fractional franchise exemption in Ontario have been clarified such that the exemption is available for the grant of a franchise to a person who sells goods or services within a business in which that person has an interest if the sales arising from those goods or services "during the

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[5] *Arthur Wishart Act (Franchise Disclosure),* 2000, S.O. 2000, c. 3.

first year of operation of the franchise", do not exceed 20% in relation to the total sales of that business during that year.

Statement of Material Change – a statement of material change document must now be certified by any two directors or officers of the franchisor, using prescribed language, similar to the certification requirements relating to franchise disclosure documents in Ontario.

b. Possible Amendments to French Language Requirements

In May 2021, the Quebec government introduced Bill 96 – *An Act respecting French, the official and common language of Quebec* ("Bill 96").[6] The laws of the Province of Quebec already impose a multitude of restrictions and requirements with respect to the use of the French language in commerce, and Bill 96 fundamentally amends these restrictions and requirements under the *Charter of the French Language* even further in order to enshrine French as the official language of the province.

Under Quebec law, most franchise agreements are considered to either be contracts of adhesion or contracts containing standard clauses. These agreements have been required under the Charter to be written in French, unless the contracting parties agree in writing in both English and French for the agreement to be written in English. Bill 96 provides that this permission to provide a franchise agreement in English to a franchisee in Quebec may only be relied upon after the Quebec franchisee has examined a French version and then provided its consent to receive and sign an English version.

As well, currently, a recognized trademark in a language other than French (meaning a registered or common law trademark) has been exempt from translation requirements on packaging and labelling provided that no French version of the mark has been registered. Bill 96 would narrow the scope of this permission such that it would only apply to registered trademarks, and not common law trademarks.

If Bill 96 is enacted, these amendments are likely to come into force three years after such date. As of the date of writing, Bill 96 is still being debated.

c. Quantification of Damages

1777453 Alberta Ltd. v. Got Mold Disaster Recovery Services Inc.[7]

The Alberta Court of Appeal provided guidance with respect to the quantification of losses which can be recovered in a claim for rescission damages. The franchisor-defendant had not provided the franchisee-plaintiff with a disclosure document as required under Alberta's *Franchises Act*[8] (the "Alberta Act"), and the lower court had

[6] Bill 96, *An Act respecting French, the official and common language of Québec*.
[7] *1777453 Alberta Ltd. v. Got Mold Disaster Recovery Services Inc., 2021 ABCA 9*.
[8] RSA 2000, Chapter F-23

determined that the franchisor was liable to compensate the franchisee's net losses (among other types of damages) as a result.

The lower court was focused on assessing damages based on reliance damages rather than expectation damages, stating that reliance damages are "intended to put the plaintiff back in the same position it would have been had the agreement never been executed". The court went on to conclude that net profits made by the franchisee *after* the date of rescission could be factored into the calculation of the franchisee's net losses if the profits earned were connected to the "assets, training and knowledge the franchisee obtained through the franchise agreement".

On appeal, it was held that rescission damages should only consider those net losses during the term of the franchise agreement up to the point of rescission, and that future profits or losses following the date of rescission exceeded the intent and scope of calculating rescission damages under the Alberta Act[9].

d. Disclosure Documents

2611707 Ontario Inc., et al v. Freshly Squeezed Franchise Juice Corporation, et al.[10]

The Ontario Superior Court of Justice concluded that an objective test should be applied in determining whether deficiencies in a disclosure document were material enough to impact a franchisee's decision to have acquired the franchise at issue, though that test should be applied on a case-by-case basis depending on specific facts of the franchise agreement.

In this case, the following deficiencies were considered sufficiently material to have invalidated the franchisor's disclosure document:

1. The disclosed financial statements were missing pages that contained notes to the statements which would have provided material information.

2. A signed agreement to lease for the location being offered to the franchisee was not disclosed.

3. The disclosure document did not specify that the franchise would be located in a hospital and was the first location in the system that would be located outside of a mall.

This case underscores the importance of customizing disclosure documents in Canada on a case-by-case basis, relative to the particular offering terms and particular location and particular context being presented to the specific prospective franchisee at issue.

2364562 Ontario Ltd. v Yogurtworld Enterprises Inc.[11]

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10 *2611707 Ontario Inc., et al v Freshly Squeezed Franchise Juice Corporation, et al., 2021 ONSC 2323.*

The Ontario Superior Court of Justice dismissed a franchisee's rescission claim and provided clarity with respect to whether certain information must be known at the time of disclosure. In this case, the court decided in favour of the franchisor in concluding that a franchise location does not need to be known at the time of signing the franchise agreement.

Disclosure documents in Canada must include all material facts, which is generally interpreted to include site-specific information where the franchisor has knowledge or control over the location or lease terms.

The franchisee based its claim on a number of alleged deficiencies in the disclosure document, including that the franchisor did not disclose a lack of availability of eligible locations, nor the expected earnings of the franchisee.

In deciding in favour of the franchisor, the court found that unknown future lease costs were within the power and control of the franchisee to negotiate, since the franchisor had merely an approval right with respect to leases. The franchisee had the responsibility to find a location to lease and had the ability to negotiate, which did trigger a franchisor requirement to provide site-specific disclosure. Further, there was no requirement to disclose anticipated earnings.

2619506 Ontario Inc. v. 2082100 Ontario Inc.[12]

The franchisor was found liable, both by the lower court and affirmed on appeal, for rescission damages to a franchisee on the basis that the disclosure document at issue contained financial statements from two years prior to the issuance date. This failure to provide compliant financial statements was sufficiently material as to invalidate the entire disclosure document.

Of particular relevance for franchisors doing business in Canada was that two individual principals of the franchisor were deemed to be "franchisor's associates" under Ontario's *Arthur Wishart Act (Franchise Disclosure), 2000* and personally liable to the franchisee, as well. This was owing to the fact that both individuals were directly involved in the grant of the franchise and had certified the disclosure document, thereby representing to the franchisee that the document was true and complete.

This decision underscores the importance for franchisors doing business in Canada of being mindful of the uniquely Canadian requirements that disclosure documents be certified by any two directors and officers of the franchisor entity, and the corresponding personal liability of those individuals.

e. Good Faith

C.M. Callow Inc. v. Zollinger[13]

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[11] *2364562 Ontario Ltd. v Yogurtworld Enterprises Inc.,* 2021 ONSC 5964.
[12] *2619506 Ontario Inc. v 2082100 Ontario Inc.,* 2021 ONCA 702.

Though not relating to franchising, this Supreme Court of Canada decision revisited and expanded the common law duty of good faith.

The court found that, under certain circumstances, silence can be construed as dishonesty during the performance of one's contractual obligations. In this case, a condominium corporation provided ten-days' notice to terminate its winter maintenance contract with the contractor pursuant to a provision in their agreement. At issue was that the board had made the decision to terminate the contract months before the winter season but did not communicate this with the contractor until days before the season began.

The court decided that the condominium corporation breached its contractual duty to act in good faith by knowingly withholding the information of its intention to terminate, and continuously implying to the contractor that the contract was not at risk of being terminated.

Although the condominium corporation had the right to terminate on short notice, it was not entitled to lie or knowingly mislead the contractor about the issues regarding the performance of the contract. The condominium corporation knowingly withheld that it was not content with the work and led the contractor to reasonably believe that the contract was in good standing and was not at risk of being terminated.

This decision may be particularly relevant for franchisors when considering when and how to communicate to franchisees in Canada that a franchise agreement is being terminated (with or without cause, as applicable) or not renewed for failure to satisfy certain conditions.

2161907 Alberta Ltd. v. 11180673 Canada Inc.[14]

At issue was a license agreement for a cannabis retail store, and the licensor's exercise of a right to terminate on the basis of the licensee ceasing or threatening to carry on business. The licensor had agreed to advance first month's rent to the franchisee, however, when it refused to do so, the licensee e-mailed the licensor that the licensee would be laying off staff and not opening the store for business. The licensee ultimately did open the store, but the position of the licensor was that the licensee had expressed a threat to cease carrying on its business, and consequently terminated the license agreement on that basis.

The application judge found that the licensor breached both the terms of the license agreement and the duty of good faith, since it was evident that the licensee's threat had been more of an emotional response and there was no credible threat of a cessation of the business. Further, the evidence supported that the licensor had been seeking means of ending its relationship with the licensee.

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[13] *C.M. Callow Inc. v Zollinger, 2020 SCC 45.*
[14] *2161907 Alberta Ltd v 11180673 Canada Inc.*, 2021 ONCA 590.

On appeal, the ruling that the license agreement had been invalidly terminated was upheld, but the appeal was allowed on the issue of good faith. "Pouncing" on an opportunity to end a contractual relationship did not rise to the level of breaching the duty of good faith. Moreover, to have satisfied the test for a breach of good faith, a party needs to have knowingly misled the other party to trigger a breach, which was not evident here.

f. Joint Employer

Sobeys Capital Incorporated/Sobeys Capital Incorporee[15]

The British Columbia Labour Relations Board (the "Board") found that Sobeys Capital Incorporated ("Sobeys") (the franchisor of a chain of grocery stores) and its franchisees were, collectively, a common employer under the British Columbia *Labour Relations Code*.

The United Food and Commercial Workers International Union, Local 1518 (the "Union") argued that Sobeys franchise structure possessed substantially more control over the franchisees than what was commonly found in a franchisor and franchisee relationship, as Sobeys was a shareholder of each of the franchises at issue. Sobeys and its franchisees argued that their particular franchise relationship is not novel, though the Board did not comment on whether the franchise arrangement provided Sobeys with substantially more control over its franchisees than is customary.

The Board confirmed that the requirements for making a common employer declaration pursuant to the Code were:

1) more than one entity is carrying on a business or activity;
2) the entities are under common control or direction;
3) the entities are engaged in associate or related activities or business; and
4) there is a labour relations purpose for making a common employer declaration.

The Board was particularly focused on the second and fourth elements above and found that the nature of the franchise agreement provided Sobeys with substantial control over its franchisees. The Board also decided that by virtue of Sobeys' ownership of shares of the franchisee entities, Sobeys ought to be deemed a common employer.

Sobeys and several of the franchisees sought leave for reconsideration of the Board's decision. They were granted leave for reconsideration on the basis that the parties were entitled to an oral evidentiary hearing.

g. Trademarks

Miller Thomson LLP v. Hilton Worldwide Holding LLP[16]

[15] *Sobeys Capital Incorporated/Sobeys Capital Incorporee, 2021 BCLRB 97.*
[16] *Miller Thomson LLP v. Hilton Worldwide Holding LLP, 2020 FCA 134.*

The Federal Court of Appeal upheld the decision of the Federal Court of Canada to maintain the registration of the trademark WALDORF-ASTORIA in association with "hotel services", notwithstanding that Hilton (the owner of the trademark) does not have any Waldorf-Astoria hotels in Canada.

The trademark registration was the subject of cancellation proceedings on the basis that the mark was not actually in use in Canada since no brick-and-mortar hotels bearing the mark had ever been operated within Canada.

Hilton filed evidence of use of the trademark in association with its website, online reservation services, and rewards and loyalty programs, all of which were offered to, and accessed by, Canadian customers who made reservations and accumulated points relating to their stays at Waldorf-Astoria properties in the United States.

The Opposition Board of the Trademarks Office allowed the cancellation on the basis that Hilton's evidence supported use of its trademark in association with services ancillary to the operation of a hotel, and this did not rise to the level of use in association with "hotel services".

The Federal Court of Canada took a contrary view and stated that the concept of "services" should be interpreted broadly so that services which are incidental or ancillary to the primary services ought to constitute the use of those primary services in association with the mark. To that end, the evidence established that Canadian customer were able to derive a tangible and meaningful benefit of the mark in association with hotel services.

This decision was upheld by the Federal Court of Appeal, which noted that the use of incidental or ancillary services in association with a trademark must be assessed on a case-by-case basis. In this instance, the overall evidence supported a multitude of Canadian customers using booking and payment systems online, which were integral to the provision of hotel services.

The decision in this case may be quite relevant to international brand owners seeking to acquire or maintain a trademark registration in Canada despite having not operated or franchised a brick-and-mortar outlet there. Relevant evidence of use may include Canadian customers booking reservations or participating in loyalty programs in connection with their visit to an outlet outside of Canada.

Subway IP LLC v Budway, Cannabis & Wellness Store[17]

The Federal Court of Canada decided a trademark infringement case in favour of the trademark owner, notwithstanding that the parties sold their products through different channels of trade.

[17] *Subway IP LLC v Budway, Cannabis & Wellness Store*, 2021 FC 583.

At issue was whether the top image below which was used in association with a cannabis retail store was infringing of Subway's well-known trademark, used in association with its restaurant services.

Of relevance to brand owners doing business in Canada, the court found that the Subway trademarks had a sufficiently high degree of inherent distinctiveness that it extended far enough to preclude the use of similar marks in association with different services and different natures of trade. Of greater relevance, the court found that Subway proven that the use of the Budway trademark at issue was likely to depreciate the goodwill attached to the Subway mark, contrary to Canada's *Trademarks Act* since the necessary elements of deprecation of goodwill had been established, namely (i) use, (ii) goodwill, (iii) linkage, and (iv) damage.

h. Enforceability

Coffee Time Donuts v. 2197938 Ontario Inc.[18]

This decision provided clarity with respect to the enforcement of the terms of a franchise agreement after it has expired, but the franchisee continues to operate.

At issue was a franchise agreement which expired in 2014. The franchisee continued to pay royalties until 2016, at which point it ceased to do so, yet continued to operate until 2021 bearing the franchisor's trademark and following its system standards.

The franchisee submitted that it believed it was able to operate without payment obligation to the franchisor following expiration of the franchise agreement, and its payments made between 2014 and 2016 were merely a courtesy. The Ontario Superior Court of Justice stated that this position "flies in the face of commercial realities" and concluded that the terms of the expired franchise agreement were effective until 2021, since it was evident from the conduct of the parties that the agreement was being followed during that interim period (notwithstanding the non-payment of royalties).

The court awarded damages of the amounts billed in the period of the claim which fell within the applicable limitation period, plus the interest on late payments contemplated within the franchise agreement.

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[18] *Coffee Time Donuts v 2197938 Ontario Inc.,* 2021 ONSC 3109.

1384334 Alberta Ltd. v. Buster's Pizza Donair & Pasta Enterprises Ltd.[19]

At issue was the enforceability of an apparent verbal agreement to open a franchised restaurant location.

A principal of the franchisor entered into a lease with the franchisee to open a franchised location. The parties verbally agreed that the franchisee would develop the premises in a manner consistent with the franchisor's design standards at its other locations, which subsequently led to a dispute. The franchisee argued that it was entitled to rescind the verbal franchise agreement and to corresponding rescission damages under Alberta's *Franchises Act*, notwithstanding that no written agreement was ever signed.

The court concluded that the essential terms of a verbal agreement had not been agreed to before the restaurant opened, and that it was clear that the franchisee had not been willing to agree to the terms of any written agreements. Since a verbal franchise agreement could not be established as having been entered into, the franchisor was not liable for rescission damages arising from an alleged verbal franchise agreement.

V. Egypt

In 2019, the government of Egypt released a proposed draft of franchise legislation. As of the date of this writing, the draft legislation is under debate.

VI. European Union

a. Competition Law

Competition law in the European Union ("EU") is governed by the Treaty on the Functioning of the European Union (the "TFEU").[20] The objective of the TFEU is to prevent or limit the abuse of substantial market power and free competition among enterprises conducting business within the EU.

Certain terms and restrictions which are systemic to conventional franchise agreements may fall within the scope of the TFEU, such as requirements that franchisees purchase products exclusively from sources designated by the franchisor, or non-competition covenants. EU competition law, though, has historically recognized that restrictions of this nature are unique to the franchise relationship and necessary to protect brand goodwill and standards of operation across multiple channels and borders. A franchise agreement is a type of "vertical agreement" which may violate EU competition law if it can affect trade within the European Economic Area.

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[19] *1384334 Alberta Ltd v Buster's Pizza Donair & Pasta Enterprises Ltd,* 2020 ABQB 369.

[20] *Treaty on the Functioning of the European Union* (TFEU) [2016] OJ C202/1.

To that end, the EU's Vertical Block Exemption Regulation on Vertical Restraints (the "VBER") has exempted franchise relationships from the application and purview of the TFEU provided that the market share of the subject franchisor's and franchisee's business does not exceed 30%, and the franchise or distribution agreement at issue does not contain "hardcore" restrictions, such as prohibiting franchisees from setting their own prices or from selling online.

The European Commission (the "Commission") had been reviewing the VBER and its accompanying Guidelines on Vertical Restraints to determine whether they should be renewed, lapse or be amended in view of new market developments, including the manner in which consumers engage in electronic commerce, and reconciling changes in consumer habits and technology with the need of franchises to maintain systemwide uniformity.

Since customers are no longer limited to purchasing products and services from brick-and-mortar locations, the VBER has been revisited to determine how franchisors and franchisees can co-exist in an anti-competitive nature, in spite of a franchisor's need to control sales channels between franchisees and their customers and obtain considerable data and information on franchisees' customers, while still operating in the same market as many of those franchisees in a unique dual-distribution system.

As described above, the current competition laws in the EU exempt franchise agreements from their application and permit franchisors to also sell directly to end users if neither franchisor nor franchisee have an individual market share exceeding 30%. Proposed amendments to the VBER would deny this exemption to franchisors if the combined market share with franchisees exceeds 10%.

In February 2022, the Commission released a proposed rule allowing for information exchanges in a dual-distribution system provided it was "necessary to improve the production or distribution of the product", including in respect of those businesses which fall within the scope of the 30% threshold for individual market share. To that end, if these rules are adopted, franchisors operating in the EU may need to revisit the type and nature of information required to be delivered by franchisees in order to limit it as much as possible to a "need to know" basis.

The guidelines which will inform and clarify the new VBER rules will include examples of information deemed necessary to improve the production or distribution of a product, such as customer-specific data, non-aggregated information on sales and customer identity. Of course, if these new rules are adopted, and franchisors are prohibited from requiring that certain customer and sales data is reported by franchisees, this would be quite challenging and burdensome in order to plan for business intelligence, product development and customer loyalty and engagement.

In February 2022, the Commission released guidance with respect to the types of information exchanges within a dual distribution relationship (including franchises) that may or may not satisfy the "necessity" criteria.

Permitted exchanges of information between franchisors and franchisees would include:

- technical information relating to the subject products or services
- information relating to supply, such as inventory levels, sales volumes and returns
- aggregated information relating to purchases and customer preferences and feedback
- pricing information
- recommended resale prices
- marketing information

Prohibited exchanges of information would include:

- information on actual future prices at which products will be sold downstream
- customer-specific sales data, including non-aggregated volume
- information relating to goods sold by a buyer under its own brand name which is exchanged with a manufacturer of a competing brand

As of the date of this writing, the current VBER rules will expire on May 31, 2022, and the new VBER rules and their corresponding guidelines have not been finalized.

b. Data Transfers

On June 4, 2021, the European Commission issued new Standard Contract Clauses ("SCCs") for the sharing and transfer of data of EU residents. This change followed a 2020 decision by the EU Court of Justice that the previous SCCs did not provide adequate protection for personal data and personal data transfers relating to EU residents. The new SCCs are to be used as provided, without amendments, in all contracts for data transfers between the EU and a recipient of personal data in another country. The maximum penalties for non-compliance are equal to the greater of €20 million or 4% of a company's global annual sales.

The new SCCs came into effect for all new data transfers on June 27, 2021. All existing transfers that use the previous SCCs must move all these transfers to the new SCCs by December 27, 2022.

c. Digital Commerce

In December 2020, the Commission presented the *Digital Services Act*, which was agreed to by the EU Parliament in March 2022 and must now be approved by the Permanent Representatives Committee before becoming law. If approved, the *Digital Services Act* would provide more robust mechanisms for brand owners to report online intellectual property infringement and the sale of infringing goods and have their IP ownership rights enforced.

VII. Italy

The Italian Antitrust Authority (the "AGCM") opened an investigation against the Benetton Group S.r.l. ("Benetton") for an alleged abuse of economic dependence, concerning a franchise agreement with a franchisee for the sales of their products. This investigation began as a result of a complaint by a former franchisee who operated two Benetton franchises. The franchisee claimed to have suffered an abuse of economic dependence that led to the cessation of operations of both franchises. The AGCM's preliminary analysis claimed that the alleged abuse relates to contractual clauses that are in the franchise agreement that have permitted Benetton to influence the franchisee's decisions and ultimately, preventing the franchisee from managing its own franchises, creating economic dependence on the franchisor. Although the AGCM is investigating this complaint, Italian courts have to date never found franchise arrangements as creating a relationship of economic dependence. As of the date of this writing, the investigation has not yet been completed.

VIII. Malaysia

On March 6, 2020, the Franchise (Amendment) Act (the "Amendment Act") was published though is not yet in effect.[21] The Amended Act will amend the Franchise Act 1998. The amendments require additional registration for foreign franchisors, as they must obtain approval from the Franchise Registry.

IX. Nigeria

The National Office for Technology Acquisition and Promotion Act, requires that all agreements which provide for the import of intellectual property (including a franchise agreement) must be registered with the National Office for Technology Acquisition and Promotion.[22]

X. Netherlands

The Dutch Franchise Act (the "Act") came into effect on January 1, 2021.[23] Pursuant to the Act, a franchisor must provide disclosure materials at least four weeks prior to the conclusion of the sale, and during this four-week cooling off period, the franchisor is prohibited from requiring any payment from the prospective franchisee and from making any changes that would be to the detriment of the franchisee.

The Act states that a franchisor is required to provide all information that can reasonably be expected to be of importance to a franchisee before executing the franchise agreement, including the franchise agreement, financial obligations required of the franchisee, and the extent to which a franchisor may compete with the franchisee.

In addition, the franchisor must provide the financial information about the prospective location of the franchise, and if this information does not exist, the franchisor is required to disclose the financial information of a similar location along with

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[21] *Franchise (Amendment) Act 2020.*
[22] *Nation Officer for Technology Acquisition and Promotion Act cap 268 LFN 1994.*
[23] *Dutch Franchise Act* [2021].

reasons for why this location is comparable. There exists an ongoing obligation to disclose information and provide an annual update about the allocation of fees or contributions paid by the franchisee.

Franchisors must also consult with their franchisees at least once per year and must set a maximum investment cap or minimum loss cap that a franchisee will incur as a result of new programs, new fees, or other investments franchisees can be required to make without amendments to the franchise agreement.

XI. Poland

In July 2020, the Ombudsman for Small and Medium-Sized Enterprises appointed a working group to prepare draft franchise legislation.

XII. Saudi Arabia

In April 2020, The Commercial Franchise Law (the "Franchise Law") came into effect in Saudi Arabia.[24] This was the first franchise legislation to be enacted in Saudi Arabia to specifically regulate and govern franchising. The Franchise Law requires that the franchise agreement and disclosure document are registered with the Ministry within 90 days of execution and be translated into Arabic. In order to sell franchises to a franchisee, the franchisor must prove that two franchises have operated individually for at least one year, which can include master franchisees.

The disclosure document must be provided to a franchisee within 14 days before signing the franchise agreement, or any payment toward the franchise. The disclosure document must be up to date and accurate, and if there are any material changes after the disclosure document has been provided to the franchisee, the franchisor must submit a new disclosure document to the franchisee or provide a document that describes the material changes as soon as it is feasible and before the franchise agreement is executed. The disclosure document must also contain a copy of the franchise agreement.

XIII. South Africa

On January 29, 2016, a draft Industry Code for the Franchise Industry (the "Code") was published for public comment. The Code includes methods of dispute resolution between franchisors and franchisees, and the establishment of a "Franchise Industry Ombud" (the "Ombud") to assist in resolving disputes. The Ombud decision is not binding on the parties unless the parties agree, and it does not remove the ability of parties to bring the dispute to court or arbitration. The process of codification of the Code is currently underway, as the draft proposal has been submitted for deliberation to the Consumer Protection Commission. The codification of the Code would provide a regulatory framework for franchising. The Code will be a self-funded model financed through levies on franchisors and franchisees.

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[24] *Commercial Franchise Law* 122/1441 [2020].

XIV. South Korea

On November 19, 2021, the amendments to the Fairness in Franchise Transactions Act (the "FFTA") came into effect.[25] The FFTA amendments introduced a requirement that franchisors must have one year of experience in directly operating one or more stores before franchising in South Korea. This requirement will not be applicable to franchisors who have already registered a disclosure statement with the Korea Fair Trade Commission, or franchisors that business models have already been approved as sustainable through earning another type of license or qualification. Further, (i) franchise fees must be deposited by franchisees in escrow to a designated financial institution, (ii) franchisors are subject to increased disclosure obligations regarding sales of their products online and through the stores they manage directly, and (iii) small-size franchisors are no longer exempt from the obligation to register disclosure documents.

XV. Thailand

A notification regarding the Guidelines for the Consideration of Unfair Trade Practices in Franchise Businesses (the "Guidelines") became effective on February 4, 2020, to afford more protection to franchisees against unfair contractual conditions. The Guidelines impose a few main obligations on the franchisor. Foremost, there is an obligation on the franchisor prior to entering into the franchise agreement to disclose important information such as: the remunerations and business costs of the franchise including, the royalty fee and other mandatory fees relating to the operation of the franchise; the franchise business plan; the relevant intellectual property rights and their license terms; and the terms and conditions for renewal and termination of the franchise agreement. In addition, if a franchisor will open and operate an outlet by itself, the franchisor must notify its franchisee whose outlet is located in the "nearest area" and offer such franchisee the right of first refusal with a reasonable period of time for the franchisee to respond to the offer.

The Guidelines prohibit franchisors from certain unfair trade practices that may cause damages to franchisees. In order to determine whether or not the trade practice is unfair, the following will be considered:

1. Setting unreasonable conditions against the rights of the franchisee, for-instance, exclusive purchasing of products that are not related to the franchise.

2. Requiring the franchisee to purchase products or services that were not included in the franchise agreement, except if it is appropriate business reason or necessity for the franchisor to maintain its reputation, quality and business standards.

3. Prohibiting franchisees from purchasing similar products from other producers of equivalent quality at a cheaper price.

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[25] *Fair Transactions in Franchise Business Act.*

4. Unreasonably restricting franchisees from offering perishable or expiring products for a discounted price.

5. Including different terms and conditions for other franchisees leading to discriminatory trade practices.

6. Enforcing any other inappropriate terms or conditions for purposes other than to maintain quality, reputation and standards that were agreed to in the franchise agreement.

XVI. United Kingdom

The Competition and Markets Authority has published a recommendation for adopting a United Kingdom Vertical Restraints Block Exemption (VABEO). This would come into effect and apply to vertical agreements as of June 1, 2022, replacing the previous legislation. The legislation is similar to the EU's proposed VBER amendments.

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2022 Judicial Update

Joint Employment and Misclassification: Decisions and Trends

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JOINT EMPLOYMENT AND MISCLASSIFICATION:
DECISIONS AND TRENDS

I. Developments In Joint Misclassification Cases

A review of the decisions issued over the last year shows that there has been no decline in the number of lawsuits asserting that franchisors should be deemed joint employers of their franchisees' employees. If anything, the converse seems to be true. Although no groundbreaking decisions came out last year, the decisions that were issued reinforced some principles that have emerged in past years, and perhaps signaled that some things that have been taken for granted are no longer assured.

To being with, last year's joint employment decisions showed that, as in past years, it remains exceedingly difficult to get rid of joint employment claims at the pleading stage. In fact, the few instances where franchisors were successful in obtaining dismissal largely involved cases in which the plaintiffs were proceeding *pro se*. In *Stewart v. Chick-Fil-A Inc.*, for example, a franchisee's employee, proceeding *pro se*, filed a lawsuit alleging she had been sexually harassed, retaliated against, and discriminated against on the basis of her age and gender.[1] She named as defendants the franchisee she worked for, the individual owners of the entity that owned the franchise, and the franchisor. After all the defendants moved to dismiss the complaint, the court granted the plaintiff leave to file an amended complaint. She did so, but as with the original complaint, her amended complaint contained no allegations which explained why Chick-Fil-A was liable for her employer's allegedly wrongful actions. The court therefore dismissed the action as to Chick-Fil-A with prejudice but allowed some of the plaintiff's claims to proceed as to the other defendants.

The plaintiff and the remaining defendants subsequently participated in a mandatory settlement conference, which successfully resolved their disputes. However, about six weeks prior to the settlement conference, the plaintiff had filed another complaint, this one solely against Chick-Fil-A, in state court. Chick-Fil-A removed that suit to federal court and filed another motion to dismiss. The court granted that motion, with prejudice. It noted that, as in the prior proceeding, the plaintiff neither alleged that Chick-Fil-A was her employer nor sufficiently alleged that Chick-Fil-A was her joint employer.[2] Her only allegation—that there was an "operator's agreement" between Chick-Fil-A and her employer—was insufficient, as that "merely show[ed] that she was employed by a [Chick-Fil-A] franchisee."[3]

Mitsubishi Motors was similarly successful in obtaining the dismissal of a lawsuit which alleged it was liable as a joint employer for the hostile work environment and adverse employment actions allegedly experienced by a dealership's employee. In *Nelson v. Argyropoulous*, the plaintiff claimed he was subjected to a variety of race- and

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[1] Case No.: 21cv587-CAB-DEB, 2021 WL 2290770 (S.D. Cal. June 4, 2021).

[2] *Id.* at *2.

[3] *Id.* at *2 n.3.

age-related slurs by the dealership's employees, physically struck by one employee, undermined by other employees, and ultimately terminated based on his age and race.[4] Proceeding *pro se*, the plaintiff asserted that Mitsubishi Motors was liable for these alleged wrongs because it "exercised control over" its franchisee's daily operations.[5] In the plaintiff's view, this control was evidenced by both the training program Mitsubishi Motors implemented and its rewards program, "which awarded salespeople a payment for every [Mitsubishi] vehicle sold."[6]

A Magistrate Judge recommended that the district court dismiss the plaintiff's claims against Mitsubishi Motors, and the plaintiff filed a timely objection to the Magistrate's Report and Recommendation. Although the court noted that the plaintiff had failed to exhaust his administrative remedies against Mitsubishi Motors (because he did not name Mitsubishi Motors in his EEOC charge), the court nonetheless addressed the Magistrate's alternative recommendation that the plaintiff's claims against Mitsubishi Motors be dismissed "due to a failure to establish an employer/employee relationship between him" and Mitsubishi Motors.[7]

As a general rule, when a party makes objections to a Magistrate's report and recommendation, a court reviews that report and recommendation *de novo*. However, "when a party makes only conclusory or general objections, or simply reiterates his arguments, the court reviews the report and recommendation strictly for clear error."[8] Concluding that the plaintiff's objections were conclusory, the court applied the clear error standard in reviewing the Magistrate's recommendations. It found none. The court first concluded that the Magistrate did not commit clear error in deciding that Mitsubishi Motor's training program was insufficient to create an employer/employee relationship.[9] The court noted that the plaintiff's other objection—that the Magistrate erroneously failed to apply the "horizontal joint employer" test—was likewise unfounded. Without commenting on whether that test would have supported a claim against Mitsubishi Motors, the court held that the Magistrate correctly concluded that while the test was applicable to FLSA claims, it did not apply to claims under either Title VII or the Age Discrimination in Employment Act.[10]

In *Morana v. Park Hotels & Resorts, Inc.*, the court also dismissed allegations that a franchisor was a joint employer, but it did so under very different circumstances.[11] The plaintiff in *Morana* worked as a banquet server at the Waldorf Astoria and later, when that hotel closed, at the New York Hilton Midtown. After his employment ended, he filed a

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4 18 Civ. 11413 (AT) (SDA), 2021 WL 4352326 (S.D.N.Y. Sept. 24, 2021).

5 *Id.* at *1.

6 *Id.*

7 *Id.* at *3.

8 *Id.* at *2 (internal quotations and citations omitted).

9 *Id.* at *3.

10 29 U.S.C. § 621 *et seq.*

11 20-cv-2797 (RA), 2022 WL 769327 (S.D.N.Y. Mar. 14, 2022). DLA Piper LLP (US) represented Hilton Worldwide Holdings, Inc. in this matter.

putative class action against the entities that employed him claiming that tips that were intended for him and the other putative class members were unlawfully retained by his employers. Hilton Worldwide Holdings, Inc. ("Hilton"), which directly or indirectly owned those entities, was also named as a defendant on the theory it was his joint employer.

Hilton moved to dismiss the complaint for lack of subject matter jurisdiction. Specifically, Hilton alleged that, because there were not more than 100 putative class members, the Class Action Fairness Act ("CAFA")—which requires that there be more than 100 class members, and which was the sole asserted basis for the district court's exercise of jurisdiction—did not apply.

To prevail on this argument, Hilton needed to establish, among other things, that the individuals who worked at franchised hotels were not properly considered members of the putative class. And to establish that, Hilton needed to show that it was not, as plaintiff claimed, the joint employer of all those employees.

Addressing the standards applicable to claims of joint employment in the Second Circuit, the court noted that other courts within the Circuit had allowed claims of joint employment to proceed where the franchisor: imposed mandatory training programs for employees; maintained the right to inspect a hotel at any time; imposed mandatory requirements for record keeping; established standards and controls for the development and operation of a hotel; retained the right to make changes in the way in which a hotel was operated; regularly performed inspections to review compliance with financial record-keeping requirements; and was aware that workers were not paid gratuities owed to them but took no steps to stop that practice.[12] Such claims had also been deemed viable where the plaintiff alleged that the franchisor set and enforced operational requirements, required franchisees to track hours and wages, monitored employee performance, and exercised control, direct or indirect, over timekeeping and payroll practices and employee performance.[13]

The court held that the plaintiffs' complaint pled none of these facts. In their place, it simply recited, without any factual support, the factors courts consider in determining whether an entity is properly deemed a joint employer. The plaintiff's claim that he could not make specific allegations because he did not have access to Hilton's franchise agreements was unavailing. The court held that even without those agreements, the plaintiff did "not make any allegations—on the basis of information and belief or otherwise—that Defendants exercised formal or functional control over the franchise hotel workers."[14] For these reasons, the court held that the employees of the franchised hotels were not properly considered members of the putative class and that, as a result, the plaintiff had failed to plausibly allege the existence of 100 class members as required by CAFA.[15]

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12 *Id.* at *6.

13 *Id.*

14 *Id.*

15 *Id.* at *9.

The ruling in *Morana* is far more the exception than the rule, as courts are typically reluctant to grant motions to dismiss joint employment claims. In fact, about one month earlier, a judge in a different district in the same Circuit allowed substantially identical claims to withstand a motion to dismiss. In *McArdle-Bracelin v. Congress Hotel, LLC.*, a different banquet server brought suit against the franchisee she worked for claiming, among other things, that her employer improperly retained service charges that were intended for her and the other putative class members.[16] Both the franchisor of the hotel, Embassy Suites Franchise LLC, and Hilton Franchise Holding LLC were named as additional defendants on the ground they were allegedly joint employers of the members of the putative class.

Embassy Suites and Hilton moved for judgment on the pleadings claiming that the plaintiff had not alleged facts sufficient to sustain the claim they were joint employers. The court disagreed. Reviewing the allegations of the complaint, the court noted that the plaintiff had alleged that the defendants: licensed their trademarks and operating system to the franchisee; required the franchisee to use their software and hardware systems, which include revenue management, learning management and proprietary reservations systems; required franchisees to use their training materials and to conform to all rules and regulations; and provided additional training to the franchisees' employees in a way that impacted class members' working conditions.[17] Although these allegations did not indicate that the defendants had formal control over the class members—*i.e.*, none of them showed that either defendant kept employment records or had the power to hire, fire, or set the wages of hotel employees—they did enough, in the court's view, to make plausible the claim of joint employment.[18]

The defendants' other argument, which asserted that the complaint impermissibly used group pleading and failed to identify which defendant allegedly committed which act, was also rejected. The court held that "asserting claims against a group of defendants is appropriate if those defendants allegedly acted in concert to violate a Plaintiff's rights," and that "[a] complaint that pleads enough facts to make claims of such wrongdoing plausible need not then describe each defendant's particular role in detail to avoid dismissal on 'group pleading grounds.'"[19]

While the link between the allegations in *McArdle-Bracelin* and control over working conditions appears tenuous at best—the court in fact acknowledged the plaintiff's allegations were "sufficient, if barely, to state a claim"—another opinion highlights even more clearly how little is often required for a joint employment claim to survive a motion to dismiss.[20] In *Patzfahl v. FSM ZA, LLC*, a pizza delivery driver filed a putative class action alleging that he and all other delivery drivers were not properly compensated for

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16 1:20-dv-861 (TJM/TWD), 2022 WL 486805 (N.D.N.Y. Feb. 17, 2022).

17 *Id.* at *4.

18 *Id.* at **4-6.

19 *Id.* at *7.

20 *Id.* at *6.

the expenses they incurred delivering pizzas.[21] One of the defendants, whose liability rested on the assertion it was a joint employer, moved to dismiss on the ground that the plaintiff's allegations were "vague and barebones conclusions" that did nothing more than recite the elements of a joint employment claim.[22] The allegations referenced in the opinion seemed to support this argument. Specifically, the entirety of the plaintiff's allegations apparently consisted of the following: that the plaintiff was an employee of the defendant and that the defendant "has substantial control over Plaintiff['s] … working conditions, has direct or indirect control of the terms and conditions of Plaintiff's work, and maintains control, oversight, and direction over Plaintiff … including, but not limited to, hiring, firing, disciplining, timekeeping, payroll, reimbursements, pay rates, deductions and other practices."[23] The court nonetheless denied the motion to dismiss, concluding that the allegations were "factual matters that, if proven," would establish a violation of the FLSA or state law.[24]

Two other district courts, addressing joint employment claims against McDonald's, took a similarly lenient view of what is required to sustain a joint employment claim at the pleading stage. In *Johnson v. McDonald's Corp.*, for example, an employee of a McDonald's franchisee claimed she was sexually harassed and assaulted while she worked at a franchised restaurant.[25] She filed suit against the franchisee, McDonald's Corp., and McDonald's USA, LLC alleging violations of Title VII of the Civil Rights Act.

The McDonald's entities moved to dismiss. They first asserted that the plaintiff had failed to allege facts specifying why each entity was liable for the wrongs she alleged she experienced. While it acknowledged that "it would have been preferable for the Plaintiff to plead specific facts regarding each corporate defendant," the court refused to dismiss the complaint on this basis.[26] It noted that the Plaintiff was employed for only a few months, may not have known what role each entity played with respect to the franchisee or "within the corporate structure," and that the allegations "were sufficient to put the Defendants on notice of the claims against them."[27]

The court took the same view in addressing McDonald's argument that the plaintiff failed to plead enough facts to establish either a joint employer or agency relationship. It noted that the plaintiff had alleged that the McDonald's entities "conducted frequent inspections of the franchise and specified particular employees that were not performing their jobs in accordance with McDonald's standards, trained the franchise's general manager at Hamburger University at McDonald's Corporate Headquarters, and provided guidance about the employee training, including training regarding the prevention and

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21 Case No. 20-C-1202, 2021 WL 4912883 (E.D. Wis. Oct. 21, 2021).

22 *Id.* at *3.

23 *Id.* (internal quotations omitted).

24 *Id.* at *4.

25 542 F. Supp. 3d 888 (E.D. Mich. 2021).

26 *Id.* at 891.

27 *Id.*

reporting of sexual harassment."[28] Although it acknowledged that these allegations were "relatively general," the court felt they were sufficient to put the McDonald's entities on notice of the claims against them.[29]

The court also concluded that these allegations were sufficiently specific to distinguish the case before it from *Doe v. McDonald's USA, LLC*, which had dismissed a suit raising similar allegations.[30] In *Doe*, the court held that allegations that McDonald's provided explicit details regarding operations, provided manager training, and had the right to inspect the franchise were not sufficient to create a joint employment relationship. These allegations, the *Doe* court held, may have shown that McDonald's had control over the operations of the franchise, but they did not show that McDonald's had control over the terms and conditions of employment, as required to sustain a claim of joint employment.

The *Johnson* court held that, while *Doe* was persuasive, the facts before it were different because Ms. Johnson alleged that she applied for her job "on a generic McDonald's application that Defendants supplied to the franchisee," the McDonald's entities allegedly provided guidance on sexual harassment, and the McDonald's entities specified during inspections which employees were not meeting McDonald's standards.[31]

McDonald's faced similar allegations in *Fairley v. McDonald's Corp*.[32] In that case, two employees of a company-owned restaurant in Florida filed a putative class-action asserting claims for sexual harassment, hostile work environment and retaliation. They named, as defendants, the following entities: McDonald's of Florida, McDonald's Corp. and McDonald's USA, LLC. The defendants moved to dismiss on several grounds. First, the defendants contended that the Complaint was defective because it grouped all the defendants together without attributing the conduct they complained of to any particular defendant. Holding that group pleading like this was permitted as long as the complaint contained sufficient detail to put the defendants on notice of the claims, the court rejected this argument. It held that the notice standard had been met because the complaint alleged that the defendants provided inadequate training on sexual harassment and did not adequately address claims of harassment that had been reported.

Second, the defendants argued that Title VII clams could only be brought against the entity with which the plaintiff had an employment relationship. The court agreed with this argument in principle but noted that an employee can have more than one employer for purposes of Title VII and, further, that an entity can be a joint employer. The plaintiffs alleged that, because of the relationship between the various entities, all of whom were directly or indirectly owned by McDonald's Corp., all the defendants should be deemed a "single integrated enterprise" that jointly employed all the employees at all the company-

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28 *Id.*

29 *Id.*

30 No. CV-19-05925, 2020 WL 7133520 (E.D. Pa. Dec. 3, 2020).

31 *Id.* at 892.

32 No. 20-cv-2273, 2021 WL 3054804 (N.D. Ill. July 20, 2021).

owned restaurants in Florida.[33] The court agreed, at least for purposes of the motion to dismiss. It held that, based on the information available to them, and the fact that it was not necessarily clear from publicly available information which entity employed them, the plaintiffs had adequately pleaded an employment relationship with each defendant. And in the court's view, the plaintiffs' allegations that the defendants "jointly controlled Plaintiffs' working conditions, including with respect to training, hiring, discipline, transfer, and firing," were sufficient, at least at the pleading stage, to sustain their claim of joint employment.[34]

As another case involving McDonald's shows, franchisors have been far more successful in obtaining the dismissal of joint employment claims at summary judgment. In *Ries v. McDonald's USA, LLC*, employees of a franchised restaurant brought suit against their employer claiming that they were subject to physical and verbal harassment.[35] As in *Doe* and *Fairley*, the plaintiffs named McDonald's USA, LLC as a defendant on the theory it was the joint employer of its franchisee's employees. After discovery, McDonald's moved for summary judgment claiming, among other things, that: (i) there was no evidence which showed that it retained sufficient control over the plaintiffs' working conditions to be deemed a joint employer; and (ii) there was nothing which supported the plaintiffs' claim that the franchisee was its "apparent agent."

Much as in the cases which denied motions to dismiss, the plaintiffs claimed that McDonald's exercised extensive control over its franchisees through its franchise agreement, which required that franchisees abide by the McDonald's system of operations. The plaintiffs also pointed out that McDonald's required franchisees to operate their restaurants in a "good, clean, wholesome manner," set standards that franchisees needed to meet if they wanted to expand or renew their franchise agreements, inspected restaurants to assess compliance with standards, and provided an operations manual that contained a list of duties and procedures to be followed in connection with the operation of a restaurant.

The court disagreed. It held that none of these factors showed that McDonald's "set the terms of the relationship between Franchisee and its employees."[36] The court noted, for example, that even if the franchise agreement could be construed to impose on McDonald's an obligation to prevent sexual discrimination and harassment among the franchisee's employees, there was no evidence that this gave McDonald's the right "to do anything other than find Franchisee in breach of the Franchise Agreement and terminate that agreement."[37] That, the court noted, did "not amount to control over Franchisee's relationship with its individual employees."

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[33] *Id.*, 2021 WL 3054804, at *6.

[34] *Id.* at *8.

[35] Case No. 1:20-cv-2, 2021 WL 5768436 (W.D. Mich. Dec. 6, 2021).

[36] *Id.* at *2.

[37] *Id.* at *3.

The court reached the same conclusion with regard to both McDonald's standards for growth and renewal and the template human resources materials McDonald's provided to its franchisees. As to the former, the court held that the plaintiffs pointed to no evidence that McDonald's used its assessments to "dictate the discipline, promotion, or any other change in the terms of conditions of employment for any particular employee of Franchisee."[38] In the court's view, the fact that the franchisee may have taken these assessments into account "when exercising *its own control* does not mean that McDonald's co-determined the essential conditions of Plaintiffs' employment."[39] With respect to the latter, the court noted that even if McDonald's required franchisees to display the human resource materials it distributed, "displaying a policy is one thing. Implementing it is another."[40] There was, the court noted, "no evidence that McDonald's played any role in implementing or enforcing such a policy."[41] In fact, the posters the plaintiffs pointed to specifically required employees to report any complaints to the franchisee, not McDonald's.

Finally, the court distinguished the cases the plaintiffs relied on, noting that those cases involved attempts to dispose of joint employment claims at a point where the court was required to take the plaintiffs' allegations at face value. At the summary judgment stage, in contrast, the plaintiffs had to support their allegations with evidence, which they did not do. At most, all their evidence showed was that McDonald's exercised control "'over conformity to standard operational details inherent in many franchise settings'" and had "'the power to terminate,'" neither of which sufficed to give rise to joint employer liability under Title VII.[42]

The plaintiffs' attempt to hold McDonald's liable under an agency theory was similarly unavailing. The court held that the plaintiffs' wrongful belief that McDonald's was their employer was not enough to create liability under Title VII. It noted that the case the plaintiffs relied on (*Miller v. D.F. Zee's, Inc.*)[43] was distinguishable, as there was no indication in that case that the restaurant was owned by a franchisee. In *Ries*, in contrast, each plaintiff signed a document when they began their employment in which they acknowledged that (i) the restaurant they worked at was owned and operated by an independent franchisee, and (ii) they were applying for employment with an independent franchisee that was "a separate company and employer from McDonald's corporation and any of its subsidiaries."[44]

Other franchisors did not fare as well as McDonald's in their attempts to obtain summary judgment on joint employment claims. In fact, in contrast to past years, during

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38 *Id.*

39 *Id.* (emphasis in original).

40 *Id.* at *4.

41 *Id.*

42 *Id.* at *5 (quoting *Evans v. McDonald's Corp.*, 936 F.2d 1087, 1090 (10th Cir. 1991)).

43 31 F. Supp. 3d 792 (D. Or. 1998).

44 *Id.* at *7.

which franchisors consistently defeated joint employment claims at summary judgment, this year saw two cases where those efforts were unsuccessful.

In the first case, *Ward v. Cottman Transmission Sys., LLC*, a mechanic at a Cottman Transmission franchise filed suit claiming he was subject to harassment on the basis of his race, national origin and color and denied the overtime wages he was entitled to under the FLSA.[45] Cottman, which was sued as an alleged joint employer, originally moved to dismiss the complaint. After that was denied, it moved for summary judgment. Its motion argued that summary judgment was warranted because "it did not have sufficient control over [the plaintiff] and employment decisions to render it an employer subject to liability for discriminatory comments made by" the franchisee.[46]

That motion was denied, as the court held that issues of fact precluded the grant of summary judgment. It held that Cottman's franchise agreement showed it "could help its franchisees with hiring," required franchisees to "retain a 'staff of trained employees sufficient to operate the CENTER in accordance with this Agreement," and mentioned possible retraining of employees by Cottman.[47] The court further concluded that there was a dispute as to Cottman's ability to control the hours of the center's employees because Cottman "had the right to set the hours for the center in general," which the court stated "necessarily implied the hours that the center's employees would have to work."[48] Finally, the court noted that Cottman representatives "could and did make suggestions to center employees regarding how to perform certain tasks …."[49] In the court's view, these facts collectively created a genuine dispute as to whether Cottman was a joint employer.[50]

The second case where summary judgment was denied is *Medina v. Equilon Enters., LLC*.[51] And while it is not technically a franchise case, *Medina* should be cause for concern for those franchisors that do business in California. The defendant in *Medina* was a subsidiary of Shell Oil Company ("Shell"). At the time in question, Shell's gas stations were operated through a Multi-Store Operator ("MSO") model. Under this model, Shell would lease its gas stations to independent companies who provided the fueling and related services available at the stations. Shell gave these operators a $2,000 monthly fee for the fuel services they provided, and a separate reimbursement amount which "was designed primarily to reimburse the operator for its labor expenses."[52] Operators were required to use Shell's point-of-sale system, and the proceeds from the station's operations were paid directly to Shell. Operators were also required to follow Shell's detailed operations manuals, to provide daily reports, to submit to periodic inspections, and to grant Shell access to their accounts so that Shell could unilaterally

45 No. 1:18-cv-02155-NLH-MJS, 2022 WL 909637 (D.N.J. Mar. 29, 2022).

46 *Id.* at *3.

47 *Id.* at *3.

48 *Id.*

49 *Id.* at *4.

50 *Id.*

51 68 Cal. App. 5th 868 (2021).

52 *Id.* at 870.

withdraw money from and deposit money into their account. Shell also controlled the stations' hours of operation, reserved the right to audit the operator's payroll records and, most importantly, had the ability to remove any of the operator's employees for good cause.

The plaintiff in *Medina* was an employee of an MSO operator who claimed his operator failed to pay him the wages he was entitled to under California law. He sued both the operator he worked for and Shell, claiming that it was liable as a joint employer. In his complaint, which he brought as a putative class action, he alleged that he was trained by Shell's employees, one of whom said he had the ability to fire employees who failed to comply with Shell's policies, and that another Shell employee advised him that he had "the power to get [him] fired."[53] The plaintiff also claimed that he reported certain issues directly to Shell rather than the operator and that, on occasion, he would receive direct instructions from Shell's employees.[54]

Relying primarily on two different appellate court decisions which had affirmed trial court decisions rejecting substantially similar claims, Shell moved for, and was granted, summary judgment. This time, however, the appellate court reversed.

The court noted that, under California law, an entity could be deemed a joint employer if it: (1) exercised control over wages, hours, or working conditions, directly or indirectly, or through an agent; (2) suffered or permitted the individual to work; or (3) engaged that person.[55] Focusing on the second prong—the "suffer or permit" element—the court noted that, in a different context, the California Supreme Court had concluded that this phrase was to be defined broadly.[56] Under that broad definition, a defendant can be deemed a joint employer merely if it had knowledge of and failed to prevent the work from occurring. Although *Medina* acknowledged that the case that adopted this standard (*Dynamex*) did so in a misclassification case, not a joint employment case, it did not see anything in *Martinez* which suggested it should narrow the definition for joint employment purposes.

That broad standard led the court to reverse the grant of summary judgment in Shell's favor. The court first noted that, in contrast to the facts presented in the two other appellate opinions, the plaintiff in *Medina* presented evidence of Shell's direct control over his employment. For example, he alleged that Shell employees told him they had the power to fire him. The court also noted that Shell had the power to remove individual stations from the operator at any time, for any reason. In its view, that power showed that

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53 *Id.* at 872.

54 *Id.* at 873. Under this test, "the term 'engage' invokes a common law employment relationship." *Martinez v. Combs*, 49 Cal. 4th 35, 64 (2010). Under the common law in California, "[t]he principal test of an employment relationship is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the desired result." *S.G. Borello & Sons, Inc. v. Dept. of Industrial Rel.*, 48 Cal. 3d 341, 350 (1989).

55 *Id.* at 874 (citing *Martinez v. Combs*, 49 Cal. 4th 35 (2010)).

56 *Id.* at 875 (citing *Dynamex Operations West, Inc. v. Superior Court*, 4 Cal. 5th 903 (2018)).

Shell “has the ability to prevent plaintiff from working in Shell’s business, which relates to the ‘suffer or permit to work’ test.”[57]

Medina also disagreed with the other appellate courts’ conclusion that Shell did not exercise control over wages and working conditions. Noting that the applicable standard rendered someone an employer even if that person’s control was exercised indirectly or through an agent, *Medina* held that there was sufficient evidence that Shell met that standard through its detailed instructions and standards for managing stations, its employees’ statements that they could fire the plaintiff for violating those standards, and its setting of reimbursement rates for labor costs “while mandating hours of operation,” which “had the practical effect of controlling plaintiff’s wages.”[58] Finally, the court noted that Shell could have stopped the plaintiff from working by either removing the station from the operator’s MSO agreement of removing the plaintiff himself.[59]

Shell argued that the court’s approach to the “suffer or permit” standard was far too broad, and that application of such a broad standard was unnecessary in the joint employment context, where the alleged joint employer becomes relevant only when the primary employer is unable to pay. While the court acknowledged that this argument had some “practical appeal,” it noted that the argument necessarily raised the following question: “who should bear the risk of an MSO operator’s inability to pay its employees’ wages—Shell or the employees themselves?”[60] The court quickly concluded that should be Shell’s risk to bear, particularly given its “near-complete control” over the operator’s finances, operations, facilities, and practices.[61]

II. Misclassification

In contrast to the joint employment area, the past year saw several significant decisions issued on the misclassification front. In *Haitayan v. 7-Eleven, Inc.*, four franchisees of 7-Eleven brought suit alleging that, because of the controls allegedly exercised by 7-Eleven, they had been “misclassified” as independent contractors and were entitled to damages under both the Fair Labor Standards Act (“FLSA”) and the California Labor Code.[62] The suit, which was filed as a putative class action on behalf of all 7-Eleven franchisees in California, claimed that the plaintiffs were entitled, as damages, to virtually all the expenses they incurred operating their franchises, including the monies they paid their own employees.

Early on in this case, by Order dated March 14, 2018, the district court dismissed the plaintiffs’ claims they had been “misclassified” because, in the court’s view, “the type

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[57] *Id.* at 878.

[58] *Id.* at 876.

[59] *Id.*

[60] *Id.* at 880.

[61] *Id.* at 881.

[62] Case No. 17-7454 (C.D. Cal.). DLA Piper represents 7-Eleven in this matter.

or degree of control alleged by Plaintiffs is wholly insufficient to make them employees."[63] The Ninth Circuit vacated that Order. It held that, in reaching its conclusion, the district court improperly "considered the persuasiveness of the plaintiffs' factual allegations rather than the plausibility of the plaintiffs' legal claims" and, further, "focused on the franchise agreement but did not consider the plaintiffs' allegations regarding 7-Eleven's actual control."[64]

After the case was remanded, the parties engaged in significant litigation over which test—the ABC test adopted in *Dynamex* or the California Supreme Court's decision in *S.G. Borello & Sons, Inc. v. Dept. of Industrial Rel.*—governed Plaintiffs' claim for expense reimbursement.[65] The court ultimately concluded that the *Borello* test applied and, on March 23, 2021, the parties went to trial on the plaintiffs' remaining claims.

On September 8, 2021, the district court issued its Findings of Fact and Conclusions of Law After Court Trial.[66] Finding for 7-Eleven on all claims, the district court held that the evidence "compel[led] the conclusion" that Plaintiffs controlled the manner and means of their franchises' operations.[67] Specifically, the court noted that the evidence established "that Plaintiffs exercised their own judgment in determining, among other things: what products they would carry, how to price the products, how to organize the store, what promotions to take part in, whom to hire or fire, the scheduling of employees, how often and when Plaintiffs would be present at their stores, and what draws to take from the stores and when."[68]

The court concluded that the secondary factors considered under the *Borello* test supported this same conclusion. Most significantly, the court held that 7-Eleven was engaged in a different course of business than its franchisees—which is the equivalent of the Prong B inquiry under the ABC test—and that the plaintiffs were engaged in a distinct

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63 *Haitayan v. 7-Eleven, Inc.*, Case No. 17-7454, 2018 WL 1626248, at *5 (C.D. Cal. Mar. 14, 2018).

64 *Haitayan v. 7-Eleven, Inc.*, No. 18-55462, No. 18-55910, 18-56346, 762 Fed. Appx. 393, at *395 (9th Cir. Feb. 27, 2019).

65 48 Cal. 3d 341 (1989). Under *Borello*, "[t]he principal test of an employment relationship is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired ...." *Id.* at 350. In addition, the *Borello* test considers a number of secondary factors, including:

> (a) whether the one performing services is engaged in a distinct occupation or business; (b) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision; (c) the skill required in the particular occupation; (d) whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work; (e) the length of time for which the services are to be performed; (f) the method of payment, whether by the time or by the job; (g) whether or not the work is a part of the regular business of the principal; and (h) whether or not the parties believe they are creating the relationship of employer-employee.

Id. at 351.

66 *Haitayan v. 7-Eleven, Inc.*, Case No. 17-7454, 2021 WL 4078727 (C.D. Cal. Sept. 8, 2021).

67 *Id.* at *18.

68 *Id.* at *13.

business and held themselves out as business owners—which is the inquiry under Prong C of the ABC test. In reaching the first conclusion, the district court observed that 7-Eleven and its franchisees engage in wholly distinct functions.[69] It noted that 7-Eleven's business consists of locating and developing store sites, marketing and selling franchises, licensing the right to use its intellectual property, developing an operations manual that sets forth its recommended practices, leasing property and equipment, conducting advertising, developing new products and providing back-office support and business advisory assistance to its franchisees. The plaintiffs, the district court noted, "do none of these things."[70] Additionally, the district court observed that treating franchising as a distinct course of business was consistent with how the California legislature has described this business model. In particular, the court noted that the statute that regulates the sale of franchises in California (the California Franchise Investment Law ["CFIL"]) specifically refers to "the widespread sale of franchises" as a "form of business."[71] In contrast, the CFIL describes "franchisees" as those who "engage in the business of offering, selling or distributing goods or services under" the franchisor's operating system.[72]

With respect to the other conclusion—*i.e.*, that the plaintiffs operated independent businesses—the district court observed that: (i) the CFIL defines "franchises" as "businesses" and the relationship created between a franchisor and a franchisee as a "business relationship," not an employment relationship; (ii) the plaintiffs had the ability to sell their franchises; (iii) most of the plaintiffs owned competitive businesses; and (iv) the plaintiffs portrayed themselves as business owners on social media, in correspondence, and on their tax returns.[73] The district court held that, collectively, this evidence "convincingly establish[ed] that Plaintiffs were not employees."[74] This decision is currently on appeal to the Ninth Circuit Court of Appeals.

Across the country in Massachusetts, another 7-Eleven victory proved to be short-lived. In *Patel v. 7-Eleven*, Inc., a group of franchisees in Massachusetts (represented by the same attorney involved in the *Haitayan* lawsuit) filed a putative class action asserting that the controls 7-Eleven allegedly exercises over its franchisees transformed them into employees under the Massachusetts Independent Contractor Law ("ICL").[75] 7-Eleven filed a motion for summary judgment, which the district court granted. The court concluded that there was an irreconcilable conflict between the Federal Trade Commission's ("FTC's") Franchise Rule,[76] which defines a franchise as a relationship where "the franchisor ... exerts a significant degree of control over the franchisee's method of operation," and the Massachusetts ICL, which converts workers into employees if they are not "free from control and direction in connection with the

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69 *Id.* at *17.

70 *Id.*

71 *Id.*

72 *Id.* (quoting Cal. Corp. Code § 31005(a)(1)).

73 *Id.* at *14.

74 *Id.* at *18.

75 Civil Action No. 17-11414-NMG (D. Mass.). DLA Piper represents 7-Eleven in this matter.

76 16 C.F.R. § 436.1 *et seq.*

performance of th[eir] service."[77] According to the court, because "[t]he franchise-specific regulatory regime of the FTC governs over the general independent contractor test in Massachusetts," "the Massachusetts ICL does not apply to 7-Eleven in these circumstances."[78] Any other approach, the court observed, would mean "that, in qualifying as a franchisee pursuant to the FTC's definition, an individual necessarily becomes an employee."[79]

The plaintiffs appealed this ruling and, based on its brief discussion, the First Circuit Court of Appeals seemed to agree with the underlying premise of the district court's ruling. After quoting the text of both the FTC Rule and the ICL, the appellate court stated that "there appears to be a conflict between the Massachusetts ICL and the "exert[ing] ... control" prong of the FTC Franchise Rule."[80] "It appears difficult, if not impossible, for a franchisor to satisfy the FTC Franchise Rule's requirement that the franchisor 'exert or ha[ve] authority to exert a significant degree of control over the franchisee's method of operation' and simultaneously rebut the Massachusetts ICL's employee presumption by demonstrating that each franchisee is 'free from control and direction in connection with the performance of the service.'"[81] Nonetheless, because it concluded that the issue involved significant issues of state law, the court decided to certify the following question to the Massachusetts Supreme Judicial Court: "Whether the three-prong test for independent contractor status set forth in Mass. Gen. Laws ch. 149 § 148B applies to the relationship between a franchisor and its franchisee, where the franchisor must also comply with the FTC Franchise Rule."[82]

The Massachusetts Supreme Judicial Court answered "yes" to that question.[83] The court first concluded that there was not a conflict between the ICL and the FTC Rule, which the court held merely concerns the presale disclosures franchisors must give to franchisees. In the court's view, "[c]ompliance with these disclosure requirements does not mandate that a franchisor exercise any particular degree of control over a franchisee."[84] "Rather, the regulation establishes rules for when the franchisor chooses to exercise a certain degree of control."[85] Because a franchisor can comply with the FTC Rule by making the prescribed disclosures, "and in situations where a franchisee is deemed an employee under the independent contractor statute," also "comply with its obligations under the wage statutes," the court concluded there was no conflict. *Id*. at 409. The court also stated—without explanation—that "'significant control'" over a franchisee's 'method of operation' [as envisioned by the FTC Rule] and 'control and direction' of an individual's 'performance of services' [as prohibited under the ICL] are not necessarily

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77 *Patel v. 7-Eleven. Inc.*, 485 F. Supp. 3d 299 (D. Mass. 2020) (quoting Mass. G.L. c. 149, § 148B(1)).

78 *Id.* at 310.

79 *Id.*

80 *Patel v. 7-Eleven, Inc.*, 8 F.4th 26, 28 (1st Cir. 2021).

81 *Id.*

82 *Id.* at 29.

83 *Patel v. 7-Eleven, Inc.*, 183 N.E.3d 398 (Mass. 2022).

84 *Id.* at 408.

85 *Id.*

coextensive."[86] Implying that exercising the control contemplated by the former did not necessarily constitute the sort of control prohibited by the latter, the court cited several cases—including the *Haitayan* decision from California—in which courts had concluded that franchisors satisfied "the first prong of the ABC test or its equivalent."[87]

The Southern District of California came to a similar conclusion in *Goro v. Flower Foods, Inc.*[88] In *Goro*, a group of bakery product distributors filed suit against the manufacturer of those products claiming they had been misclassified as independent contractors. They sought, among other things, overtime pay, indemnification for expenses incurred, and damages for the manufacturers' failure to comply with meal and rest break obligations.

Pursuant to the franchise agreements the distributors entered into with the manufacturer, each received a territory in which to sell the manufacturer's products. The products the distributors were allowed to sell, and the purchase price for those products, were both set forth in those agreements.[89] The distributors had the right to hire others to operate their businesses, to deliver product for other companies, to sell non-competitive products, and to change pricing.[90] The distributors also had the right to decide when to work, which routes to take, when to take breaks, and the products they would order for their customers.[91] Each distributor was responsible for the expenses they incurred operating their businesses, such as obtaining all required insurance and delivery vehicles.[92]

Early in the proceeding, the parties filed cross-motions for summary judgment on various issues. In its motion, the manufacturer claimed that the plaintiffs could not prevail on their claims because they were preempted by the FTC Rule and the Lanham Act.[93] Specifically, the manufacturer argued that "the FTC Franchise Rule requires a "franchisor

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86 *Id.* at 409.

87 *Id.* Although the court refused to exempt franchised businesses from the reach of the ABC test altogether, it did provide some helpful guidance regarding the interpretation of that test in franchised cases. It concluded, among other things, that: (i) nothing in the ICL "prohibits legitimate franchise relationships among independent entities that are not created to evade" the wage statutes; (ii) the predicate requirement for the application of the ICL—*i.e.*, that the worker perform services for the employer—was not satisfied merely because the parties' relationship served their mutual economic interests; and (iii) nothing in the ICL barred a franchisor from assessing a franchise fee as a cost of doing business, even if that fee was deducted from the franchise's gross revenue. *Id.* at 411.

88 Case No. 17-cv-2580 TWR(JLB), 2021 WL 4295294 (S.D. Cal.).

89 *Id.*, 2021 WL 4295294, at *2.

90 *Id.*

91 *Id.* at *3.

92 *Id.* at *2. This system, the court noted, had already been the subject of significant investigation and litigation, with mixed results. On the franchisor's side, the California Labor Commissioner concluded that a franchisee who filed a claim for business expense reimbursement was a "franchisee and therefore outside of the Labor Commission jurisdiction." *Id.* at *4. On the other hand, the Department of Labor had concluded (in an investigation in Georgia) "that Defendants had misclassified their Distributors as independent contractors rather than employees." *Id.*

93 15 U.S.C. §§ 1051 *et seq.*

... to exert a significant degree of control over the franchisee's method of operation" [citations omitted] and the Lanham Act requires franchisors to "control use of their trademarks," [citation omitted] requirements that "directly conflict with the ABC Test's 'free from control' requirement."[94] The court disagreed. It held that the defendant "fail[ed] to identify any actual conflict between the ABC Test and the FTC Franchise Rule or Lanham Act."[95] Although it acknowledged that all three statutes mentioned "control," the court held that this reference did not mean "that the provisions are related, much less that they conflict."[96] Further, the court stated that neither the FTC Franchise Rule not the Lanham Act evidenced a clear and manifest purpose to preempt state labor law.[97]

With those defenses dismissed, the court turned to the plaintiffs' motion for summary judgment on their claim that they had been misclassified. After concluding that the ABC test applied to all the plaintiffs' claims, the court granted that motion. It concluded that the defendant failed to identify a genuine issue of fact as to Prong B of the test, which requires that the defendant show that the worker performed work that was "outside the usual course of [the defendant's] business."[98] In *Dynamex*, the California Supreme Court held that this requirement was intended "to bring within the 'employee' category *all* individuals who can reasonably be viewed as working 'in the [hiring entity's] business[.]'"[99] The Ninth Circuit expounded on this standard by holding that, in addressing Prong B, courts should consider several factors, including "whether the work of the employee is necessary to or merely incidental to that of the hiring entity, whether the work of the employee is continuously performed for the hiring entity, and what business the hiring entity proclaims to be in."[100]

These formulations, the district court concluded, compelled the grant of summary judgment for the plaintiffs.[101] Initially, the court noted that because the distributors' work accounted for 85% of the defendant's yearly sales, it could not dispute that the plaintiffs' work was necessary to their business. In fact, the court pointed out that the defendant identified their distributors as part of their "core business."[102] The court also concluded that the defendant held itself out as a distributor of bakery products, which is just what the plaintiffs did.[103] For example, the court noted that, while the defendant identified itself as

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94 2021 WL 4295294, at *10.

95 *Id.*

96 *Id.*

97 *Id.* at 811.

98 Cal. Labor Code § 2775(b)(1)(B).

99 *Dynamex*, 4 Cal. 5th at 959 (emphasis in original) (quoting *Martinez v. Combs*, 49 Cal. 4th 35, 69 (2010)).

100 *Vazquez v. Jan-Pro Franchising Int'l, Inc.*, 986 F.3d 1106, 1125 (9th Cir. 2021).

101 Because the ABC test is conjunctive, the failure to satisfy any one of the three prongs compels a finding that the parties were in an employment relationship.

102 *Id.* at *12.

103 *Id.* at *13.

a "producer and marketer" of packaged bakery foods, it also touted its distribution capacity.[104]

In 2021, as an increasing number of suits were filed alleging that franchisors were employers under the ABC test, the International Franchise Association, joined by several franchisee associations (such as the Asian American Hotel Owners Association, the Supercuts Franchisee Association, and the DD Independent Franchise Owners Association) filed suit to enjoin the application of the statute that codified the ABC test (California Labor Code § 2775(b)(1)) to franchised businesses. The plaintiffs claimed that the test, as applied to franchises, violates the Dormant Commerce Clause, constitutes a regulatory taking, and is preempted by federal law.

By Order dated January 12, 2022, the district court dismissed that suit without ever reaching the merits.[105] The court noted that, to invoke the jurisdiction of a federal court, a party must satisfy the threshold requirement of showing an actual case or controversy under Article III of the Constitution. "'[T]wo components of the Article III case or controversy requirement are standing and ripeness.'"[106] "To satisfy the constitutional ripeness, or injury in fact required by Article III, the plaintiff must allege 'an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent, not conjectural or hypothetical.'"[107] Phrased differently, "[t]he touchstone for determining injury in fact is whether the plaintiff has suffered an injury or threat of injury that is credible, not 'imaginary or speculative.'"[108]

According to the court, the plaintiffs' claims were not ripe because the complaint "allege[d] nothing more than a general threat of application of [the ABC test] to franchises …."[109] The court concluded that the specific example of state action the plaintiffs had cited—a lawsuit brought against one of the IFA's members alleging that its franchisees had been misclassified—was somehow "conclusory" and unsupported by the Complaint or any "evidence properly submitted to the court."[110] And in the court's view, the plaintiffs' general fear about the enforcement of the statute, without more, was not enough to give the plaintiffs standing to challenge the law. The complaint, it held, did "not establish that Plaintiffs face a reasonable or imminent threat of prosecution under" the statute (AB5) that codified the ABC test.[111] For this reason, the court dismissed the Complaint without prejudice on prudential ripeness grounds.

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[104] *Id.*

[105] *International Franchise Association v. State of California*, Case No. 20-cv-02243-BAS-DEB, 2022 WL 118415 (S.D. Cal. Jan. 12, 2022).

[106] *Id.* at *3 (quoting *Bova v. City of Medford*, 564 F.3d 1093, 1095-96 (9th Cir. 2009)).

[107] *Id.* at *3 (quoting *Lujan v. Defs. of Wildlife*, 504 U.S. 555, 560-61 (1992)) (internal citations and quotations omitted).

[108] *Lopez v. Candaele*, 630 F.3d 775, 786 (9th Cir. 2010) (quoting *Babbitt v. United Farm Workers Nat. Union*, 442 U.S. 289, 298 (1979)).

[109] *Id.* at *4.

[110] *Id.*

[111] *Id.* at *5.

The final case on misclassification concerns not whether a franchisee was in fact misclassified, but what damages (if any) it was entitled to in the event it was. In *Mujo v. Jani-King Int'l, Inc.*, a putative class of franchisees filed suit claiming they had been misclassified as independent contractors under Connecticut law.[112] In the Jani-King franchise system, customers remit payment to Jani-King for the services provided by Jani-King's franchisees. Jani-King deducts the fees its franchisees owe from those payments and then remits the balance to the franchisees. The franchisees in *Mujo* claimed that, because they were actually employees, the deductions Jani-King took from the customer revenue it received constituted unlawful deductions under the Connecticut Minimum Wage Act. They also claimed that Jani-King was unjustly enriched by its receipt of those fees.

The district court dismissed the plaintiffs' Minimum Wage Act claim and, after discovery, granted summary on their unjust enrichment claim.[113] The plaintiffs appealed, and the Second Circuit Court of Appeals affirmed. With respect to the Minimum Wage Act claim, the Court first noted that the Act "'does not purport to define the wages due; it merely requires that those wages agreed to will not be withheld for any reason.'"[114] In other words, the statute protects the wages earned pursuant to the agreement the employee entered into with its employer; it does not dictate "the means by which those wages are calculated."[115] The Second Circuit concluded that these principles barred the plaintiffs' minimum wage claim because the parties' franchise agreements "expressly provide[d] for the deductions challenged by the [plaintiffs] and defined franchisees' compensation as the funds remaining after the deductions are taken."[116] Therefore, even assuming the plaintiffs were employees, the wages they received were exactly what they were supposed to be under the parties' written agreements.

The appellate court held that the plaintiffs' unjust enrichment claim was similarly deficient. The court noted that, under Connecticut law, a party claiming unjust enrichment must prove, among other things, that the other party received a benefit to which it was not entitled. Although the plaintiffs claimed that Jani-King received their franchise fees "for something of no value"—"a purported franchise right that is in fact an employment relationship contingent" on impermissible payments—the court held that at least three principles of Connecticut law precluded this claim.[117] First, bona fide franchise agreements under which a franchisee receives the benefit of the franchisor's intellectual property in exchange for a fee are expressly permitted under Connecticut law.[118] Second, courts have held that a worker who is deemed an employee may also be a franchisee.[119] Finally, "an employee-franchisee may enter into a compensation agreement that defines

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[112] 13 F.4th 204 (2d Cir. 2021).

[113] *Mujo v. Jani-King Int'l, Inc.*, 431 F. Supp. 3d 18 (D. Conn. 2019).

[114] *Mujo*, 13 F.4th at 320 (quoting *Mytych v. May Dep't Stores Co.*, 793 A.2d 1068, 1072 (Conn. 2002)).

[115] *Id.* at 211.

[116] *Id.*

[117] *Id.* at 213.

[118] *Id.*

[119] *Id.*

her compensation as the portion of the gross revenue attributable to the employee-franchisee's work after franchise fees are subtracted."[120] In the end, because the plaintiffs did not muster any evidence which showed that the rights they received under the franchise agreements were illusory, their claim for unjust enrichment was properly dismissed.

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120 *Id.* at 214.

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2022 Judicial Update

Insurance and Force Majeure: Decisions and Trends

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Insurance and Force Majeure COVID-19 Case Decisions and Trends

I. INSURANCE COVERAGE DECISIONS

As many of us expected, the vast majority of insurance related coverage cases covering the period from May 2021 (after the last IFA Legal Symposium) through April 2022 addressed the handling of COVID-19 damage claims made by franchisees and franchisors. These cases arose primarily from claims made under general commercial liability and property policies for first-party losses like business income and extra expense. The claims by insured businesses asserted damages caused by the COVID-19 pandemic resulting from: (1) loss revenue for location or unit closures; (2) decreased revenue resulting from attendance/customer limits and gathering/capacity restrictions; and (3) amounts paid for safety mitigation efforts, such as cleaning supplies, new protective equipment, and social distancing fixtures.

The current trend continues to follow the majority position of 2020 and the first half of 2021 where most courts held that general commercial liability policies did not indemnify for pandemic related losses, citing either or both: (a) a virus exclusion in the policy or (b) the failure for the insured to establish physical damage to the premises necessary to trigger an insurance carrier's obligation to defend and indemnify. These cases are discussed in subsection (A) below. In the last COVID-19 related pandemic loss related case discussed in this section, McDonald's' insurance carrier was found to have a duty to defend it against employee negligence claims that it failed to provide proper COVID-19 safety protections. The case ultimately settled last summer, but provides an interesting discussion on the broader scope of an insurance company's duty to defend these types of claims.

Additionally, there were three other notable franchise and distribution insurance coverage cases addressing claims for defense or indemnity under policies unrelated to the COVID-19 pandemic losses since the last IFA Legal Symposium. These three cases are summarized in more detail in subsection (B) below, but the brief takeaways are as follows:

1. An insurance carrier cannot deny it has a duty to defend a hotel franchisor using the "Abuse and Molestation" exclusion because the plaintiff in the underlying negligence case was not in the "*care, custody or control*" of the hotel franchise.

2. An insurance carrier had no duty to defend or indemnify a franchisee who misappropriated a franchisor's intellectual property and deliberately competed against the franchisor in breach of the franchise agreement's post-termination restrictive covenants since the policy contained a list of applicable exclusions, including the (i) knowing violation exclusion; (ii) breach of contract exclusion; and (iii) infringement exclusion, among others.

3. A McDonald's' multi-unit franchise owner was not covered under its general commercial liability policy for alleged violations of a state biometric data protection law resulting from a fingerprinting time-keeping program at its restaurants because the policy contained an applicable *Access Or Disclosure Of Confidential Or Personal Information And Data-related Liability* exclusion.

A. COVID-19 Pandemic Coverage Disputes

As of April 25, 2022, approximately 1,370 lawsuits were filed in federal courts by plaintiffs seeking coverage under insurance policies for COVID-19 related losses.[1] The results so far are as follows:

- 43% of the cases have been permanently dismissed;
- 17% of the cases have been voluntarily dismissed; and
- 40% of the cases have yet to be fully decided.[2]

A "Virus Exclusion" in a large percentage of insurance policies precluded coverage in these cases.[3] Courts throughout the United States interpret this exclusion under standard insurance policy rules of construct which require a court to analyze the provision in its "ordinary and popular sense."[4] The language in a standard general commercial liability policy typically excludes: "*loss or damage caused or resulting from any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness or disease*".[5] This language is reasonably explicit and clear to mean that if the damage experienced by the insured business was caused by a virus, then the policy will not cover the claim. Any policies with this particular exclusion have not made it pass the first threshold for coverage despite insureds' creative and at times, strained, arguments to the contrary.[6]

For policies that did not contain a virus exclusion, a small split of authority developed with respect to determining whether an insured suffered the necessary "direct physical loss or damage" to the insured premises that triggers coverage under a business policy. Within the past year, a number of cases survived motions to dismiss filed by the insurance carriers. However, there are no significant cases finding coverage for pandemic related losses in the franchise context. In the vast majority of cases, the courts decided coverage was not triggered under the policy due to the failure of the insured to meet the "direct, physical loss or damage" condition. As you review the cases throughout the last year, you can see where insured businesses learned from previous decisions and expanded the scope of proposed theories for recovery. Unfortunately, franchisors and

[1] See Law360 Insurance Authority COVID-19 Case Tracker at https://www.law360.com/insurance-authority/covid-map.
[2] Zigterman, Ben, *Gym Owners Ignored COVID-19 Rulings, Insurer Tells 4th Cir.,* Law 360 (March 3, 2022), available at Gym Owners Ignored COVID-19 Rulings, Insurer Tells 4th Circ. - Law360.
[3] *Kingray Inc. v. Farmers Group, Inc.,* 523 F. Supp.3d 1163 (March 4, 2021).
[4] *Kingray*, 523 F.Supp3d at 1172.
[5] *Id.*
[6] *Id.*

franchisees were unsuccessful and, as time went on, courts became less sympathetic to insured parties asserting the same rejected arguments again and again.

Byberry Services and Solutions LLC v. MT. Hawley Insurance Company, 2021 WL 3033612 (D.C., N.D. Illinois, July 19, 2021)

This is one of many COVID-19 pandemic related cases where the court found the insured had no coverage under the policy for (1) business income losses related to government order closures of its locations or (2) first party losses related to out-of-pocket increases in COVID-19 related cleaning supplies and reduced capacity compliance obligations.

Byberry Services was a group of Snap Fitness Center franchisees required to participate in the franchisor's, Snap Fitness's, insurance plan. Under the franchisor's plan, the defendant, MT. Hawley Insurance Company, insured all Snap Fitness franchisees under a single "all risk policy." [7] The state of New Jersey, where many of the Snap Fitness locations operated, ordered that all fitness centers and gyms close in 2020.[8] Ohio followed the next day with a similar order.[9] All plaintiffs in the case closed their locations in accordance with these state requirements. After the state restrictions were lifted, the Snap Fitness locations re-opened in limited capacity and made changes to their fitness facilities including reducing work-out equipment, limited exercise room capacity, and increasing cleaning protocols which required the hiring of additional staff.[10] In the months that followed the re-openings, a number of employees and fitness members contracted COVID-19. These outbreaks required the franchisees undertake costly deep cleanings.[11] Multiple franchisees submitted claims to their insurance carrier for lost income and were denied coverage. The court determined that all of the arguments asserted by the franchisees failed.

The "all risk" policy included (1) business income, (2) extra expense, (3) civil authority and (4) 'sue and labor' coverage.[12] The business income section of the policy provided: "*We will pay for the actual loss " of 'earnings' you sustain due to the necessary suspension of your 'operations' during the 'period of restoration'*."[13] However, the policy also stated that the suspension of the operations must be caused by *direct physical loss of or damage to property at the covered location*.[14] The civil authority insuring agreement portion of the policy covered losses that were the product of government decree.[15]

As we learned during the COVID-19 pandemic and as described in the introduction above, insurance policies can be divided into two categories: (A) those policies that

[7] *Byberry Services and Solutions LLC v. MT. Hawley Insurance Company*, 2021 WL 3033612 (D.C., N.D. Illinois, July 19, 2021)
[8] *Id.*
[9] *Id.*
[10] Byberry Services, at *3.
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] Byberry Services, at *2.
[15] *Id.*

contained a very clear and unambiguous exclusion for viruses or communicable diseases and (B) those policies that do not contain such exclusion. The standard exclusion stated: "*We will not pay for loss or damage caused by or resulting from any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness or disease*."[16] In cases analyzed during the 2021-2022 year, franchisors or franchisees with policies containing virus exclusions were quickly resolved in favor of the insurance carriers and against coverage for the insureds.[17] The policy issued to the Snap Fitness franchisees did not contain the fairly standard and common exclusion for losses resulting from viruses or communicable diseases.[18] Otherwise, the court's analysis would have stopped there.

Instead, the court conducted a thorough analysis of the policy, but ultimately rejected all of the franchisees theories for recovery.

First, the franchisees argued that the government mandated closures created a "*direct physical loss*" of their property. The court looked to a recent opinion of the Eight Circuit that found a government shutdown did not constitute physical loss or damages under the policy because there was no actual physical alteration, contamination, or destruction of property.[19] In determining the insurance policy did not cover the plaintiffs' claims, the court decided that mere loss of use was insufficient to meet the direct physical loss standard.[20] Installing plexiglass dividers and otherwise altering the premises was not sufficient. If governmental regulation itself was sufficient for recovery under the policy, then it would render the word 'physical' meaningless.[21]

Second, the plaintiffs argued that the virus physically contaminated their gyms, damaging their property.[22] The Snap Fitness franchisees tried to draw a comparison to a Minnesota Court of Appeals case where the court found an insurance carrier had a duty to indemnify for losses when pesticides contaminated a property rendering the products on the property unfit for sale.[23] The court was not persuaded because a virus like COVID-19 can be eliminated from the premises with standard cleaning methods, unlike asbestos or pesticides.[24]

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[16] ISO form CP 01 40 07 06, "Exclusion for Loss Due To Virus Or Bacteria". For those readers unfamiliar with ISO, it the acronym for Insurance Services Office, Inc. Among other insurance related analytical and actuarial activities, the organization drafts many of the standard insurance policy insuring coverage provisions, exclusions, endorsements and related form language. Almost all of the policies held by businesses are "ISO" policies or contain "ISO" language. An insured party can determine whether they have an ISO policy by looking at the bottom footer of the policy.
[17] See *Diesel Barbershop, LLC v. State Farm Lloyds*, 479 F.Supp.3d 353 (W.D. Tex 2020)(finding that a viral exclusion in State Farm's policy was explicit and should be followed since the closure of the barbershop franchised businesses was caused by the COVID-19 virus).
[18] *Byberry Services*, at *2.
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.* at *4.
[23] *Byberry Services*, at *4 citing *Gen. Mills, Inc. v. Gold Metal Ins. Co.*, 622 N.W.2d 147, 152 (Minn. Ct. App. 2001).
[24] *Id.* citing *Bachman's Inc. v. Florists' Mut. Ins. Co.*, 525 F. Supp. 3d 984 (Dist. Minn 2021).

Third, the court determined that the civil authority coverage provision providing coverage for "*the loss of 'earnings' you sustain . . . caused by action of civil authority that prohibits access to the scheduled location(s) due to direct physical loss or damage to protection, other than at the scheduled location(s) resulted from a Covered Cause of Loss*" did not apply because "coverage only applies when physical damage to property leads the government to prohibit access to the insured property."[25] The court found that the 'civil authorities' were "not motivated [to close the fitness locations] by physical damage to the property, but a state-wide health crisis."[26]

Finally, the court determined that the sue and labor coverage[27] claim also failed since the coverage also only applies when there is a directly physical loss or damage to property.[28] None of the four types of insurance coverage in the policy applied since each one still required physical damage to the premises. The court granted the insurance carrier's Motion to Dismiss the case.

Gateway Clippers Holdings LLC v. West Bend Mutual Insurance Company, 2021 WL 3784991 (E.D. Missouri August 26, 2021)

The plaintiff, the multi-unit franchisee owner of twenty Great Clips hair salons ("Great Clips"), filed a lawsuit against its insurance carrier, West Bend Mutual Insurance Company ("West Bend"), after it denied its claim for actual businesses losses incurred when the salons were closed for two months at the onset of the COVID-19 pandemic.[29] West Bend also denied the Great Clips franchisee's claim for extra expenses incurred in purchasing and implementing additional safety protocols like plexiglass dividers, masks and cleaning supplies.[30] The court granted West Bend's Motion to Dismiss stating that the Great Clips franchisees' decision to close the hair salons did not constitute a direct physical loss of its property since nothing physical happened to the salon locations.[31] The court also concluded that even if the Great Clips franchisee could succeed on its argument that a direct physical loss was suffered, there was a clear virus and bacteria exclusion that would also unequivocally preclude coverage.[32]

Golden Corral Corp. v. Illinois Union Insurance Company, 2021 WL 4097684 (E.D. N.C. September 8, 2021)

The plaintiffs in this coverage case were Golden Corral Corporation and Golden Corral Franchising System ("Golden Corral"). Golden Corral filed a complaint against its insurance carrier, Illinois Union Insurance Company ("Illinois Mutual"), seeking to recover under its policy for losses suffered by its restaurants as a result of the COVID-19

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[25] *Id.* citing *Sandy Point Dental, PC v. Cincinnati Ins. Co.*, 488 F. Suppl. 3d 690, 694 (N.D. Ill 2020).
[26] *Id.* at *7.
[27] Sue and labor provides insurance coverage for costs and expenses taking reasonable steps to protect a property from further damage. *Id.*
[28] *Id.*
[29] *Id.*
[30] *Gateway Clippers Holdings LLC v. West Bend Mutual Insurance Company,* 2021 WL 3784991 (E.D. Miss. August 26, 2021)
[31] *Gateway Clippers* at *3.
[32] *Id.* at *5. Supra, note 19.

pandemic.[33] Golden Corral argued that it was entitled to coverage under three separate sections of its insurance policy:

1. The endorsement for Interruption by Civil or Military Authority;
2. The endorsement for Loss of Ingress or Egress; and
3. The Business Interruption provision.[34]

The insurance carrier denied that any of these provisions triggered coverage under the policy for the COVID-19 related losses. Illinois Mutual argued that the "Pollution, Contamination" exclusion precluded coverage since it specifically defined "*contaminants or pollutants*" to include a "*bacteria, virus, or hazardous substances.*"[35]

The court, applying North Carolina law, agreed with the insurance carrier that coverage under the (i) Loss of Ingress or Egress and (i) Business Interruption provision each requires direct, physical loss or damage and therefore, are only triggered when there is a tangible, physical harm or destruction to covered property or loss of property.[36]

The court also analyzed the period of recovery section of the Business Interruption coverage which limits recovery to "*that period of time necessary to rebuild, repair, or replace damaged or lost property so that the property is restored to the 'same . . . operating conditions that existed prior to the loss*.'"[37] The court stated that these provisions cannot be "harmoniously construed" consistently with each other unless there is tangible physical damage[38]. In other words, after the government order shut-downs were lifted, there was no rebuilding or repairing for Golden Corral to undertake. The businesses could just re-open, albeit often at limited capacity, with mitigation equipment in place, and new COVID-19 risk management polices implemented.

The court recognized a diverging coverage interpretation with respect to "physical loss," but determined that the plain-meaning of the policy language supported a conclusion that actual tangible harm or loss to the property is required to trigger coverage.[39] The court granted the insurance carrier's Motion for Judgment on the Pleadings.

Fountain Enterprises, LLC v. Markel Insurance Company, 2021 WL 4999447 (D.C. Virginia October 26, 2021)

In this case, a group of Anytime Fitness franchise owners located in the states of Alabama, Mississippi, Pennsylvania and Washington brought a class action complaint against the franchisor's recommended insurance provider, Markel Insurance Company

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[33] *Golden Corral Corp. v. Illinois Union Insurance Company*, 2021 WL 4097684 (E.D. N.C. September 8, 2021).
[34] *Golden Corral* at *3.
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Fountain Enterprises, LLC v. Markel Insurance Company*, 2021 WL 4999447 at *2 (D.C. Virginia October 26, 2021).

("Markel"), seeking damages for loss of income and other expenses due to government ordered COVID-19 shutdowns after Markel denied their insurance claims.[40] The District Court for the Eastern District of Virginia agreed with the majority of courts which determined that the "loss of usability is not a 'direct or physical' loss that entitles an insured to gain coverage from an insurer, particularly in the case of COVID-19 shutdowns."[41]

In addition, the policies issued by Markel contained a virus exclusion. The plaintiffs unsuccessfully argued that it was the shutdown – and not the virus – that caused the loss of business income and that if Markel intended for the exclusion to apply whenever a virus played any role in a shutdown, then the exclusion should have been more expansive.[42] The court disagreed stating "it is sufficient for COVID-19 to be a cause of the plaintiffs' alleged harm and not the sole cause."[43]

The court interpreted the policy under Mississippi[44], Pennsylvania[45] and Washington[46] state law, as well as Virginia[47] law (which the plaintiffs argued applied in this case) and came to the same conclusion under each state specific insurance coverage case precedent.[48]

The case is currently under appeal to the Fourth Circuit which has yet to issue a decision.[49]

McDonald's Corporation, McDonald's USA, LLC v. Austin Mutual Insurance Company, 526 F. Supp. 3d 346 (N.D. Ill. 2021)

In this coverage case, McDonald's Corporation and a group of its franchisee owners (hereinafter referred to collectively as "McDonald's") survived a Motion to Dismiss filed by its insurance carriers in the Federal District Court for the Northern District of Illinois over whether the insurer had a duty to defend McDonald's against an injunction filed by its employees over its safety protocols.

McDonald's brought an action against their insurance company, Austin Mutual Insurance Company ("Austin Mutual"), demanding the insurance carrier satisfy its duty to defend the plaintiffs under its commercial general liability insurance policies against lawsuits alleging nuisance and negligence against the McDonald's locations for remaining open during the COVID-19 pandemic without taking enhanced health and safety

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[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.* at 9.
[44] *Real Hosp. LLC v. Travelers Cas. Ins. Co. of Am.,* 499 F. Suppl. 3d 288, 296 (S.D. Miss. 2020); *Kirland Grp., Inc. v. Sentinel Ins. Co., Ltd.*, 2021 WL 2772561 (S.D. Miss June 29,, 2021).
[45] *RDS Vending LLC v. Union Ins. Co.,* 2021 WL 1923024 (E.D. Pa. May 13, 2021); *Shantzer v. Travelers Cas. Ins. Co. of Am.*, 2021 WL 1209845 (E.D. Pa. March 21, 2021).
[46] *Ainsworth v. Progressive Cas. Ins. Co*., 322 P.3d 6, 11 (Wash. Ct. App. 2014).
[47] *Professional Baseball LLC v. National Casualty Co*., 2021 WL 44933920 at *3 (9th Cir. Oct. 1, 2021).
[48] *Id.*
[49] Zigterman, Ben, *Gym Owners Ignored COVID-19 Rulings, Insurer Tells 4th Cir.,* Law 360 (March 3, 2022) at Gym Owners Ignored COVID-19 Rulings, Insurer Tells 4th Circ. - Law360.

protocols.[50] In the underlying lawsuit, the plaintiffs were seeking an injunction against McDonald's requiring it to take certain enumerated safety measures on behalf of its employees such as supplying hand sanitizer, requiring customers wear face masks, providing adequate personal protective equipment and monitoring employee COVID-19 outbreaks.[51]

Under the policy, the insurance carrier agrees to pay "*those sums that the insured becomes legally obligated to pay as damages because of bodily injury . . . to which this insurance applies*" but the bodily injury must have been caused by an occurrence that takes place in the coverage territory.[52] In denying a duty to defend, Austin Mutual argued:

- the underlying lawsuit did not seek damages because of bodily injury; and
- the request by the employees for enhanced safety protocols were not to remedy bodily injury to third persons.[53]

McDonald's argued in response to this denial that *but for* the plaintiff employees contracting COVID-19 (a 'bodily injury'), the restaurants would not have to spend money as damages to comply with the injunction.[54]

This case was not a coverage dispute over a duty to indemnify. Instead, this case was filed against Austin Mutual only to establish that it had a duty to defend McDonald's in the underlying lawsuit. The duty to defend is much broader than the duty to indemnify and an insured party only must show that the underlying complaint alleges facts potentially within policy coverage.[55] The threshold is much lower than an indemnity coverage analysis and liberally construed in favor of the insured.[56]

The court conducted a three-step analysis.

First, it determined whether the definition of damages under an insurance policy can include the cost to comply with a mandatory injunction. Prior cases decided under Illinois law decided in the affirmative. McDonald's met this first test since "it would require [McDonald's] to expend money to remediate the continuous and ongoing exposure to the virus."[57]

Once the court concluded that the underlying lawsuit remedy does meet the definition of potential damages, the court turned to deciding whether those damages are *because of* bodily injury.[58] Again, the court found in favor of McDonald's, stating that it

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[50] *Massey v. McDonald's*, 2020CH04247 (Ill. Cir.).
[51] *McDonald's Corporation v. Austin Mutual Insurance Company*, 526 F.Supp.3d 346 at 348 (N.D. Ill 2021).
[52] *McDonald's*, 526 F.Supp.3d at 348.
[53] *Id.*
[54] *Id.* [emphasis added].
[55] *Id.* citing *Federated Mut. Ins. Co. v. Coyle Mech. Supply, Inc.* 983 F.3d 307, 314 (7th Cir. 2020).
[56] *McDonald's*, 526 F.Supp.3d at 349.
[57] *Id.* at 350.
[58] *Id.*

adequately alleged that *but for* the employees actual contraction of COVID-19, McDonald's would not have to incur damages to comply with the injunction.[59]

Finally, the court analyzed whether bodily injury was suffered. Because neither party disputed that a number of the employees contracted COVID-19, this was decided in favor of McDonald's as well. The court did mention the "vexing" question of whether the damages (safety protocols) would actually have a remedial purpose (a required element under Illinois law) since the employees already have COVID-19. However, in a duty to defend determination, it is not a "dispute about the better interpretation: it is a dispute about a potential and legally defensible interpretation" and the court denied the insurance carrier's Motion to Dismiss.[60]

McDonald's subsequently settled the public nuisance lawsuits in this underlying coverage matter last summer.[61] As part of the settlement, McDonald's agreed to provide a mechanism for employees to voice pandemic safety related concerns to management.[62]

B. Non-COVID-19 Franchise Insurance Coverage Disputes

Starr Indemnity and Liability Company v. Choice Hotels International Inc., 2021 WL 2457107 (D.C. S.D. NY June 16, 2021)

This is a very timely insurance coverage case with potentially far-reaching application as law enforcement, the media and society generally call greater attention to the scourge of human exploitation existing throughout the world, including within the United States. In this case, the United States District Court for the Southern District of New York decided that Starr Indemnity and Liability Company ("Starr") had a duty to defend franchisor, Choice Hotels International, Inc. ("Choice"), as an additional insured under one of its franchisee's policies, when it was sued for its alleged role in a human trafficking venture occurring at one of its hotel chains.[63]

Starr issued a general commercial liability policy to a Quality Inn franchisee operating in Columbia, South Carolina.[64] A complaint was filed against both the franchisee and Choice by a plaintiff alleging she was lured to the hotel where she was forcibly raped and then held captive for approximately three weeks.[65] During the time she was trapped at the hotel, she was required to provide commercial sexual services by her traffickers.[66] The plaintiff alleged that Choice violated the William Wilberforce Trafficking

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[59] *Id.* Austin Mutual also argued that the policy is intended to cover third-party damages, not first-party damages sustained by the insured. However, Austin Mutual was unable to point to a provision in the policy supporting such a conclusion so the argument failed. *Id.*
[60] *McDonald's*, 526 F.Supp.3d at 351-352.
[61] Bronstad, Amanda. *McDonald's Settles Some of the First Workers' Lawsuits over COVID-19 Protections*, National Law Journal, August 12, 2021.
[62] Supra, note 60.
[63] *Starr Indemnity and Liability Company v. Choice Hotels International Inc.*, 2021 WL 2457107 (S.D. NY June 16, 2021).
[64] *Id.* at *1.
[65] *Id.*
[66] *Id.*

Victims Protection Reauthorization Act of 2008 and had a statutory obligation not to profit from the venture it should have known was illegal and that Choice violated state law by facilitating sexual abuse.[67] In support of these causes of action, the plaintiff alleged that (1) the foot traffic was "constant, voluminous and obvious", (2) her captures would book rooms for only one night, pay in cash and leave evidence of sexual activity in the rooms and (3) she was witnessed in the hotel with prominent and visible injuries.[68] Based on the circumstances of her confinement, she argued that Choice should have known the circumstances of her confinement and acted in a willful blind way to protect its steady income stream from sex workers and traffickers.[69]

Starr denied coverage and did not agree to participate in Choice's defense or indemnity in connection with the lawsuit based on an "Abuse and Molestation" Exclusion. The Abuse and Molestation Exclusion stated:

> *This insurance does not apply to "bodily injury," "property damage," or "personal or advertising injury" arising out of:*
>
> *1. The actual or threatened abuse or molestation by anyone of any person while in the care, custody or control of any insured; or*
>
> *2. The negligent:*
>
> *a. Employment;*
> *b. Investigation;*
> *c. Supervision;*
> *d. Reporting to the proper authorities, or failure to report; or*
> *e. Retention;*
>
> *Of a person for whom any insured is or ever was legally responsible and whose conduct would be excluded by Paragraph 1. above[70].*

Starr argued that the plaintiff was in the "care" of the franchisee hotel at the time she was trafficked by "virtue of her presence on the premises [and] her status as a business invitee" and therefore, the claim fell within the Abuse and Molestation Exclusion under the policy.[71] The court firmly rejected Starr's interpretation that the exclusion applied to *any* person owned a legal duty of care under the legal negligence theory calling it a "strained reading" of the exclusion.[72] Instead, the "care, custody or control" phrase should be interpreted more narrowly to charge, supervision, management or responsibility for a person.[73] When interpreting the word 'care' as it appears in the Abuse and Molestation

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67 *Id.*
68 *Id.*
69 *Id.* at *2.
70 *Choice Hotels,* at *4.
71 *Id.*
72 *Id.*
73 *Id.* at *6-7.

Exclusion, the policy refers to "responsibility for or attention to safety and well-being" – not a general duty of care that owed under negligence claims.[74]

Starr urged the court to set a bright line rule that the exclusion should apply whenever a hotel guest suffers abuse or molestation on hotel premises.[75] The causes of action asserted and the facts supporting the claims are similar to dozens of cases filed against hotels across the county in recent years so it is likely that Starr was hoping for a supportive coverage determination it could use in denying a duty to defend to the many hotel chains it likely underwrites insurance. However, the court thoroughly rejected the argument and concluded that Starr wrongfully disclaimed its duty to defend.[76]

Great American Insurance Company v. Beyond Gravity Media, Inc., 2021 WL 4192738 (S.D. TX Sept 15, 2021)

In this insurance coverage case, the insurer brought an action requesting a declaratory judgment that it had no obligation to defend or indemnity claims in an underlying lawsuit filed by a franchisor against a former franchisee.[77] The court granted the motion and determined that the Great American Insurance Company ("Great American") had no duty to defend or indemnity a former Code Ninja franchisee alleged to have misappropriated confidential information and trade secrets of the franchisor and violate restrictive covenants in the franchise agreement against competition because all of the wrongful conduct was excluded under the policy.[78]

The insured secured a general commercial liability policy with Great American after entering into an agreement with the franchisor to open multiple Code Ninja franchise locations in California.[79] A year later, the insured attempted to rescind the franchise agreements and Code Ninja responded by alleging that the franchisee created a competing education business under the brand "CoDojo" using its confidential and proprietary information gained through the franchisor's training program, annual conferences and other communications.[80] The franchisor and franchisee eventually entered into a settlement agreement, but before doing so, Great American filed an action for a declaratory judgment contending that the policy does not cover the former franchisee's alleged wrongful conduct and breaches of the franchise agreement non-disclosure and restrictive covenant provisions.[81]

First, the court determined that the franchisee's misappropriation of Code Ninja's branding to redirect students to his own competing schools and registering of an impermissible competing trademark (which it then used to advertise on social media) did

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[74] *Id.* at *7.
[75] *Id.* at *9.
[76] *Choice Hotels,* at *11.
[77] *Great American Insurance Company v. Beyond Gravity Media, Inc.*, 2021 WL 4192738 (S.D. TX Sept 15, 2021).
[78] *Great America*, 2021 WL 4192738 at *1.
[79] *Id.* at *1.
[80] *Id.*
[81] *Id.*

constitute potential "Personal and Advertising" injury under the policy.[82] However, the court determined that all of the following exclusions applied to the franchisee's conduct:

1. Knowing violation
2. Contractual liability
3. Infringement of intellectual property
4. Breach of contract
5. Unauthorized use
6. Access or disclosure of confidential information.[83]

The majority of these exclusions are standard and commonly found in most general commercial liability policies. Unfortunately, this type of conduct by franchisees is not unusual after termination of a franchise relationship. Franchisors should be aware when pursuing lawsuits against franchisees that standard insurance policies are unlikely to cover these types of wrongful acts and insurance policy proceeds will not be available for any action to recover damages.

American Family Mutual Insurance Company, S.I and Austin Mutual Insurance Company v. Carnagio Enterprises, Inc. No. 20 C 3665, 2022 BL 109861 (N.D. Ill. March 30, 2022)

The defendant in this case was a McDonald's franchisee operating thirteen locations.[84] A class action was brought against the franchisee by its employees alleging violations of Illinois's Biometric Information Privacy Act[85]. According to the plaintiff, the franchisee required its employees to clock in and out of shifts using fingerprints, but did not provide any disclosures to the employees about its retention and destruction policies with respect to the biometric data it collected.[86] The insurance carrier cited a number of exclusions in denying its duty to defend and indemnify which were systematically addressed by the court:

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[82] *Id.* Coverage Part B in the general commercial liability policy defined "Personal and advertising injury" as "injury . . . arising out of one or more of the following offenses: f. the use of another's advertising idea in your "advertisement"; or infringing upon another's copyright, trade dress or slogan in your "advertisement." *Id.*
[83] *Great American*, at *7.
[84] *Am. Family Mut. Ins. Co. v. Carnagio Enterprises, Inc.*, No. 20 C 3665, 2022 BL 109861 (N.D. Ill. March 30, 2022).
[85] 740 ILCS 14 et seq (2008). The Illinois's Biometric Information Privacy Act (BIPA) was enacted in 2008 and is known as one of the most stringent state laws protecting citizens from unauthorized use of biometric data (DNA, fingerprints, face, hand, retina, or other physical features). The law requires that businesses: (1) obtain informed consent prior to collection, (2) mandates protection obligations and retention guidelines and (3) prohibit profiting from biometric data. The BIPA also creates a private right of action for individuals harmed by BIPA violations and provides for statutory damages up to $1,000 for each negligent violation, and up to $5,000 for each intentional or reckless violation. Lazzarott, Joseph and Abrahams, Nadine, Illinois Biometric Information Privacy Act FAQ, Jackson Lewis, available at IllinoisBIPAFAQs.pdf (jacksonlewis.com) [PDF].
[86] *Carnagio,* 2022 BL 109861.

Employment Related Practices Exclusion

"EPLI" exclusions cover claims of bodily injury or personal advertising injury related to a person arising out of any "1. Refusal to employ that person; 2. Termination of that person's employment; or 3. Employment related practices, policies acts or omissions, such as coercion, demotion, evaluation, reassignment, disciple, defamation, harassment, humiliation or discrimination directed at that person . . . ."

The court analyzed a split of legal authority determining whether this exclusion applies to BIPA claims.[87] The court determined the alleged wrongful conduct did not fall within the scope of activities described in the exclusion and therefore, did not apply.[88]

Distribution of Material in Violation of Statute

This provision excluded *"'Bodily injury", "property damage", or "personal and advertising injury" arising directly or indirectly out of any action or omission that violates or is alleged to violate: (1) The Telephone Consumer Protection Act (TCPA), including any amendment or addition to such law; or (2) The CAN-SPAM [*3] Act of 2003, including any amendment of or addition to such law; or (3) Any statute, ordinance or regulation, other than the TCPA or CAN-SPAM Act of 2003, that prohibits or limits the sending, transmitting, communicating or distribution of material or information."*

Again, the court described a split of authority as to whether BIPA claims are similar enough to CAN-SPAM Act and TCPA claims to fall within the scope of the exclusion. Some courts previously determined the exclusion does cover BIPA claims since all of the statutes are intended to protect privacy rights.[89] Other courts determined the BIPA is materially different since it regulates information that is given away.[90] The court found the exclusion ambiguous and therefore, decided against the drafting insurance carrier.[91]

Access Or Disclosure Of Confidential Or Personal Information And Data-related Liability

This provision excludes coverage for *"(1) Damages, other than damages because of "personal and advertising injury", arising out of any access to or disclosure of any person's or organization's confidential or personal information, including patents, trade secrets, processing methods, customer lists, financial information, credit card information, health information, or any other type of nonpublic information, or (2) Damages arising out of the loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate electronic data."*

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[87] *Id.*

[88] *Id.* The court used the principal of *noscitur a sociis* (the meaning of neighboring words can help guide a word's meaning and the fact that several items share an attribute counsels in favor of interpreting the other items as possessing that attribute as well). Since the listed wrongful conduct were directed at a particular employee and this was a policy for all employees, the court determined it was not like the other listed excluded activities. *Id.*

[89] *Id.*

[90] *Id.*

[91] *Id.*

The insurance carrier won its case on this exclusion. The court determined that the disclosure of the fingerprint data did clearly fall within this exclusion and the underlying class action was not covered under the policy[92].

II. FORCE MAJEURE CASES RAISING THE COVID-19 PANDEMIC

Over the past year there were no significant franchise or distribution cases where a party to a lawsuit successfully argued that a force majeure clause excused performance under a franchise agreement, distribution agreement, lease or other contractual obligation between a franchisee, distributor, or licensee on one hand and a franchisor or licensor on the other. Following what we saw with last year's cases, the existence of the COVID-19 pandemic by itself was not sufficient to raise a force majeure provision as an affirmative defense to performance under a contract. The party seeking to invoke the provision must show that the force majeure event (the COVID-19 pandemic) was the reason for the non-performance. As you will see from the cases, this was not an easy threshold to meet. Similar arguments raising frustration of purpose or impracticability were equally unsuccessful. However, the pandemic was used as a contributing mitigating factor in two cases. The first time when setting aside a default judgment against a former nail salon franchisee and the second, when determining the scope of an injunction against a former tax preparation service franchisee violating its post-term restrictive covenants.

La Simple Co. Ltd v. SLP Enterprises, LLC, 2021 WL 1648762 (April 27, 2021)

In this case, a sunglass distributor was unable to invoke a force majeure clause in an exclusive distribution agreement to avoid contractual obligations during the pandemic.[93]

SLP Enterprises ("SLP"), the plaintiff in this case, was a Massachusetts children's sunglass manufacturer and La Simple ("La Simple") was an exclusive distributor of SLP's products in China. The distributor, La Simple, filed a lawsuit against SLP for breach of contract and other state law claims arising under Massachusetts law after SLP terminated La Simple's agreement for failing to meet minimum purchase requirements under the agreement.[94] The agreement contained standard non-waiver language and an integration clause.[95] Neither party disputed that La Simple failed to meet the required sales quotas for the July 31, 2020 and September 30, 2020 deadlines.[96] However, La Simple argued that SLP agreed to suspend the quotas during an oral telephone conversation.[97] SLP disagreed and terminated the agreement.[98]

The court determined that the plain language of the agreement allowed SLP to terminate the agreement if the distributor failed to meet quotas.[99] Since La Simple

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[92] *Id.*
[93] *La Simple Co. Ltd v. SLP Enterprises, LLC*, 2021 WL 1648762 (D.C. Mass, April 27, 2021).
[94] *Id.* at *1.
[95] *Id.*
[96] *Id.* at *3.
[97] *Id.*
[98] *La Simple Co.*, at *3.
[99] *Id.*

indisputably failed to meet the required quotas, it could only succeed in its case if (1) SLP waived the requirements under the contract or (2) the force majeure clause was triggered.[100]

The court concluded that La Simple was unable to provide sufficient evidence that its failure to satisfy its contractual obligations were the result of a force majeure event.[101] It is not sufficient to simply argue that a force majeure event occurred (in this case, the "Act of God" beyond the control of La Simple, being the pandemic). The party invoking the clause must establish that the Act of God directly impacted its ability to fulfill the contract provision it is attempting to *avoid.* La Simple was unable to establish this proof. In fact, the evidence showed that (1) SLS own representatives in the territory were able to continue to move product during the pandemic and (2) La Simple was failing to meet minimum sales requirements even prior to the start of the pandemic.[102] Therefore, "assuming arguendo that the pandemic and [its] effects. . . are a force majeure under the [Distribution] Agreement," La Simple "has not shown that its failure to perform its obligations" was "caused by" the pandemic as required by the language of the Force Majeure clause.

Nails v. Hoang Minh T Ha, No. 20-14388-CIV-MARTINEZ/MAYNARD, 2021 BL 343870, 2021 Us Dist Lexis 172265 (S.D. Fla. Sept. 09, 2021)

The court set aside a default judgment against a Regal Nails franchisee after the franchisee ceased making monthly payments of rent or franchise fees.[103] After the franchisee abandoned the premises and stopped operating the salon, the franchisor sued for breach of the franchise agreement[104]. After the franchisee failed to respond, the franchisor moved for a default judgment but the court ordered an evidentiary hearing.[105] During the hearing, the franchisee explained that he was unable to pay fees and rent because everyone was sick due to COVID and the salon was not making money.[106]

The court determined that the franchisee ***may*** have a meritorious defense of contractual force majeure or common law defenses based on frustration of purpose or impossibility or impracticability of performance due to the illnesses of the employees and the state closure mandates during the time and set aside the default judgment.[107] This is one case where the court took the pandemic into consideration when setting aside the default judgment, however, the franchisee's lack of English and the hefty legal fees, interest and damages included in the default judgment did not help the franchisor's case either.

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[100] *Id.* at *5.
[101] *Id.* at *7.
[102] *Id.*
[103] *Regal Nails, Salon & Spa, LLC v. Hoang Minh T Ha*, No. 20-14388-CIV-MARTINEZ/MAYNARD, 2021 BL 343870, 2021 Us Dist Lexis 172265 (S.D. Fla. Sept. 09, 2021)
[104] *Id.*
[105] *Id.* The court ordered the evidentiary hearing after determining that the franchisee did not speak English and there may have been deficiencies with service of process. *Id.*
[106] *Id.*
[107] *Id.* [emphasis added].

Lucky U, LLCX v. S&F Investments, LLC, A&V Petroleum, LLC and Fadi Qumbargi, Civil No. 3:21cv931 (Dist. CT, January 11, 2022)

This a gas station lease case where the plaintiff operated a gas station and convenience store leased from the defendants[108] and brought a lawsuit against the defendant for (1) breaches of the lease, supply agreement and key money agreement, (2) violations of state unfair trade practices law, (3) negligence and (4) fraud as well as a demand to reform or rescind the fuel supply agreement .[109] After a two day evidentiary hearing, the court granted the defendant's motion for a preliminary injunction and ordered the franchisee to surrender the locations.

Plaintiff and defendant were parties to a lease, supply agreement under which the parties attempted to create a franchise relationship and key money agreement.[110] On October 15, 2021 the defendant provided notice of termination listing sixteen different grounds with an effective date of termination three days later.[111] One of the eleven affirmative defenses raised by the franchisee dealer included the equitable defense of "force majeure" as the plaintiff alleged that the COVID-19 pandemic negatively impacted the sale of gasoline.[112] The Supply Agreement contains a Force Majeure Clause, excusing A&V for "delay or non-performance" if an event beyond its control occurs but also states: "[i]n no event shall any force majeure condition affect Dealer's obligation to pay for Product when due."[113]

Like the previous cases, however, the franchisee dealer was unable to demonstrate how the COVID-19 prevented it from complying with other conditions under the agreements, including required upgrades.[114] The force majeure defense was again unsuccessful because the party asserting the defense was unable to specifically show how the circumstances of the pandemic were directly responsible for the non-performance under the agreement.[115]

Level 4 Yoga, LLC v. Corepower Yoga, LLC, 2022 WL 601862 (DE Chancery March 1, 2022)

In one of the most recent and more highly publicized COVID related franchise deal cases, franchisor, CorePower Yoga LLC, was ordered to pay close to $30 million to a large multi-unit franchisee of the system after it backed out of an agreement to purchase thirty-four of its franchised units during the pandemic.[116]

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[108] *Lucky U, LLC v. S&F Investments, LLC, A&V Petroleum, LLC and Fadi Qumbargi*, Civil No. 3:21cv931 (Dist. CT, January 11, 2022).
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *Lucky U,* Civil No. 3:21cv931 (Dist. CT, January 11, 2022).
[114] *Id.*
[115] *Id.*
[116] *Level 4 Yoga, LLC v. Corepower Yoga*, LLC, 2022 WL 601862 (DE Chancery March 1, 2022).

In May 2019, the franchisor exercised a "call option" requiring its largest franchisees, Level 4 Yoga ("Level 4"), to sell all of its franchised CorePower Yoga studios to it and the parties entered into an asset purchase agreement on November 27, 2019.[117] The first tranche of closings under the asset purchase agreement were scheduled for April 2020 – one month after the COVID-19 pandemic overtook the country.[118] The franchisor sought to terminate the purchase agreement or delay closing, but the franchisee refused.[119] The franchisor then ordered its franchised units (including Level 4) to temporarily close to combat COVID-19.[120] Once Level 4 closed its yoga studios, the franchisor then declared the asset purchase agreement terminated. It argued that Level 4 repudiated the agreement by violating the requirement that the franchisee seller continue to operate the business in ordinary course.[121] CorePower also argued that the closures had a "material adverse effect" on the business such that the franchisor was no longer required to perform. The franchisee responded that it was operating in the ordinary course by complying with the franchise agreement and franchisor's demands to close, as a franchisee of a franchise system is required to do under system standards.[122] Level 4 also argued that the asset purchase agreement was purposely structured as a one-way deal with no right for either party to terminate.[123]

In a long decision where the court even cited singer Gavin Rossdale – "Everything Zen? Everything zen? I don't think so"[124] it decided in favor of the franchisee. First, the court analyzed the franchise agreement described of "System Standards" particularly those provisions which allowed the franchisor to regulate Level 4's days of operation and dictate Membership Terms as well as the franchisees requirement to compliance with law and adhere to good business practices.[125] Then the court analyzed the Call Option Agreement which allowed the franchisor to all acquire all of the studios upon exercise at a contractually determined price calculation method.[126] Once determined, CorePower was required to close on the transaction within 60 days.[127]

When a private equity firm acquired the franchisor it re-negotiated the terms of the call option to allow the purchase all of the franchisee's currently operating studios in stages with no closing conditions with the first to occur on April 1, 2020.[128] After CorePower did not appear at the first virtual closing, Level 4 filed suit.[129] The court

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[117] *Id.*
[118] *Id.* at *1.
[119] *Id.*
[120] *Id.*
[121] *Level 4 Yoga, LLC* at *1
[122] *Id.*
[123] *Id.*
[124] *Id.* at *2 citing Gavin Rossdale, *Everything Zen* (Interscope, ©MBG 1994).
[125] *Id.* at *4.
[126] *Level 4 Yoga, LLC* at *4
[127] *Id.*
[128] *Id.* at *6.
[129] *Id.* at *9.

determined that there was no contractual or common law right to terminate the purchase agreement so CorePower's refusal to close was a breach.[130]

III. OTHER FRANCHISE COVID-19 DECISIONS

Jackson Hewitt Inc. v. Collins Njoku, Civ. No. 21-7665 (U.S. D.C. NJ May 6, 2021)

This case was brought after franchisor, Jackson Hewitt, terminated the defendant franchisee's tax preparation business after many notices of default and failed opportunities to cure.[131] The terminated franchisee allegedly breached its post-termination restrictive covenants against competing and soliciting and failed to return confidential information.[132] The court determined that the franchisee was violating the post-term obligations under the franchise agreement, but tailored the injunction so it would not interfere with the filing of tax returns on behalf of existing customers stating that "*many customers are entitled to tax refunds that make a substantial difference in economic wellbeing. Their livelihood is a significant public interest that may be harmed by prematurely imposing the preliminary injunction, particularly in the current context of COVID-19 pandemic."* The court also cited the general hardship caused by COVID-19 which it called a "*universally shared burden that could not have been anticipated when the agreement was signed*" to support its decision to narrowly tailor the injunctive relief granted to the franchisor.[133] The court still granted the relief for the franchisor, but did so in a more sensitive matter given the impact the pandemic had on both businesses and consumers alike.

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[130] *Id.* at *10.
[131] *Jackson Hewitt Inc. v. Collins Njoku, Civ.* No. 21-7665 (U.S. D.C. NJ May 6, 2021)
[132] *Jackson Hewitt*, No. 21-7665 at *5.
[133] *Id.* at *15.

International Franchise Association
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2022 Judicial Update

Pricing and Rebates/Mark-up Cases

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[1] My thanks to Elizabeth McIntosh of our firm for her work on this paper.

INTRODUCTION

There have been only a few cases involving mark-ups and rebates in the last couple of years. Two are from Washington state, and construe the Washington Franchise Investment Protection Act (the "FIPA"). The FIPA precludes a franchisor from selling franchisees products and services at more than a "fair and reasonable price." However, even outside Washington state, the question of what prices are fair and reasonable, as well as questions relating to rebates, are relevant to claims involving Item 8 disclosures. The most recent cases are discussed first, with a discussion of several older cases, for context, to follow.

RECENT CASE LAW ANALYSIS

1. *Money Mailer v. Brewer* Cases

A. *Money Mailer v. Brewer*, 449 P.3d 258 (Wash. 2019) (*Money Mailer I*)

In *Money Mailer I,* the Washington Supreme Court answered two certified questions from the United States District Court for the Western District of Washington regarding the proper interpretation and application of the FIPA's prohibition against a franchisor selling a franchisee products or services for more than a "fair and reasonable price."

The *Money Mailer v. Brewer* cases arose from a dispute between the franchisor Money Mailer, LLC ("Money Mailer") and Brewer, its franchisee. By way of background, Money Mailer is an "enveloped-based direct marketing company" whose franchisees sell local business advertisement space in Money Mailer's shared envelopes, which are then mailed to potential customers in the area. Money Mailer requires its franchisees to enter into contracts with Money Mailer for certain services related to the printing and inserting of advertisements into shared mail envelopes. In 2015, Money Mailer sued Brewer in Washington federal district court, alleging breach of contract and nearly $2 million in damages. Brewer counterclaimed against Money Mailer, alleging, among other things, that Money Mailer had violated the FIPA by selling Brewer "products and services . . . at more than a fair and reasonable price," in contradiction to Wash. Rev. Code § 19.100.180(2)(d).

Brewer moved for partial summary judgment on the alleged FIPA violations. The district court found that it was undisputed that Money Mailer violated the FIPA by selling printed advertisements to Brewer at twice the price Money Mailer obtained and/or produced them, and granted in part Brewer's motion for summary judgment.[2] However, after denying Money Mailer's motion for reconsideration and/or interlocutory review, the district court decided to certify the following two questions to the Washington Supreme Court:

> (1) For purposes of FIPA's prohibition on selling "to a franchisee any product or service for more than a fair and reasonable price," (Wash. Rev. Code § 19.100.180(2)(d)) may the franchisee rely on the price at which the franchisor is able to obtain the product or service in the absence of evidence indicating that the price was not a true market price?
>
> (2) Does a franchisor violate Wash. Rev. Code § 19.100.180(2)(d) as a matter of law when it charges the franchisee twice what it pays for a product or service?

[2] *Money Mailer v. Brewer*, No. C15-1215RSL, 2018 WL 3156901, at *2 (W.D. Wash. June 28, 2018).

The Washington Supreme Court answered “no” to both questions.

Initially, before answering either question, the Washington Supreme Court stated that a “fair and reasonable price” was a question of fact “regarding what reasonably prudent franchisors and franchisees in similar circumstances would consider an appropriate price.” The court then turned to the first question. Based on the plain language of the FIPA and its legislative history, the court determined that the statute’s intent was to look at the market and market forces to determine whether prices are fair and reasonable under the FIPA. When making such a determination, the relevant factors that should be taken into consideration in determining what constitutes a “fair and reasonable price” include: the price at which the franchisor acquired the products or services, the prices of competitor franchisors, what other franchisors charge other franchisees, business and industry practices, and the price at which the franchisor could have obtained the goods or services elsewhere, including in an arm’s length deal on the open market. Moreover, the court stated that the list was not exhaustive and other factors could apply. After analysis of these factors, the court determined that a price is not fair and reasonable under Wash. Rev. Code § 19.100.180(2)(d) merely because it is the price the franchisor paid, or the price that the franchisee might pay if it purchased the products or services from a third party.

Next, with regard to the second question, the Washington Supreme Court held that a franchisor does not violate the FIPA as a matter of law by charging a franchisee twice what the franchisor paid for the product or services. Nor does the FIPA contain an implicit or explicit requirement that a franchisor can never markup products. The court explained that there might be situations in which a franchisor may charge a franchisee twice what it paid to acquire a good or service, but nevertheless still be charging a fair and reasonable price. The court held that a “per se rule” does not reflect Washington law. And, because the determination of fair and reasonable price is fact specific, the amount of markup charged, when considered with all of the other relevant factors, will drive the determination as to what is a fair and reasonable price. Accordingly, the Washington Supreme Court held that what is a “fair and reasonable price” is a question of fact that turns on “what prudent franchisees and franchisors in similar circumstances would regard as an appropriate price.”

Bottom Line:

Selling a product or service to a franchisee at twice the price the franchisor paid for it is not a per se violation of the FIPA. A “fair and reasonable price” is a question of fact which considers what a prudent franchisor and franchisee in similar circumstances would regard as an appropriate price. The price that the franchisor paid for the product or service is not determinative of what is fair and reasonable under Wash. Rev. Code § 19.100.18(2)(d).

B. *Money Mailer v. Brewer*, No. C15-1215RSL, 2020 WL 3639623 (W.D. Wash Sept. 6, 2020) (*Money Mailer II*)

After the Washington Supreme Court issued its opinion, the district court applied the relevant standards and held that there was evidence from which the fact finder could reasonably conclude that Money Mailer was charging fair and reasonable prices for its products and services despite the markups, and thus Brewer’s previously filed summary judgment motion was denied. The district court found there was evidence in the record regarding the price of comparable printing services on the wholesale market, the price a competitor franchisor charged its franchisees, the price other franchisees paid for the printing services, value-added services included in the “printing services” for which Brewer paid, and the price Brewer would have to pay

to obtain the printing services elsewhere. Therefore, because Money Mailer raised a genuine issue of material fact regarding the fairness and reasonableness of its charges for printing services the court denied Brewer's motion for summary judgment.

Thereafter, Brewer nevertheless again moved for partial summary judgment. The district court held that in response to the Washington Supreme Court's answers to its certified questions in *Money Mailer I*, while the price at which the franchisor acquired the product or service is relevant, the Washington Supreme Court had made clear that the price does not necessarily establish the "fair and reasonable price" of the product or service. The district court set forth the relevant factors denoted by the Washington Supreme Court, but explained that the list was not exhaustive, exclusive, or mandatory.

The court also noted that Brewer again sought judgment on the "fair and reasonableness" issue, but noted that he had not offered any new evidence or argument regarding most of the factors identified by the Washington Supreme Court. Accordingly, since the court had already found that there was evidence from which the factfinder could reasonably conclude that Money Mailer was charging fair and reasonable prices for its products and services, reconsideration of the issue was not warranted and summary judgment was denied.

The court then addressed Brewer's argument in its latest motion for summary judgment that Money Mailer's failure to disclose that it charges franchisees more for products and services than it pays violates Wash. Rev. Code § 19.100.170(2). However, the court dismissed the argument, holding that Brewer failed to establish that Money Mailer misled prospective franchisees by failing to disclose in its FDD that it earned a profit on the sale of certain products and services. In fact, the court specifically noted that Money Mailer had disclosed in the FDD that it provided such products and services at "customary prices." The court held that the statement was not misleading because the court already determined that there was evidence from which the fact finder could reasonably conclude that the prices Money Mailer charged for the products and services were fair and reasonable. Accordingly, the court denied Brewer's motion for partial summary judgment.

Although the *Money Mailer* cases are specific to Washington's FIPA, they may have broader application. For example, a number of states have relationship laws that constrain—subject to important exceptions—a franchisee's ability to limit the purchase of products from the franchisor or particular suppliers where, for example, goods and supplies of comparable quality are available from other sources.[3] Additionally, franchisees might argue that unreasonably high

[3] *See e.g.*, Indiana Code §23-2-2.7-1 § 1(1) ("It is unlawful for any franchise agreement entered into between any franchisor and a franchisee who is either a resident of Indiana or a nonresident who will be operating a franchise in Indiana to contain any of the following provisions: Requiring goods, supplies, inventories, or services to be purchased exclusively from the franchisor or sources designated by the franchisor where such goods, supplies, inventories, or services of comparable quality are available from sources other than those designated by the franchisor. However, the publication by the franchisor of a list of approved suppliers of goods, supplies, inventories, or service or the requirement that such goods, supplies, inventories, or services comply with specifications and standards prescribed by the franchisor does not constitute designation of a source nor does a reasonable right of the franchisor to disapprove a supplier constitute a designation. This subdivision does not apply to the principal goods, supplies, inventories, or services manufactured or trademarked by the franchisor."); Haw. Rev. Stat. § 482E-6(B) ("For the purposes of this chapter and without limiting its general application, it shall be an unfair or deceptive act or practice or an unfair method of competition for a franchisor or subfranchisor to: . . . (B) Require a franchisee to purchase or lease goods or services of the franchisor or from designated sources

prices charged for restricted products violate the implied covenant of good faith and fair dealing, although such a claim would be of dubious merit.

2. ***Tim Minn, Inc. v. Tim Hortons USA, Inc.*, No. 20-23481-Civ-WILLIAMS/TORRES, 2021 WL 4482733 (S.D. Fla. Aug. 2, 2021)**

Tim Minn, Inc. v. Tim Hortons USA, Inc. is another recent case regarding markups on goods and services. In *Tim Minn, Inc.*, the franchisee alleged that the franchisor violated the Minnesota Franchise Act because, in its FDD, it stated that the franchisor would charge only a reasonable markup on goods that it requires its franchisees to purchase. However, in practice, the franchisee claimed that the markups were objectively unreasonable and that, in some cases, the franchisor charged the franchisee between 20%-50% above the market rate for the necessary items that could not be procured through a different source.

In its motion to dismiss, the franchisor first argued that, under the plain language of the FDD, it had the discretion to determine what should be considered a reasonable markup, and therefore the count should be dismissed. The court denied the motion to dismiss holding that it was unclear how much discretion the franchisor had in determining the amount of the reasonable markup. And, the court stated that at least at the motion to dismiss stage, it could not make this determination. Next, the franchisor argued that reasonable reliance is an essential element of a Minnesota Franchise Act claim, and the complaint made no mention of such reliance. The court stated that the "question here is whether the allegation – '[t]he Franchisee Plaintiffs would not have entered into franchise agreements with the [franchisor], had the true nature of these so-called 'reasonable mark-ups been made apparent' – qualifies as reasonable reliance." The court ultimately held that while it did not find a case opining on "reasonable reliance" under Minnesota law, the terms were not subject to much debate. And even though the franchisees' allegations may have implied that they would have exercised due diligence if they had greater knowledge and not relied upon the franchisor's markups, it needed to be made clearer in a subsequent pleading. Therefore, the court granted the franchisor's motion to dismiss in part without prejudice for the franchisee to amend its Minnesota Franchise Act claims.

Although not discussed in the above-referenced opinion, the franchisor subsequently sought summary judgment on the claims arguing that there was no evidence that its markups were unreasonable. The franchisee agreed that it lacked evidence to support the claim, in responding to the motion for summary judgment. The court has yet to rule on the motion for summary judgment which also involves the franchisee plaintiffs' other claims, unrelated to price or rebate.

3. ***Upshaw v. Lacado*, No. 02-20-00031-CV, 2021 WL 3085757 (Tex. App—Fort Worth[2nd Dist.] July 22, 2021)**

In *Upshaw v. Lacado*, the taco fast-food restaurant franchisee brought an action against the franchisor for fraud based on the franchisor's failure to disclose vendor rebates, among other things. Before the purchase of the franchise, the franchisor assured the franchisee that he did not receive rebates from vendors. However, the franchisor's contract with one of the vendors required the franchisor to give written notice to his franchisees that he was receiving rebates and the

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of supply unless such restrictive purchasing agreements are reasonably necessary for a lawful purpose justified on business grounds. Suppliers suggested or approved by a franchisor as meeting its standards and requirements shall not be deemed designated sources of supply.");

purpose for which those funds were to be used. The contract stated that the purpose of those rebates were for the "benefit" of the franchisees, which the franchisor understood to mean that he was to use the rebates for advertising for the franchisees.

The franchisee discovered that another franchisee had filed suit against the franchisor, alleging that the franchisor was receiving undisclosed rebates from the franchisor's approved vendors. In fact, the franchisor admitted that at the time he provided the FDD to another franchisee, he had been receiving rebates from vendors when his franchisees would buy the vendors' products. Thereafter, the franchisee filed suit against the franchisor, claiming fraud based on the franchisor's failure to disclose vendor rebates, among other things. Specifically, the franchisee claimed that had he known the franchisor was being "dishonest" about the rebates, he would never have entered into the franchise agreements. Importantly, however, the franchise agreement contained a disclaimer-of-reliance paragraph.

After a two-week trial, the jury found that the franchisor committed fraud upon the franchisee and the franchisee had been fraudulently induced to enter the franchise agreements causing $139,650 in damages. On appeal, the franchisor raised a number of arguments based on breach of contract claims, as well as the fraud claims. However, the appellate court found that the evidence was legally sufficient to support the jury's breach-of-contract findings and its calculation of damages. Therefore, the appellate court held that it did not need to address the franchisor's issues challenging the jury's fraud findings.

4. ***Jai Sai Baba, LLC et al v. Choice Hotel International, Inc. et al*, No. 5:20-v-02823 (E.D. Pa. March 19, 2021), ECF. No 8**

The *Jai Sai Baba, LLC* case is a recent case which illustrates the kind of unreasonable pricing claims that can be made, although the litigation ultimately was transferred to arbitration.

In *Jai Sai Baba, LLC*, 90 franchisee plaintiffs filed a lawsuit against a hotel franchisor, in a 591-paragraph 21 court amended complaint which included alleged violations of the Racketeer Influenced and Corrupt Practices Act ("RICO"), 18 U.S.C. § 1962(c)-(d); the Sherman Act, 15 U.S.C. § 1; the Civil Rights Act, 42 U.S.C. § 1981; breach of contract and fiduciary duty; common law fraud; and various state franchise acts. The franchisee plaintiffs asserted that the franchisor was liable for requiring the franchisee plaintiffs to pay inflated prices to third-party vendors for products necessary to the operation of their hotels, among other things. The franchisee plaintiffs alleged that the franchisor had established a qualified-vendor program, which provides necessary hotel items, in order to extract payments from its suppliers. As alleged by the franchisee plaintiffs, vendors could not be considered for inclusion in the program unless they pay an up-front fee of $25,000 to the franchisor. The vendors would then pass that cost onto the hotel operators. For example, the franchisee plaintiffs alleged that franchisor hotel operators pay $34.50 for 10 pounds of frozen sausage links, while non-franchisor hotel operators pay $22.37 for the same amount of meat. Further, the franchisee plaintiffs alleged that the franchisor devised methods of imposing additional fees on them in order to increase its share of the revenue created through the lodging properties they operate

The franchisor moved to compel arbitration and stay the proceedings based on the arbitration clause in the parties' franchise agreements. The franchisor also argued that arbitration should proceed on an individual basis and there was no contractual basis for concluding that it ever agreed to collective arbitration—and in fact with respect to the latter, the franchise agreements contain clauses that preclude collective arbitration. The court held that the franchisee

plaintiffs must proceed to arbitration on an individual basis and case was stayed pending the resolution of the arbitration proceedings.

5. *Fruit Creations, LLC v. Edible Arrangements, LLC,* 3:20-CV-00479, 2020 WL 5095460, at *2 (M.D. Tenn. Aug. 27, 2020)

Fruit Creations, LLC is another more recent "unreasonable pricing" case that was ultimately sent to arbitration. In *Fruit Creations, LLC*, the franchisees sued the franchisor for "[the franchisor's] failure to provide [the franchisees] with an adequate and competent franchise system." Specifically, the franchisees allege that the franchisor "through its affiliated entities, which it controls, . . . has unfairly and capriciously increased fees on a variety of products and services that [the franchisees] are required to buy or use, without any basis for doing so." Based on these, and other allegations, the franchisees assert seven causes of action: (1) breach of contract against EA; (2) breach of the implied covenant of good faith and fair dealing; (3) violation of the Tennessee Consumer Protection Act; (4) misappropriation of funds; (5) conversion; (6) fraud in the inducement; and (7) for an accounting.

The franchisor filed a motion to compel arbitration, based on the arbitration provisions in the parties' franchise agreement, and the court granted the motion and stayed the case in favor of arbitration.

OTHER CASE LAW ANALYSIS

As a result of the dearth of recent cases, we include a discussion of some less current cases for context.

6. *The Cleaning Authority, Inc. v. Neubert*, Civil Nos. JKB-10-203, JKB-09-3447, 2011 WL 666892 (D. Md. Feb. 11, 2011)

In *Cleaning Authority, Inc. v. Neubert*, the franchisor brought suit against the franchisee for alleged improper termination of the franchise agreement. The franchisee counterclaimed against the franchisor claiming that it was fraudulently induced to enter into the franchise contracts because of the franchisor's material misrepresentations and failure to disclose "rebates, kickbacks or other payments" the franchisor received from an affiliate. Specifically, the franchisee claimed that the franchisor failed to disclose payments that the franchisor's affiliate made to the franchisor from required payments made by the franchisee to the affiliates.

In rejecting the franchisee's claim, the court examined the text of the offering circular to determine exactly what was disclosed. Specifically, the court stated "[o]n the first page of the preamble to the FOC, it is stated, 'You must also pay an affiliate of ours an initial mailer set up fee of $2,000.'" Then, in Item 1, the court noted that the franchisor disclosed its two affiliates, one of which was the company that franchisee was allegedly paying the kickbacks to the franchisor. Additionally, the court found that in Item 5, the franchisor disclosed that the required services must be purchased from the affiliate; and in Item 8, the franchisor stated that many of its products would have to be purchased from approved suppliers, and that the franchisor's approval would be required if the franchisee wanted to purchase products from suppliers other than approved suppliers.

The court ultimately held that the franchisee's allegations that the franchisor failed to consider alternate suppliers for the undisclosed reason that its affiliate rebated some of the payments it received to the franchisor were implausible because the franchisor never indicated it

would consider an alternate supplier, and it clearly required franchisees to purchase advertising services through its affiliate in the FDD. Thus, the court determined that "any reasonably reader of the [FDD] would have understood that he or she had no option when it came to a source for advertising mailers." The court also held that the franchisees did not plead sufficient facts to establish the materiality of the financial relationship between the franchisor and the affiliate in the decision to purchase a franchise, nor why franchisees would be entitled to such information. Lastly, the court held there was a distinction between an affiliate from whom franchisees are required to buy advertising services and "approved suppliers," with whom franchisees may, but are not required to do business. The court held that this further undercut any notion that the franchisee was unaware of the business relationship between the franchisor and the affiliate or that the representations were false. The court stated that "[w]hat was required was for [franchisor] to disclose whether it or its affiliate [] 'will or may derive revenue' from required purchases." Given that the franchisee disclosed this, the fact that it may have transferred certain monies between the affiliate and the franchisor after receipt of the funds was of no legal consequence.

7. *Siemer v. Quizno's Franchise Co. LLC,* No. 07 C 210, 2008 WL 904874 (N.D. Ill. March 31, 2008)

In *Siemer v. Quizno's Franchise Co. LLC*, the franchisee-plaintiffs brought a class action against the franchisor asserting several causes of action, including violations of the Racketeer Influenced and Corrupt Organization Act ("RICO"), the Sherman Act, the Illinois Antitrust Act, the Illinois Franchise Disclosure Act of 1987, and the Illinois Consumer Fraud and Deceptive Business Practices Act, as well as claims for common law fraud, breach of contract, and breach of the covenant of good faith and fair dealing. The franchisee-plaintiffs alleged that the franchisor was an association-in-fact enterprise within the meaning of RICO that asserted control over franchisees by requiring them to pay inflated prices for products, services, and materials. The franchise agreements required franchisees to purchase products and materials necessary for the running of the franchise from either the franchisor or the franchisor's approved vendors. The franchisee-plaintiffs alleged that the franchisor sold these goods to franchisees at "supra-competitive" prices, and that the franchisor benefitted directly when it (or an affiliated company) sold the goods, or indirectly when an approved vendor sold the goods and the franchisor received a vendor rebate. The franchisee-plaintiffs also claimed that the franchisor fraudulently withheld information it was required to disclose, including the substantial markups and kickbacks on required products that added to the prices of food, supplies, services, and other materials that must be purchased from the franchisor or its approved suppliers.

The franchisor argued that the franchisee-plaintiffs' reliance on the alleged misrepresentations regarding operating costs and vendor rebates was unreasonable in light of the disclosure made in the offering circular and the explicit terms of the franchise agreements. The court noted that the offering circular included cautionary language regarding the potential profitability, as well as the costs, of running a franchise. Moreover, the court determined that the offering circular contained disclosures relating to the franchisor's relationship with suppliers. Likewise, the offering circular repeatedly emphasized that the costs included therein were estimates. And, the franchise agreement expressly disclosed potential vendor rebates. Further, the court noted that the franchise agreements contained an integration clause, and that each franchisee had signed an Illinois rider to the franchise agreement stating it would not rely on any statements not contained in the offering circular or franchise agreement. Lastly, each franchisee had signed a "Disclosure Acknowledgement Statement," acknowledging receipt of the offering

circular and exhibits, acknowledging its awareness of the potential business risks, and acknowledging that acceptance of the business risks was not conditioned on guarantees from the franchisor.

The court held that, in light of the explicit and comprehensive disclosures in the offering circular and franchise agreements, the franchisee-plaintiffs could not sustain any claim predicated on the contractual terms in question and dismissed the RICO, Sherman Act, Illinois Antitrust Act, and common law fraud claims. The court specifically noted that the franchisee-plaintiffs could not demonstrate that the franchisor committed fraud, given that "there [was] no tenable argument that [franchisee-plaintiffs] reasonable relied on the alleged misrepresentations they set forth."

Likewise, the court held that claims relating specifically to price markups legally failed. The franchisee-plaintiffs' argued that the franchisor required them to pay prices it knew to be higher than those the franchisees could get from third-party vendors for goods of equal or better quality, and that the prices franchisees paid were deliberately inflated by kickbacks to the franchising entity. The court noted that the franchise agreement explicitly warned the franchisees that the franchisor might "receive payments from suppliers on account of such suppliers' dealings with [f]ranchisee and other franchisees and may use all amounts so received without restriction and for any purpose Franchisor and its affiliates deem appropriate." The offering circular also warned the franchisees that the franchisor had "the right to receive payments from suppliers on account of their dealings with [the franchisee] and other [f]ranchisees and to use the amounts [the franchisor] receive[s] without restriction ... for any purpose [the franchisor] or our affiliates deem appropriate."

Therefore, the court held that "[i]n light of the explicit contractual provisions, it would be unreasonable for [the franchisee-plaintiffs] to have assumed that [the franchisor] would not negotiate contracts with suppliers that would benefit [the franchisor]. And even if [the franchisor] did owe [the franchisee-plaintiffs] a duty to disclose, the contractual provisions would clearly satisfy any such duty." Additionally, the court found legally untenable the franchisee-plaintiffs' contention that the franchisor fraudulently induced them to enter the franchise agreements through their misrepresentations and omissions, given that the offering circular and the franchise agreements each contained disclaimers and non-reliance clauses that were repetitive and "easily seen by any party who takes the time to read them." As the court stated: "Faced with these 'unambiguous' clauses, [the franchisee-plaintiffs] cannot have reasonably relied upon any oral statements concerning likely profits and expenses in deciding whether to invest in a Quizno's franchise." The court held that it was unreasonable for the franchisee-plaintiffs to claim reliance on extra-contractual representations despite stating in writing that they would not rely on any statements outside the offering circular and the franchise agreements. Accordingly, the court found that the allegations of the complaint did not establish that the franchisor committed fraud with respect to its franchisee's pricing and the claims were dismissed.

8. *Westerfield v. Quizno's Franchise Co., LLC*, No. 06-C-1210, 2008 WL 2512467 (E.D. Wis. Apr. 16, 2008)

In *Westerfield v. Quizno's Franchise Co., LLC*, a group of franchisees brought an "overpricing" RICO claim against Quizno's arguing that Quizno's had a practice of "overcharging franchises and requiring kickbacks from approved vendors," and that Quizno's had made fraudulent statements in its offering circular to further this scheme. Specifically, the franchisees

alleged that Quizno's fraudulently misrepresented that it would negotiate purchase arrangements with suppliers "for the benefit of [its] Franchisees."

The court originally dismissed the franchisees' civil RICO, fraud and anti-trust claims on their merits with prejudice. Then, lacking direct jurisdiction over the remaining state law claims, the court exercised its discretion to dismiss those claims without prejudice to allow the franchisees to pursue them in state court. Thereafter, the franchisees filed a motion to alter or amend judgment pursuant to Rule 59(e) in which they sought to resurrect their RICO and fraud claims on grounds of manifest error of law and fact, as well as newly discovered evidence. The court ultimately granted the franchisees' motion, for the reasons set forth below.

The franchisees argued that the court's dismissal of the overpricing RICO claim was based on a misunderstanding of their theory of liability. The franchisees contended that the court rejected their claim that Quizno's fraudulently overcharged them for essential goods and services "because: (1) Quizno's did disclose in the [offering circular] and the franchise agreements that it might receive payments from suppliers; and (2) it would be impossible for Quizno's to disclose the prices of those goods and services in advance, and in any event Quizno's advised that it was not disclosing actual costs." The franchisees argued that Quinozs' practice of knowingly overcharging franchises and requiring kickbacks from approved vendors was directly contrary to Quizno's representations to franchisees made in its various offering circulars, which provide, for example, that "[w]e and our affiliates negotiate purchase agreements with suppliers *for the benefit of Franchisees*."

The court, in its decision to grant the franchisees' motion to amend or alter judgment, expressed doubt as to whether the term "benefit" was definite enough to be fraudulent, and therefore might not be sufficient to serve as the basis for the RICO claim. Ultimately, however, the court reversed its earlier decision, concluding that it erred in its previous holding that Quizno's disclaimers and non-reliance clauses fatally undermined the franchisees' civil RICO and fraud claims as a matter of law.

The court held that the determination of whether the word "benefit" was fraudulent or simply puffery "must be left for trial, or at least a more complete development of the record." The court noted that its decision followed in part from the broad definition of the phrase "scheme to defraud" that is used in the mail and wire fraud statutes, as the mail and wire fraud statutes have been applied not only to false or fraudulent representations, but also to the omission or concealment of material information, even where no statute or regulation imposes a duty of disclosure. The court stated that "[t]he Seventh Circuit has explained in the context of a civil RICO suit that 'the mail and wire fraud statutes broadly apply to any scheme where in order to get money or something else of monetizable value from someone you make a statement to him that you know to be false, or a half truth that you know to be misleading, expecting him to act upon it to your benefit and his detriment.'" The court noted that its dismissal of the franchisees' claims was "at best" premature and that the disclaimers and non-reliance clauses were not dispositive of the franchisees' civil RICO claims.

9. *Tubby's #14, Ltd. v. Tubby's Sub Shops, Inc.*, No. 04-70918, 2006 WL 2796181 (E.D. Mich. Sept. 27, 2006)

In *Tubby's #14, Ltd. v. Tubby's Sub Shops, Inc,* franchisees sued claiming that purported kickbacks received by an affiliate of the franchisor were not disclosed in Item 8 of their FDD. The

court denied the franchisor's motion for summary judgment as to certain franchisees holding that there were issues of fact precluding summary judgment.

There, the franchisees were required to purchase all products for the operation of their sub shops from an affiliate of the franchisor, a company called SDS. Specifically, SDS entered into agreements with product manufacturers, purchased products from these manufacturers, warehoused the purchased products, and then re-sold and delivered the products to the franchisees. Although the FDD disclosed that the franchisees were obligated to purchase product exclusively from SDS, the franchisees complained that the kickbacks SDS received were not disclosed. Specifically, the franchisees alleged that SDS had manufacturers increase their invoice price to SDS by 30%-90% which SDS then billed to franchisees after adding its own overhead and profits. After SDS received payment from the franchisees, it would pay the entire manufacturer's invoice and in return, the manufacturers would pay SDS the kickback. The franchisees argued that failure to disclose SDS and the profits made from SDS in the franchisor's Item 8 disclosure was a violation of the Michigan Franchise Investment Law, and the FTC Rule and thus actionable fraud.

In response, the franchisor first argued as to certain franchise agreements, there was no violation of the Michigan Franchise Investment Law because the rebates and kickbacks occurred after the sale of the franchise, and the Michigan Franchise Investment Law only imposes liability in connection with an offer or sale of a franchise and does not apply to conduct or transactions after the initial sale. Second, the franchisor argued that there could be no reasonable reliance because there were conflicting statements in the disclosure document about rebates being limited to less than the disclosed markups. Lastly, the franchisor argued that there was no representation about the prices its affiliate would charge and therefore it was free to set its prices as it saw fit.

The court rejected each of these arguments. The court held that an issue of fact existed as to whether the franchisor must report the revenue and the amount of rebate/kickback that the franchisor received from SDS in their Item 8 disclosure. Moreover, the court determined that it was plausible that the franchisees relied on misstatements in the disclosure document. Thus, the court denied the franchisor's motion for summary judgment as to the Michigan Franchise Investment Law claims. Further, the court held that if the franchisor was required to make such disclosure and failed to do so, then an issue of fact existed as to whether the failure to disclose was fraudulent and therefore a violation of the FTC Rule. Accordingly, the court also denied the franchisor's motion for summary judgment as to that claim.

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2022 Judicial Update: Select Encroachment, Disclosure, Fraud, and Termination Cases

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While cases relating to the specific challenges of the day such as ongoing recovery from the Covid-19 pandemic, employment, and insurance rightly captured everyone's attention this year, there were also some interesting decisions in the bread-and-butter topics of the franchisee-franchisor relationship. Here we cover highlights related to encroachment, disclosure, fraud, and termination—plus a pair of contrasting cases dealing with franchisor attempts to purchase a franchisee's business.

I. Encroachment

Decisions from *Kazi v. KFC* headline this year's encroachment cases. The case was filed in November of 2019 and involves KFC's approval of a new location in the same town where the franchisee was operating. In May of 2021, the franchisee's claim for breach of the implied covenant of good faith and fair dealing survived summary judgment before the District of Colorado. The claim survived because the franchisee showed disputes of fact that required credibility determinations. The case went to trial, and the jury returned a verdict of almost $800,000 against KFC. In December of 2021, the District of Colorado considered a renewed motion for judgment as a matter of law and for a new trial, which was denied. Ultimately, the case was appealed to the Tenth Circuit where it remains pending.

***Kazi v. KFC US, LLC*, No. 19-CV-03300-RBJ, 2021 WL 1978754 (D. Colo. May 17, 2021)**

Zubair Kazi ("Kazi") was a franchisee of KFC US, LLC ("KFC") operating in Pueblo, Colorado pursuant to a franchise agreement. KFC approved a new location in the same town, and this litigation ensued. After discovery, KFC moved for summary judgement on Kazi's sole remaining substantive claim—breach of the implied covenant of good faith and fair dealing.[1] The court denied summary judgment, determining that there were material facts in dispute regarding whether KFC exercised its discretion to approve new franchisees consistent with the parties' reasonable expectations under the franchise agreement. Kentucky law applied, and under that state's common law, the covenant of good faith and fair dealing requires parties to a contract to do whatever is necessary to carry out the terms of the agreement.

Prior to approving the new franchisee, KFC had set forth "Impact Study Guidelines" ("Guidelines"). The company had undertaken a broader growth initiative, and the Guidelines were established to address franchisee concerns that new locations would negatively impact the businesses of current franchisees in the same areas. The new Pueblo location was part of this overall growth program. The Guidelines set forth how KFC would determine whether to open a new location, specifically: (1) if the anticipated impact on an existing franchisee was less than ten percent, KFC would approve the new location; (2) if the impact was ten to fifteen percent, KFC would undertake "further review;" and (3) if the impact was over fifteen percent, KFC would not approve the new location.

[1] The court previously granted KFC's motion to dismiss the other claims. *See Kazi v. KFC US, LLC*, No. 19-cv-03300-RBJ, 2020 WL 6680361 (D. Colo. Nov. 12, 2020).

Against this backdrop, KFC commissioned a third party to study the impact of opening a new location in Pueblo. The location fell into category 2 (“further review”), and KFC approved it. Kazi believed KFC’s study was invalid, and he retained his own company to conduct a separate analysis, which yielded significantly different results.

In its motion for summary judgment, KFC argued that its approval of the new franchisee was the product of a deliberate business process and that the law did not permit a jury to second-guess KFC’s business judgment. Kazi countered that KFC’s impact study of the new Pueblo location was flawed and that KFC knew it, but still accepted the results.

Importantly, the court found that the Guidelines established what would constitute KFC’s exercise of reasonable discretion under its contract with Kazi. Basically, if KFC didn’t comply with its own Guidelines, that could constitute a breach of the implied covenant of the franchise agreement.

In denying summary judgment, the court held that certain circumstantial evidence supported Kazi’s theory. In particular, the court was persuaded by Kazi’s evidence that almost every study this third-party expert had completed for KFC anticipated a low impact on existing franchisees from the opening of a new location, that KFC had refused Kazi’s request to hire a bilingual surveyor for the study, and that KFC had preliminarily approved the new location just a few days after receiving survey results. This last point was important because the study results projected a 13.4% impact on Kazi’s location, which under the Guidelines meant the impact required “further review.” KFC submitted that it did complete the “further review,” but the court found that a jury could reasonably conclude that it did not given the near immediate approval following the study.

The court noted that if the evidence had shown only that KFC’s impact study could have been more accurate, KFC would have been entitled to summary judgment. But here, when the evidence was viewed in a light most favorable to Kazi (as it must be at this stage), key fact questions of why and how KFC undertook its impact study and approved the location required credibility determinations that must be reserved for a jury.

***Kazi v. KFC US, LLC*, No. 19-CV-03300-RBJ, 2021 WL 6081832 (D. Colo. Dec. 22, 2021)**

After the case went to trial, a jury found in favor of Kazi and awarded lost future profits in the amount of $792,239. The court entered its final judgment in favor of Kazi in that amount, plus its costs. Kazi subsequently moved for prejudgment interest, and KFC filed a renewed motion for judgment as a matter of law and for a new trial.

The court first addressed KFC’s renewed motion for judgment as a matter of law, which KFC had labeled a motion for “directed verdict” after Kazi rested at trial. KFC’s first argument was that Kazi had failed to present evidence of bad faith under Kentucky law. KFC reasoned that its business decisions should not be second guessed by a jury. Kazi responded that the evidence showed that KFC knew the consulting company used for the study would tender a favorable report and that KFC disregarded information in the report

that did not support its conclusion. The court relied on evidence showing that KFC had frequently used the consulting company in the past; that it found an impact under the 15% threshold established by the Guidelines 100% of the time; and that the consulting company ignored a survey question the court deemed to be important and obvious. The court also noted that a preliminary indication of the report was an impact on Kazi of 22%, yet no further review was conducted by KFC. Accordingly, the court found at the trial that a reasonable jury could find bad faith based on the evidence.

KFC's second argument was that Kazi had not proven lost profits with reasonable certainty as required by Kentucky law. The parties agreed that reasonable certainty was the correct standard, but the court found there was sufficient evidence to deny the "directed verdict" motion at trial.

In denying the renewed motion for judgment as a matter of law, the court found KFC had failed to present any reason to change its prior ruling. The court noted that both arguments were addressed in the jury instructions and that there was sufficient evidence from which a reasonable jury could find in Kazi's favor. Moreover, because KFC failed to demonstrate any grounds for granting a new trial under Federal Rule of Civil Procedure 59(e), KFC was not entitled to a new trial.

Kazi's motion for prejudgment interest was granted in part and denied in part. The court found it did not make sense to award prejudgment interest on an award of lost future profits, but that Kazi was entitled to prejudgment "losses" for the six-day period between its lost profits calculation and the date judgment was entered.

KFC appealed the decision to the United States Court of Appeals for the Tenth Circuit on January 21, 2022.[2] As of the publication of this paper, that appeal is pending and initial briefing is due May 6, 2022.

II. Disclosure Claims

The *MTR Capital v. Lavida Massage* case out of the Eastern District of Michigan should give pause not only to franchisors, but also to any individual involved in updating the franchise disclosure document. In this case, the franchisor, its president and an area developer were held liable under Florida's deceptive trade practices statute, without the plaintiff proving fraud or having to pierce the corporate veil.

***MTR Capital, LLC v. Lavida Massage Franchise Development, Inc.*, No. 21CV13552 TGB EAS, 2021 WL 1626353 (E.D. Mich. Apr. 27, 2021)**

Plaintiff MTR Capital, LLC ("MTR"), as franchisee, entered into a franchise agreement with Lavida Massage Franchise Development, Inc. ("Lavida"), as franchisor, to operate a massage center in Florida. MTR closed the business after a year and a half because of poor performance and then sued Lavida, its president, and an area developer

[2] *See Kazi, et al. v. KFC US*, No. 22-1017 (10th Cir. Jan 21, 2022).

(collectively, “defendants”), alleging that they induced it to invest through misrepresentations and fraudulent omissions.

MTR’s claims were based (in part) on the franchise disclosure document (“FDD”), which allegedly had three problems:

1) Item 19 did not include any financial performance data. The defendants had chosen not to make an Item 19 disclosure because certain franchisees were not performing well.

2) Initial investment costs were underreported. The FDD represented that the estimated initial investment costs were $160,250 to $290,000, but MTR spent $479,000.

3) Item 20 failed to disclose that certain locations had ceased operations.

Based on these allegations, MTR sued for (1) fraudulent inducement and misrepresentation; (2) negligent misrepresentation; (3) violations of Florida’s Deceptive and Unfair Trade Practices Act (“FDUTPA”); and (4) violations of the Florida Franchise Act.

The court determined, after a full bench trial, that the defendants were entitled to judgment on all claims *except* the FDUTPA claim. For the FDUTPA claim, the court based its finding of liability on the inaccuracies in Item 20. Interestingly, the court had determined that the errors in Item 20 occurred primarily due to Lavida's poor recordkeeping. And on that basis, the court found that the evidence did not support a claim for fraud or even negligent misrepresentation. There was no intent to make a false statement or for MTR to rely.

Despite this, the court found that the same conduct violated FDUTPA. Specifically, defendants were required to disclose the total number of franchised and company-owned outlets and make quarterly updates to reflect material changes pursuant to 16 C.F.R. § 436.5(t) and § 436.7(b), and they violated those sections by including inaccurate or incomplete information in the FDD, which was in turn a violation of FDUTPA. The court further found that the inaccurate information was a contributing cause to MTR executing the franchise agreement, and as damages, it awarded the $39,000 franchise fee. The court declined to additionally award MTR’s operating losses which it determined were caused by its own mismanagement. Judgment was entered against *all* defendants—including the individuals.

Defendants then moved to modify the judgment arguing that it was error to enter the award against *all* defendants as only Lavida as franchisor had received the franchise fee. The court denied the motion on the basis that MTR had pled and proved the individuals’ “direct participation” in the Item 20 violations. For “direct participation,” it was sufficient to show that the individuals knew or should have known about the misrepresentations in the FDD, and that personal intent to deceive was not required. Because these individuals should have known the rules regarding accuracy of the FDD

and providing potential franchisees with an updated copy, they could be, and were, held liable along with Lavida.

***Arruda v. Curves Int'l, Inc.*, 861 F. App'x 831 (5th Cir. 2021)**

Plaintiffs are former franchisees who owned and operated "Curves for Women" fitness centers ("Curves") pursuant to franchise agreements with defendants, the franchisors. Plaintiffs brought suit in the Western District of Texas against defendants, alleging breaches of contract and violations of the Racketeer Influenced Corrupt Organizations Act ("RICO"). Plaintiffs asserted that the court had subject-matter jurisdiction over the case because the RICO claims presented a federal question and that the court could exercise supplemental jurisdiction over their state-law breach of contract claims.

Plaintiffs alleged that defendants became aware of a market study which indicated Curves franchise locations would continue to close at high rates if nothing further was done, due to a "negative halo" around the brand name. They also argued defendants intended to close over 1,000 Curves fitness centers. Plaintiffs alleged defendants decided to make no further investment in the Curves brand, "ensuring the further collapse" of the Curves franchise system.

Plaintiffs argued that the market study information and defendants' intent to close locations should have been disclosed in the FDD and in a letter sent to all current franchisees outlining areas of positive changes defendants claimed to make to the franchise system. Plaintiffs argued that these critical omissions, as well as the failure to disclose this information in other electronic communications, were the predicate acts of mail and wire fraud for RICO purposes.

The district court dismissed the RICO claims and declined to exercise supplemental jurisdiction over the remaining claims. Plaintiffs appealed the dismissal of only the RICO claims to the Fifth Circuit. The Fifth Circuit noted that because plaintiffs relied on fraud as the predicate act for RICO, their complaint needed to identify a duty to disclose under a heightened pleading standard. Plaintiffs claimed that the Federal Trade Commission's Franchise Rule imposed a duty on defendants to disclose the decision to prune franchises as well as the kind of information that was contained in the marketing study. The court pointed out though that even if the Franchise Rule covered such omissions, the Federal Trade Commission Act provides no private right of action. As such, Congress's omission of a private right of action controls, and a violation of the Franchise Rule does not constitute a predicate act of mail or wire fraud to support a RICO claim.

Plaintiffs also argued to the Fifth Circuit, for the first time, that defendants' conduct, which allegedly violated the Franchise Rule, constituted fraud under Texas common law. Because they had never presented this argument to the district court, the Fifth Circuit found it was waived and did not consider it. The Fifth Circuit thus affirmed the district court's decision, finding that plaintiffs had not sufficiently pleaded the predicate acts of mail or wire fraud because they did not show that defendants had a duty to disclose the information that plaintiffs relied on as the basis for their claims.

III. Fraud

All litigators know the standard for pleading fraud—including the time, place, and content of the misrepresentation—and the importance of including facts in your complaint sufficient to survive a motion to dismiss. *Roof Maxx v. Tabbert* provides a great example of doing so even when a key fact is publicly available and verifiable. *Sugarlips Bakery v. A&G Franchising* shows a plaintiff also meeting this standard, but this time in the face of Item 19 disclaimers. As a contrast, in two cases involving the franchisor ILKB, LLC, the plaintiffs' fraud claims were dismissed for failure to state a claim.

***Roof Maxx Technologies v. Tabbert*, No. 2:20-cv-03156, 2021 WL 3617158 (S.D. Ohio Aug. 16, 2021)**

Roof Maxx Technologies ("Roof Maxx") is a distributor of spray on roof shingle treatments. This dispute really began when Lisa Tabbert ("Tabbert") sent Roof Maxx a notice of rescission of the parties' exclusive dealer agreement based on fraud and misrepresentation. While the parties were engaged in confidential settlement negotiations, Roof Maxx sued for breach of contract and to enforce a post-termination noncompetition provision in the Southern District of Ohio. Unsurprisingly, Tabbert filed a counterclaim (and a third-party complaint against Roof Maxx's owners). The counterclaim alleged fraud, false advertising under the Lanham Act, and a violation of the Ohio Deceptive Trade Practices Act, and it sought a declaratory judgment regarding the enforceability of the dealer agreement. In her counterclaim, Tabbert alleged that Roof Maxx had induced her to enter in the dealer agreement by falsely claiming that its product was patented. The patent had in fact lapsed several years prior, and Roof Maxx had not reinstated it.

Roof Maxx filed a motion to dismiss arguing that Tabbert had not pled fraud with sufficient particularity or shown justifiable reliance. To satisfy Federal Rule of Civil Procedure 9(b)'s pleading requirements, a party pleading fraud must allege the time, place, and content of the alleged misrepresentation, the fraudulent scheme, the defendant's intent, and the injury. In denying the motion, the court read Rule 9(b) in concert with Rule 8's standard for simplicity of pleadings and held that the threshold test for sufficiency in pleading fraud under Rule 9(b) should be whether the complaint provides the defendant with sufficient notice of the misrepresentation which would allow the defendant to answer in an informed manner.

Tabbert's counterclaim did this based on the following factual allegations:

- *Time*: Tabbert alleged that the misrepresentations occurred during the several weeks leading up to when the agreement was signed.

- *Place & Content*: Tabbert identified oral statements, marketing materials, and social media posts in her counterclaim, and importantly she attached documents containing the allegedly fraudulent statement to her pleading as exhibits wherever possible.

- *Fraudulent Scheme*: Tabbert alleged that Roof Maxx led her and others to believe that its materials were patented and exclusive when they were not.

- *Intent*: She claimed Roof Maxx did this with the intent to "lock" her and other dealers into an agreement with restrictions such as the five-year noncompetition provision.

- *Injury*: Tabbert alleged the specific dollar amount of her initial investment plus a general description of her lost profits and business opportunities.

Regardless of these details, Roof Maxx also argued that Tabbert could not allege justifiable reliance because patents are a matter of public record. According to Roof Maxx, Tabbert could have verified Roof Maxx's patent on her own.

The court disagreed with Roof Maxx, denying its motion to dismiss. The court held that reliance may be justified if a statement is not unreasonable on its face and if, under the circumstances, there is no reason to doubt the veracity of the representation. Relevant circumstances may include the nature of the transaction, the circumstances of the representation, the relationship between the parties, and their respective levels of experience. In this case, the court was persuaded by the allegations that Roof Maxx was a well-established national distributor of roofing products but that Tabbert had no experience in the industry. Further, the misrepresentations made to Tabbert were made in printed material, so given the formality and Tabbert's relative lack of experience, she had no reason to doubt their veracity.

The court also rejected Roof Maxx 's reliance on several real estate cases in which the plaintiff failed to check public records and was, therefore, unable to show justifiable reliance in their fraudulent concealment claims. Unlike the real estate cases where the misrepresentation related to the thing being purchased, here, the misrepresentation was an inducement to the agreement, not the object of the agreement itself. Thus, the court held that absent any facts suggesting that Tabbert should have known she was being deceived, she was not obligated to independently check the patent register before entering into the dealer agreement.

***Sugarlips Bakery, LLC v. A&G Franchising, LLC*, No. 3:20-CV-00830, 2022 WL 210135 (M.D. Tenn. Jan. 24, 2022)**

Plaintiffs were franchisees who operated bakery shops under the Gigi's Cupcakes trade name. They brought suit before the Middle District of Tennessee against the corporate entity franchisor and its individual operators (collectively, the "defendants"). Plaintiffs alleged that the defendants, who had become operationally insolvent, resorted to fraud in order to enter into new franchise agreements with franchisees. Plaintiffs claimed they did not experience the level of financial success they were led to believe they would achieve, and therefore, they sued defendants under theories of fraud and negligent misrepresentation, among other things.

Specifically, plaintiffs alleged that defendants' Item 19 was false or misleading in several ways. First, they claimed that the labor costs in the figures were understated by

at least 20%. Second, some of the shops used to calculate the figures were not franchises but were shops owned by the defendants themselves. Those shops did not have to pay franchise royalties, making them inherently more profitable as compared to a franchised shop. These shops also used some personnel who were paid out of central corporate accounts, not the budgets of the shops themselves, further skewing the numbers. Plaintiffs also alleged that the net sales and COGS figures were misstated. Plaintiffs argued that if they had understood the actual performance of Gigi's franchises generally, as opposed to merely from an inflated picture of selected shops, they would not have gone forward with their franchises.

The defendants pointed out that Item 19 included a disclaimer that said, among other things, that there was "no assurance [plaintiffs will] do as well" as the shops listed and that their individual results may differ. Further, the FDD included an exhibit with defendants' audited financial statements, which provided a fuller picture of some aspects of their business. Plaintiffs complained though that the portion of the FDD with the financial statements, Item 21, provided no explanation for the statements and otherwise gave no indication defendants were experiencing financial difficulties.

Plaintiffs also alleged that defendants' representatives supplemented these omissions by orally claiming there was a great demand for the Gigi's brand nationwide and that the franchise was growing rapidly each year, when in reality this was not the case. However, the franchise agreements contained disclaimers with general statements about the lack of assured success and specific disclaimers of reliance on outside documents other than the franchise agreement or FDD. The court analyzed these issues in the context of defendants' motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).

The court considered whether plaintiffs had properly pleaded their fraud claims in view of defendants' argument that the element of "reasonable reliance" was lacking in the complaint. The court explained that while the defendants raised substantial arguments in their favor, it could not conclude that reasonable reliance was insufficiently pleaded. Nothing about the Item 19 disclaimer suggested that the information provided was useless or should not have been considered by a potential franchisee. Basically, just because Item 19 was not a guarantee does not mean relying on it was unreasonable as a matter of law. Plaintiffs plausibly alleged that Item 19 gave a false impression of the general viability of the Gigi's brand, which could have induced reasonable reliance even by a person who understood that the information was not a promise or a depiction of every Gigi's shop. The court declined to dismiss the motion on this basis.

The court also looked to Federal Rule of Civil Procedure 9(b) to determine if plaintiffs had pleaded fraud with the required particularity. Defendants claimed that plaintiffs failed to state what fraud was attributable to the franchisor's individual operators, who were also sued in their individual capacities. Plaintiffs explained that the FDD was drafted and approved by these individuals, and they need not know exactly how certain responsibilities were divided. The court agreed with plaintiffs; they didn't need to "see through corporate walls" in order to satisfy Rule 9(b). Further, plaintiffs specified certain meetings and conversations with the operators about facts relevant to the franchisees'

ultimate decisions. These oral representations were evidence of their direct role in the alleged fraudulent representations. Tennessee law does not give agents of a corporation a license by which to commit fraud themselves and then defeat liability for it by simply pointing to the corporation as the culpable party. The claims against the individual operators survived.

***W. Valley KB Venture, LLC v. ILKB LLC*, No. 20-CV-3278(JS)(AYS), 2021 WL 4171918 (E.D.N.Y. Sept. 13, 2021)**

Plaintiff West Valley KB Venture, LLC ("West Valley") purchased a franchise from defendant ILKB LLC and its agents (together, "ILKB"), a company that franchises kickboxing studios. Prior to the purchase, ILKB made certain representations in a series of emails to West Valley about how ILKB "had systems and processes that work wonders," that all they would have to do is "plug & play," and that none of the ILKB locations had closed. ILKB also made a variety of oral misrepresentations to West Valley about marketing, renewal rates, and gross revenue, among other things, which allegedly induced West Valley to purchase five territories and execute a franchise agreement for one studio.

West Valley later decided to open a second franchised location and spend $300,000 on its remodel. Within six months of opening however, the studio was performing poorly. West Valley argued that they rigorously performed their obligations but subsequently learned that ILKB had made false representations regarding its franchises, like franchised studio broke even in weeks or months typically, renewal rates were unimportant, and that ILKB handled marketing, for example. West Valley filed an action against ILKB in the Eastern District of New York for common law fraud and negligent misrepresentations, among other things. ILKB moved to dismiss the lawsuit under Federal Rule of Civil Procedure 12(b)(6) and 9(b).

The court granted ILKB's motion. The court determined that the complaint failed to plead fraud with particularity as required by Rule 9(b). West Valley alleged that ILKB made representations, later discovered to be false, via email, telephone discussions, or in person in the fall of 2015 or over the course of six months after the second studio opened. But these generalized, undifferentiated allegations failed to satisfy Rule 9(b)'s "when" and "where" requirements. The court explained that it was insufficient to state that a misrepresentation occurred over unspecified periods of time. The complaint also failed to attribute the alleged fraudulent conduct to any particular defendant, which was fatal under a Rule 9(b) analysis.

***ILKB, LLC v. Singh*, No. 20CV4201ARRSJB, 2021 WL 3565719 (E.D.N.Y. Aug. 12, 2021)**

Ardamandeep Singh ("Singh") is a former iLoveKickboxing franchisee. Singh accused franchisor ILKB, LLC and its agent (together, "ILKB") of common law fraud among other things in the Eastern District of New York. Singh argued that, prior to signing the franchise agreement, ILKB made several representations to him about franchisees in the franchise system, which induced him to sign. These representations were later

discovered to be false, and included claims that franchisees break even in weeks or months and that franchised studios could be operated via absentee owners, for example. ILKB allegedly knew these claims to be false because most ILKB franchisees were not able to operate as absentee owners and they did not break even so soon—in fact, their costs greatly exceeded their revenue.

ILKB filed a motion to dismiss, and the court analyzed Singh's claim under the Federal Rule of Civil Procedure 9(b) standard. The court noted that Singh alleged ILKB's misrepresentations took place over the course of a four-month period. Such a vague time frame was insufficient to satisfy the pleading standards. Singh also failed to say "where" ILKB made these purported misrepresentations. The motion to dismiss was granted on these grounds.

IV. Termination and Expiration

This year's termination and expiration cases are a good reminder of how much diligence on the details matters—and can affect the outcome of a case. For example, in *JTH Tax v. D'Souza*, the franchisor received very different outcomes based on the same violation of a 2011 franchise agreement and a 2014 franchise agreement because the liquidated damages provisions, and therefore the proof required at trial, differed (nominal damages versus almost $67,000 in liquidated damages). In *BP Products v. Grand Petroleum*, BP's concession that there had been "a measure of compliance" on its complained of violations factored into the court's denial of summary judgment.

***JTH Tax, LLC v. Owen H. D'Souza*, No. 20-00087 JAO-KJM, 2021 WL 4353099 (D. Hawaii Sept. 24, 2021)**

Franchisor JTH Tax LLC ("JTH"), which operated as Liberty Tax Service, sued a former franchisee and its individual guarantors in the District of Hawaii. Defendants were engaged in the operation of tax preparation services prior to entering into two franchise agreements with JTH in 2011 and 2014. Relevant here, the franchise agreements required that defendants use JTH's software, not collect a fee for tax preparation services outside of their franchises during the term of the agreement and for two years after termination, and not disclose JTH's confidential information.

JTH sued defendants following the termination of both agreements based on, among other things, defendants' performance of tax preparation services outside the scope of their franchise agreements. JTH brought four claims for breach of the franchise agreements.

Following a bench trial, the court held that defendants violated both the in-term and post-termination noncompetition covenants by preparing tax returns for a fee outside of their franchises both during the term of the agreements and in the two years after termination of the franchise agreements. Both the 2011 and 2014 agreements contained liquidated damages provisions, and the court determined both were enforceable. However, the language of the provisions differed, leading to different outcomes. For the 2011 agreement, JTH needed to prove either the amount of gross receipts defendants

received in violating the noncompetition covenant or the gross receipts JTH lost due to defendants' violation. It did neither, and so JTH was awarded nominal damages of $10. However, for the 2014 agreement, liquidated damages could be calculated based on either the franchisee's total gross receipts during the last fiscal year or the total revenue received by the defendants from violating the covenant. JTH was able to establish the total gross receipts for the last fiscal year of the franchisee's operations, and so the court found that JTH sufficiently proved damages in the amount of $66,564.80 for defendants' violation of the noncompetition covenants in the 2014 agreement.

The court found that defendants violated the franchise agreements by using unapproved software, but again because JTH failed to prove injury or damages arising from that breach, JTH was only awarded nominal damages of $10. JTH was also awarded royalties, advertising fees, and interest owed under the franchise agreements, which totaled $200,684.16 after deductions, as well as amounts owed under a promissory note. JTH asserted a number of additional claims which the court swiftly dispensed with based on JTH's failure to prove the requisite elements.

***BP Prod. N. Am. Inc. v. Grand Petroleum, Inc.*, No. 4:20-CV-0901-YGR, 2021 WL 4804275 (N.D. Cal. Oct. 14, 2021)**

Franchisee Grand Petroleum, Inc. ("Grand") operated two gas stations under franchise agreements with franchisor BP Products North America Inc. ("BP"). During the term of the parties' franchise agreements, BP announced two programs: "Luminate" and "MOJO A", which included, among other things, the installation of fans, cooler graphics, and LED lighting at franchised gas stations. BP subsequently made franchisees' compliance with the programs mandatory. Grand failed to comply with the programs' requirements, and BP terminated the franchise agreements. When Grand began operating competitive businesses at the locations of the former franchises, BP filed suit, alleging various claims for breach of contract and seeking a permanent injunction. Grand filed counterclaims alleging, among other claims, violations of the Petroleum Marketing Practices Act ("PMPA").

The parties filed cross motions for summary judgment. Relevant here was whether BP's termination of the franchise agreements was justified under the PMPA. That statute permits termination of a franchise agreement if (i) a franchisee fails to comply with a provision that is "both reasonable and of material significance to the franchise relationship," or (ii) if a franchisee fails "to exert good faith efforts to carry out the provisions of the franchise."

Grand submitted evidence that it had indeed installed fans, purchased cooler graphics from BP's preferred vendor, and installed LED lighting. BP conceded that Grand had complied to some degree, but it argued that the cooler graphics and the LED illumination levels did not meet the programs' requirements. The court denied the parties' motions, finding the record was incomplete. There was no evidence of the illumination level of Grand's installed LED's. Further, the parties had not submitted into evidence the program manuals that set forth the programs' requirements. And because the parties

disputed those requirements, the court could not determine whether Grand's failure to fully comply was material or exhibited bad faith under the PMPA.

***Servpro Indus., Inc. v. Woloski*, No. 21-5685, 2022 WL 633844 (6th Cir. Mar. 4, 2022)**

Defendant franchisee and guarantors (together, "defendants") operated a cleaning and damage-restoration service franchise in Southern California. Plaintiff Servpro Industries, Inc. ("Servpro"), defendants' franchisor, received several serious complaints about defendants' business practices, including allegations of price gouging, excessive demolition, fraudulent billing, and general unprofessionalism. Servpro terminated the franchise agreement for these reasons. The agreement expressly stated that it was "formed and made in Tennessee" (where Servpro is headquartered) and provided that Tennessee law governed the relationship. However, the agreement also included an addendum, which provided that the default and termination provision was amended by adding the California Franchise Relations Act's ("CFRA") requirements and stated that if the franchise agreement is inconsistent with California law, California law will control.

Despite termination, defendants continued using Servpro's trademarks, causing Servpro to file trademark infringement and breach of contract claims in the Middle District of Tennessee. Defendants countersued, alleging that Servpro violated the CFRA and breached the franchise agreement. The district court entered judgement for Servpro on all counts. Defendants appealed the district court's (1) dismissal of their CFRA counterclaim, and (2) grant of summary judgment for Servpro on defendants' breach of contract counterclaim.

Defendants argued that dismissal of their CFRA counterclaim was improper because (1) the franchise agreement's addendum afforded them standalone rights under the CFRA and operated as a California choice-of-law provision; (2) even if the CFRA did not apply, the counterclaim was viable under Tennessee law; and (3) their request for leave to amend was improperly denied.

The Sixth Circuit rejected each of these arguments. On the first point, it agreed with the district court that the franchise agreement's addendum neither granted defendants standalone rights under the CFRA nor operated as a choice-of-law provision. Specifically, the court reasoned that, because "addendum" is defined as adding something to a document, the addendum's incorporation of the CFRA's termination requirements merely modified defendants' rights under the contract regarding termination. As such, they affected defendants' contractual rights but did not create a standalone action under the CFRA. Essentially, to the extent the CFRA was incorporated into the franchise agreement, any breach of it was necessarily part of defendants' breach of contract claim. Further, the court concluded that the addendum did not constitute a choice-of-law provision because the franchise agreement clearly identified Tennessee as the governing law. Because Tennessee does not have an equivalent law to the CFRA, there is no inconsistency to trigger the application of California law under the terms of the addendum.

Second, the court concluded that defendants had not preserved their argument that the district court should have found this counterclaim viable under Tennessee law by failing to make that argument before the district court. Finally, the court held that defendants' request for leave to amend, made in response to Servpro's motion to dismiss, was procedurally improper because they had not formally moved the court.

With respect to the breach of contract counterclaim, defendants argued that there were triable issues of fact as to whether they actually engaged in conduct that led to Servpro's termination of the franchise agreement. Defendants simply made a "generic we-did-nothing-wrong statement," which is insufficient to withstand summary judgment—this did not create a genuine dispute of material fact. Additionally, the franchise agreement allowed Servpro to terminate the relationship with defendants if Servpro was on notice that defendants were engaged in conduct that materially reflected unfavorably on Servpro. The court held this language made it clear that Servpro was entitled to terminate the franchise agreement because Servpro presented sufficient evidence to show that defendants had received complaints about their business practices. The Sixth Circuit held there was no genuine issue of fact; the district court had properly granted summary judgment.

***Mountain Mike's Pizza, LLC v. SV Adventures, Inc.*, No. 2:21-cv-02387-TLN-AC, 2021 WL 6136178 (E.D. Cal. Dec. 29, 2021)**

Mountain Mike's Pizza, LLC ("MMP") is the franchisor of Mountain Mike's Pizza franchise system. MMP entered into a franchise agreement with defendants ("SVA") for SVA to operate a franchised restaurant in El Dorado Hills. The franchise agreement expired on January 2, 2022.

Months before the expiration of the franchise agreement, SVA made it clear that it intended to de-brand and open an independent restaurant upon expiration. On December 21, 2021, MMP filed for injunctive and declaratory relief in the Eastern District of California based on claims including trademark infringement, unfair competition, and an anticipatory breach of SVA's contractual duties "to sell the Restaurant and assign the Lease to [MMP] under [§] 15.E" and "to allow [MMP] to assume management of the restaurant when the Franchise Agreement expires under [§] 14.C." The next day MMP filed a motion for a temporary restraining order requesting that the court enjoin SVA's alleged trademark infringement and permit MMP to enter the restaurant and assume management.

SVA opposed. While not mentioned in the court's opinion, SVA argued in its briefing that it was entitled to de-brand and operate the independent restaurant at the same location after the expiration of the franchise agreement because precluding it from doing so would violate Section 16600 of the California Business and Professions Code, which provides: "Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void."[3]

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[3] Cal. Bus. & Prof. Code, Section 16600.

In analyzing the request to enjoin SVA's alleged trademark infringement, the court noted that MMP was asserting that SVA is "essentially operating a competing restaurant" under the marks. The court gave credence to SVA's argument that it was not currently infringing any trademarks and did not intend to do so. SVA entered evidence that any prior breaches (relating to signage and a DoorDash account) were inadvertent and in any event immediately resolved.

The court denied the request for a temporary restraining order, finding that MMP had not proven immediate and irreparable harm. The Court found that MMP must show the threat of a future injury is "'certainly impending' or that it presents a 'substantial risk' of recurrence for the court to hear [its] claim for prospective relief." Had MMP moved to enforce a noncompetition provision, this result would not be noteworthy. However, at this early stage, the court held that this same analysis foreclosed MMP's claim of irreparable harm based on MMP's alleged contractual rights to purchase the restaurant and assume management.

On February 4, 2022, MMP filed a notice of dismissal without prejudice pursuant to Federal Rule of Civil Procedure 41(a)(1)(A)(i), so we will never know how this court would have ultimately ruled on the merits.

V. Miscellaneous

A. Franchisor Purchases

The franchisors of both It's Just Lunch and CorePower Yoga wanted to buy a franchisee's business, and both started out relying on rights contained in the franchise agreement. It's Just Lunch exercised its right of first refusal following a third-party offer, while CorePower Yoga exercised its contractual right to require a franchisee to sell. From there things diverged: It's Just Lunch sued to force the deal; CorePower Yoga was sued when it backed out.

***IJLSF, LLC v. It's Just Lunch International, LLC*, No. E071940, 2021 WL 3012850 (Cal. App. July 16, 2021)**

It's Just Lunch International, LLC ("It's Just Lunch"), the franchisor of a dating and matching service, sought to exercise its right of first refusal in the franchise agreement to substitute itself as purchaser in a deal between its franchisee in the San Francisco territory ("franchisee") and a third-party (who also already owned several other franchises in the system). The franchise agreement permitted It's Just Lunch the right to substitute itself as the purchaser on the same price and same terms contained in the proposed offer. Relevant here, the franchise agreement also required the franchisee to submit proposed transfers to It's Just Lunch for approval, and it required It's Just Lunch not to unreasonably withhold its approval if the transfer met certain conditions.

The franchisee refused to sell to It's Just Lunch, so It's Just Lunch filed suit in California state court for breach of contract given its right of first refusal. The franchisee then filed its own counterclaim for breach of contract alleging that, among other things, It's Just Lunch had refused to approve the franchisee's sale to the third-party purchaser.

The third-party purchaser also intervened and filed its own cross-complaint against It's Just Lunch for tortious interference.

Ultimately, It's Just Lunch and the franchisee filed cross-motions for summary judgment. It's Just Lunch argued that the exercise of its right of first refusal was enforceable, while the franchisee argued that it was improper since It's Just Lunch changed material terms of the offer and offered less value.

The trial court denied It's Just Lunch's motion for summary judgment on the grounds that the third-party offer did not meet the franchise agreement's definition of a valid, bona fide offer because it was too indefinite and did not give a dollar value for the purchase price—instead, the price was contingent on future revenue. The court concluded that without a valid, bona fide offer It's Just Lunch did not have a right of first refusal to exercise. The trial court granted the franchisee's motion because without a valid, bona fide offer, the franchisee was not obligated to sell to It's Just Lunch. The court further held that the franchisee had not breached the transfer provision because it had not completed any sale to a third party.

Another round of cross-motions for summary judgment ensued, and that time, the trial court granted It's Just Lunch's motion for summary judgment on the franchisee's claims, holding that due to the lack of a valid, bona vide offer, the franchisor had the right to reject the transfer. The trial court did not address the franchisee's waiver argument.

On appeal, the California Court of Appeals was asked to review whether the trial court erred (i) in holding that the third-party purchaser's offer was not a valid, bona fide offer, and (ii) in failing to recognize evidence of waiver by It's Just Lunch.

On the first issue, the appellate court affirmed the trial court's holding that the third party's offer was not sufficiently definite to constitute a bona fide offer, as defined by the franchise agreement. As such, the offer did not trigger It's Just Lunch's right of first refusal or its obligation to not unreasonably withhold approval of the transfer. Specifically, the court found that the language in the franchise agreement that an offer must be "in a dollar amount" required a specific dollar amount, not an amount that could vary based on future revenue. Because the purchase price could vary and result in different purchase prices for different buyers (depending on how well they ran the business), the offer was too indefinite to be enforced.

Despite this, on the second issue, the appellate court held that the trial court erred in failing to consider the evidence that It's Just Lunch had waived its contractual right to reject the transfer. Important here was the fact that under relevant state law, waiver is generally a question of fact to be determined by a jury. The appellate court noted there was significant evidence that It's Just Lunch had intentionally waived its right to reject the purchase—It's Just Lunch did not object; it tried to exercise its right of first refusal. Given this, the appellate court reversed the summary judgment rulings and remanded the case for further proceedings.

***Level 4 Yoga, LLC v. CorePower Yoga, LLC*, No. CV 2020-0249-JRS, 2022 WL 601862 (Del. Ch. Mar. 1, 2022), *judgment entered*, (Del. Ch. 2022)**

Prior to the Covid-19 pandemic, defendants CorePower Yoga, LLC and CorePower Yoga Franchising, LLC (together "CorePower") exercised its contractual right to require its largest franchisee, plaintiff Level 4 Yoga, LLC ("Level 4"),, to sell CorePower all of Level 4's assets, which consisted mostly of yoga studios in several states and the business components used to operate those studios (the "Transaction"). The agreement was memorialized in an asset purchase agreement ("APA") on November 27, 2019, and per the APA, CorePower's acquisition of the yoga studios would occur in three staggered tranches, with the first tranche to close on April 1, 2020. However, due to businesses closing down as a result of the pandemic, CorePower wanted to delay or terminate the Transaction, and Level 4 refused, insisting it was ready and willing to honor its commitments under the APA.

During this time, CorePower had directed its franchisees (including Level 4) to shut down their yoga studios, either voluntarily or in response to government mandates. CorePower invoked the APA's Material Adverse Effect ("MAE") clause and the APA's requirement that Level 4 continue to operate its yoga studios in the Ordinary Course of Business, then declared that the APA was no longer valid because Level 4 had "repudiated" the contract such that CorePower was no longer obligated to perform. In response, Level 4 invoked the operative franchise agreements' requirement that it was required to follow the direction of CorePower, and therefore closing the studios was in the "ordinary course" because it was done at CorePower's direction. Level 4 further argued that it was contractually obligated to sell to CorePower, and that the APA was intentionally structured as a "one-way gate" without any conditions to closing and without any termination right, which was to account for the fact that Level 4 was not a voluntary seller once CorePower exercised its right to force the sale. However, CorePower refused to close on time and Level 4 brought suit.

Level 4 sought a declaration that the APA was a valid and enforceable contract and that CorePower was in breach and sought specific performance requiring CorePower to close as required by the APA and an award of damages. CorePower sought a declaration that Level 4 repudiated or materially breached the APA prior to closing and that CorePower was therefore excused from performing. Additionally, CorePower sought damages for breach of contract or, alternatively, a "quasi-contract" to recover payments made by CorePower after the APA was signed.

After trial, the court focused its analysis on the APA, from which the claims and counterclaims all arose. First, the court examined the parties' relationship prior to signing the APA in order to determine what effect the relationship had on the timing and structure of the APA. The court noted the importance of the franchise agreements' requirement that Level 4 comply with CorePower's system standards even after signing the APA and prior to closing, and that unlike in most cases, CorePower had the contractual right to direct how Level 4 operated its businesses post-signing and pre-closing. The court also noted the importance of CorePower's unilateral "call option" and the modified agreement with Level 4 that allowed it to acquire Level 4's studios in tranches in exchange for Level

4 receiving an acquisition agreement with no closing conditions and no force majeure clause.

Next, the court analyzed the "four corners" of the APA in order to determine the parties' intent. The court noted that describing the APA as a "one-way gate" was appropriate because there was no express right to terminate and no conditions for closing. Allowing for termination of the APA prior to closing would have led to absurd results. Specifically, because the APA terminated the applicable franchise agreements on each closing date, if a closing did not occur, then Level 4 would have been required to own the studios that were supposed to close but would not be able to operate them. The court found this supported the parties' intent to enter into the APA without any conditions for closing.

The court then analyzed CorePower's arguments that the APA did in fact contain a right to terminate. CorePower argued that the "specific performance" provision allowed for it to terminate, but the court was not persuaded, finding it was a stretch for CorePower to argue that its "bargained-for" express right to terminate was contained in a boilerplate provision entitled "Specific Performance" that appeared within other "MISCELLANEOUS" provisions in the contract. The court also reasoned that the word "terminate" appeared nowhere in that provision and that, even if it accepted CorePower's argument, Level 4 did not materially breach the APA and CorePower therefore had nothing to justify its refusal to close. The court further rejected CorePower's argument that the parties' removal of any materiality qualifiers from the APA's representations and warranties evidenced an intent to allow a party to terminate the APA prior to closing. The court considered this a post hoc attempt by CorePower to create an excuse for its failure to close.

Finally, the court analyzed CorePower's argument that it was not required to perform based on Level 4's purported repudiation of the APA and material breach of the contract. Before analyzing each proffered excuse, the court pointed out that the focus was Level 4's compliance with the terms of the APA as of the time CorePower declared it would not close, rather than actions taken by Level 4 following that declaration. The court then rejected CorePower's argument that Level 4 repudiated the APA by word. CorePower relied on a single email exchange which it argued evidenced Level 4's intent to repudiate the APA because it indicated Level 4 was not able to honor its commitment to operate in the ordinary course before closing. But the court noted that repudiation requires an outright refusal by a party to perform under a contract. The email in question, taken as a whole, showed Level 4's commitment to close.

The court was no more persuaded by CorePower's argument that Level 4 repudiated the APA by deed. The court looked to each of the contractual provisions which CorePower had asserted evidenced Level 4's repudiation, including provisions that required Level 4 to operate in the ordinary course of business to avoid a material loss or material adverse effect, not terminate or close any facility, and to operate in the ordinary course of business consistent with past practice. While the court analyzed each of these provisions in turn, it found that, as a whole, the evidence showed that the actions CorePower relied on were taken (or occurred) after CorePower had declared it would not close on the Transaction. In other words, it was CorePower who repudiated first.

Accordingly, the court found that CorePower breached the APA by refusing to close on the required date, and that Level 4 was entitled to specific performance, damages, and interest, and further denied CorePower's counterclaims.

CorePower then filed an appeal and motion to stay the court's final order and judgment pending the appeal. In order to determine whether a stay pending appeal was appropriate, the court was required to: (1) take a preliminary assessment of the likelihood of success on the merits of the appeal; (2) assess whether the petitioner would suffer irreparable injury if the stay was denied; (3) assess whether any other interested party would suffer substantial harm if the stay was granted; and (4) determine whether the public interest would be harmed if the stay was granted. On the first element, the court noted that it was required to consider whether the appeal raises a substantial question that is "fair ground" for litigation and more deliberative investigation.

The court found that much of the analysis in its post-trial memorandum was factual, not legal, and thus entitled to a more deferential review on appeal. However, the court noted that it did construe certain provisions of the APA which would be subject to de novo appellate review, and therefore "fair ground" for further review. Further, the court emphasized CorePower was at risk of suffering irreparable injury if a stay order was not entered. Specific performance of the APA required CorePower to pay for and receive 34 yoga studios from Level 4, and certain aspects of those transactions would be difficult to unwind, including, for example, the assumption of leases where the studios operate. The court then reasoned that Level 4 would not be substantially harmed by granting the stay, as the court could address the any harm to Level 4 caused by the continuation by requiring CorePower to post a bond in the amount of Level 4's damages, which it calculated at just over $40 million. Finally, the court found the public interest was not implicated in this case. Accordingly, the motion to stay was granted, conditioned on CorePower posting the required bond

B. Procedure

It would be no surprise to learn that a piece of franchise litigation was stayed in court in favor of arbitration. But in *Takiedine v. 7-Eleven,* the Eastern District of Pennsylvania reconsidered its own order entering a stay and allowed the litigation to proceed despite an arbitration provision in the parties' franchise agreement. While the court had originally entered the stay finding that the claims at issue fell within the scope of the agreement to arbitrate, in this decision the court reversed course finding that the "arbitration" agreement was effectively an agreement to not litigate at all and as such was unenforceable as unconscionable. *Window World v. O'Toole* addresses the propriety of a stay entered in federal court in favor of a state court action between the same parties—another procedural posture not uncommon to franchise litigators. This time, the stay was not lifted. The Eighth Circuit held that it did not have jurisdiction over the controversy because the stay was not a final order, so Window World would be forced to wait until the state court case was resolved to pursue its claims in federal court.

***Takiedine v. 7-Eleven, Inc.*, No. 17-4518, 2021 WL 3223070 (E.D. Pa. July 29, 2021)**

Azmi Takiedine ("Takiedine") was a longstanding franchisee of 7-Eleven, Inc. ("7-Eleven") who started operating in the 1970s and signed 7-Eleven's then-current franchise agreement when he renewed in the early 2000s. He sued in 2017 alleging that 7-Eleven had recently tried to make his business unprofitable as part of a "wider scheme" to drive out franchisees and "take back" several 7-Eleven stores in the Philadelphia market. During the litigation, Takiedine stopped operating. Takiedine's claims focused on whether 7-Eleven had satisfied its "vendor negotiation practices" obligation under the current franchise agreement to "make a commercially reasonable effort to obtain the lowest cost for products and services" or negotiate certain concessions from vendors for products that franchisees were required to purchase.

In February of 2019, the court granted 7-Eleven's motion to stay the litigation on the basis that Takiedine's "vendor negotiating practices" claims fell under the scope of the franchise agreement's arbitration provision. No arbitration was ever filed and, in 2021, Takiedine filed a motion to lift the stay, arguing that the arbitration provision left him without any recourse to litigate his claims against 7-Eleven. The court held that Takiedine's motion was effectively a two-year-late motion for reconsideration of its earlier motion enforcing the stay but, as discussed below, nonetheless granted it to prevent a "manifest injustice."

The court first found that the arbitration provision was unconscionable under Pennsylvania law. The arbitration provision was procedurally unconscionable as an adhesion contract because, after operating for decades, Takiedine was presented with the renewal agreement as a "take it or leave it" contract that 7-Eleven conceded was not negotiable if Takiedine wished to continue making his living as a franchisee. Although 7-Eleven pointed out that other franchisees had played a role in drafting the agreement and Takiedine had been given the uniform franchise offering circular to consider at least two weeks before he signed it, the court found that these factors did not overcome the parties' "vastly different bargaining positions" and Takiedine's "extreme financial compulsion" when signing the agreement.

While procedural unconscionability alone was insufficient to invalidate the arbitration clause under Pennsylvania law, the court found that the provision was substantively unconscionable because it was "unreasonably favorable" to 7-Eleven, being effectively "an agreement not to litigate at all." The franchise agreement's arbitration clause provided that "vendor negotiation practices" issues could not be litigated by complaining franchisees, but rather through a "Franchisee Selection Committee" consisting of five unelected franchisees (the "Committee"). The Committee was unable to communicate with complaining franchisees due to confidentiality agreements that members had with 7-Eleven. Rather, each year the Committee retained a "Third Party Reviewer" to inspect a list of vendor agreements for potential breaches by 7-Eleven. If the Reviewer concluded there was a breach, the Committee and 7-Eleven were required to informally attempt to resolve the issue, then go to non-binding mediation, and then go to arbitration within one calendar year from the Third-Party Reviewer's review. Notably, individual franchisees with potential claims would have no knowledge of when this

contractual review period began to run, and no involvement with the arbitration. Further, a member of the Committee testified that the dispute resolution procedures had not been used for over a decade because there was a strong damage limitations provision in the arbitration agreement that gave the Committee "little or no leverage to force 7-Eleven to change its vendor negotiating practices."

The court found that because the contract could not be construed in a way to allow individual franchisees to meaningfully litigate claims through arbitration without fundamentally rewriting the contract, it would be unenforceable as unconscionable under Pennsylvania law. The court also held that the Federal Arbitration Act ("FAA") did not preempt Pennsylvania's common law in this instance because the flaw with the arbitration provision was not that it required litigation through arbitration rather than the courts, but that it was not really an arbitration agreement at all. Rather, it was a complete litigation bar. The court held that even after the Supreme Court's recent jurisprudence clarifying that the FAA could preempt state laws that had a "disproportionate impact" or "interfered" with fundamental attributes of arbitration, common law unconscionability would not offend the FAA so long as it did not disproportionately disadvantage arbitration agreements in a way that would undermine the effectiveness of the FAA. With respect to this contract, the court noted that the FAA "says nothing about 'no arbitration' agreements." Because continuing to enforce the arbitration agreement would have the effect of keeping the franchisee's claims in permanent limbo, the court reversed its prior holding, found the arbitration provision unenforceable, and lifted the stay.

After the court lifted the stay, it reached the merits of Takiedine's claims and granted summary judgment in favor of 7-Eleven in *Takiedine v. 7-Eleven, Inc.*, No. CV 17-4518, 2022 WL 837181, at *1 (E.D. Pa. Mar. 18, 2022). The court found that, with respect to Takiedine's remaining claims, he had not proffered any evidence at all that 7-Eleven failed to use its best commercial judgment to secure good prices and other conditions for proprietary products and ingredients that 7-Eleven required its franchisees to purchase. As such, there was no genuine dispute of fact, and 7-Eleven was entitled to judgment in its favor.

***Window World International, LLC v. Jill O'Toole*, 21 F.4th 1029 (8th Cir. 2022)**

Initially, the defendants here brought various claims against Window World International, LLC ("Window World") in North Carolina Business Court alleging that they were franchisees and not licensees of Window World. As such, they claimed that Window World failed to make required federal and state franchise disclosures and sought to have their license agreements declared null and void or reformed pursuant to the parties' course of dealing.

Then, after the supposed-franchisees sent letters to Window World's customers that allegedly included Window World's trademarks and solicited prospective customers, Window World filed this case in federal court before the Eastern District of Missouri, alleging false advertising, trademark infringement, unfair competition, and dilution of a famous mark under the Lanham Act.

Defendants moved to dismiss Window World's claims and, in the alternative, to stay the federal case during the pendency of the state court action. The federal district court dismissed certain claims and granted defendants' request for stay on the remaining trademark and unfair competition claims under both the Lanham Act and Missouri law pending the state court's determination of the scope of defendants' license to use Window World's marks.

Window World appealed, arguing the district court erred in granting a stay based on the *Colorado River* abstention doctrine. Before evaluating the district court's decision to stay, the court of appeals determined whether the stay constituted a final order such that it had jurisdiction. The Eighth Circuit explained that stays entered by district courts generally do not constitute final judgments. Rather, the stay acts as a final judgment only when it has the practical effect of leaving the appellant out of court. This happens when the claims in concurrent state and federal court litigation are so similar that the federal district court has decided to relinquish its jurisdiction over the controversy in favor of the state court's judgment.

Here, the Eighth Circuit explained that the basis of the district court's stay was mischaracterized as *Colorado River* abstention—one where jurisdiction over entire claims is relinquished to state court litigation. Instead, the federal district court merely stayed the preceding case to await the state court's determination of the scope of the defendants' license to use Window World's trademarks. This did not have the practical effect of leaving Window World out of federal court because (i) the federal court was capable of determining that issue for itself, (ii) that issue was not dispositive of Window World's federal claims, and (iii) the district court's own stay order contemplated further federal court litigation in the matter because it provided all parties the option to move to lift the stay once the issue of the license was decided in state court. Accordingly, the stay did not constitute a final judgment, meaning the Eighth Circuit held it did not have jurisdiction to consider the propriety of the district court's stay.