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LJN's
# Franchising Business & Law Alert®

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## Franchised Employees Might Be Employees of Franchisor

### *Federal Court Ruling Under Federal Wage and Hour Law*

**By Megan L. Anderson and Maisa Jean Frank**

In a troubling development for franchisors, a Missouri federal district court has conditionally certified a class of plaintiffs in a collective action brought against Hotshots Sports Bar & Grill under the federal Fair Labor Standards Act ("FLSA") and Missouri's wage and hour laws. The ruling in *White v. 14051 Manchester, Inc.*, 2012 U.S. Dist. LEXIS 170052 (E.D. Mo. Nov. 30, 2012) is concerning because it holds, at least preliminarily, that employees of independently owned franchises may be considered employees of the franchisor under the FLSA, based on a common form of control exercised in most franchisor-franchisee relationships.

The named plaintiffs in the *White* case are current and former servers and bartenders of Hotshots locations who claim that they were unlawfully required to participate in a tip-sharing pool with "back of the house" employees. Under the FLSA and many state wage and hour laws, tips are the property of the employee, and an employer may not require tip sharing. Employees may voluntarily elect to share or pool tips, but

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## Franchisee Bankruptcies and Receiverships: What You Don't Know Might Surprise You

**By Patrick M. Jones and Beata Krakus**

Franchisors do not want to be associated with insolvent or bankrupt franchisees; it's not good for the brand. Therefore, franchisors carefully craft provisions in franchise agreements designed to allow termination in the event of a franchisee's bankruptcy or the appointment of a receiver as a result of a foreclosure action, typically initiated by the franchisee's lender. The bottom line, however, is that those artfully drafted provisions are frequently unenforceable and are, effectively, not worth the expensive contracts in which they are printed.

### Timing

As is the case with so much of life, timing is crucial. When a franchise agreement is terminated has a significant (sometimes a definitive) effect on whether the termination will be upheld in court. If a franchise agreement has not been effectively terminated prior to a franchisee's bankruptcy filing, the agreement becomes part of the bankruptcy estate, and the franchisor cannot unilaterally terminate the agreement. This is true even if the franchisee was in default of every essential provision of the agreement, including payment terms, and even if the franchise agreement clearly states that it may be terminated upon the franchisee's insolvency or upon filing for bankruptcy protection. Once the franchisee has received the protection of the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, any actions affecting the franchisee's interests in property — including a franchise agreement — are "stayed" and cannot proceed without an order of the bankruptcy court. Also, bankruptcy courts are unlikely to give such an order due to the value that the franchise agreement has to the franchisee.

### Debtor-Franchisee's Options

In bankruptcy terms, a franchise agreement is known as an "executory contract." A debtor franchisee may assume, *i.e.*, keep, an executory contract, assign an executory contract to a third party, or reject, *i.e.*, terminate it. Assumption and assignment require that the franchisee can cure any defaults existing at the time of

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PERIODICALS

# Bankruptcies

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the assumption or assignment — including any amounts owed pre- and post-bankruptcy filing. If that is the case, the franchisee can assign the executory contract to a third party over the objection of the creditor party to the agreement. In other words, under the general rule, a franchisee could file for bankruptcy protection, pay the amounts owed under the franchise agreement, and assign its interests in the franchise agreement to a third party whom the franchisor has never met.

The debtor franchisee must provide the franchisor with evidence, or "adequate assurance," of the assignee's ability to perform the franchisee's obligations under the franchise agreement. Adequate assurance, however, is not defined in the Bankruptcy Code, and can take many forms, including evidence of the assignee's financial standing, credit worthiness or a personal guaranty.

However, the general rule that a debtor franchisee may freely assign executory contracts is not without exceptions. One exception to the general rule that often comes into play in the franchisor-franchisee relationship is that, under § 365(c)(1)(A) of the Bankruptcy Code, a debtor franchisee may not assign certain executory contracts in contradiction of federal or state law that requires the other contract party's consent to the assignment. There is some disagreement between courts as to whether this exemption applies to all executory contracts, or only to personal services contracts. This is an important distinction for franchisors, and how a franchise agreement is characterized may determine if the franchisor has a say in who the assignee of the agreement is, or is not.

If the bankruptcy case is pending in a jurisdiction that applies the exception to all executory contracts, or if the franchisor can overcome the initial hurdle of having its franchise agreement characterized as a personal services contract, it remains to find a state or federal law that would limit the franchisee's right to assign. There are several laws and opinions upon which a franchisor may rely.

For example, in *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27 (1st Cir. 1984), the court relied on a Rhode Island statute that prohibited the assignment of an automobile dealership without the reasonable consent of the manufacturer to prevent a trustee from assigning an automobile dealership.

While franchise-specific laws limiting the right to assign are only available to certain industries, the Lanham Act, 15 U.S.C. § 1051 *et seq.*, regulates trademarks and limits assignment of non-exclusive trademark licenses without the trademark owner's consent. Given that franchise agreements, by definition, include a trademark license, franchisors may object to the assignment of a franchise agreement to a third party based on the Lanham Act protection granted to them as trademark owners.

In some circuits, § 365(c)(1)(A) of the Bankruptcy Code is taken a step further than described above. Several circuits have adopted the view that it is not just the debtor franchisee's right to assign the contract that is limited by § 365(c)(1)(A), but even its ability to assume such a contract. The argument is that since a hypothetical assignment would require the franchisor's consent, so would the assumption. For example, in *In re Kazi Foods of Michigan, Inc.*, 473 B.R. 887 (E.D.Mich 2011), KFC was able to block the debtor's motion to assume on this ground. However, not all courts agree. In *In re Jacobsen*, 465 B.R. 102 (N.D.Miss 2011), the court found the hypothetical test "somewhat nonsensical," and while it appears to agree that the franchisor could have blocked a potential assignment by the debtor based on its rights under the Lanham Act, it

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**Patrick M. Jones** and **Beata Krakus** are officers in the Chicago office of Greensfelder, Hemker & Gale, P.C. (www.greensfelder.com). Jones is a member of the firm's Creditors' Rights & Bankruptcy and Litigation Practice Groups. Krakus is a member of the firm's Franchising & Distribution and Corporate Practice Groups. Jones can be reached at pmj@greensfelder.com or 312-345-5018. Krakus can be reached at bk@greensfelder.com or 312-345-5004.

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# Discovery in Arbitration Proceedings

**By Charles F. Forer**

*This article marks the debut of an occasional column that will provide franchise attorneys with practical advice about conducting arbitrations.*

Hypothetical: Two years ago, Pupdog Limited, a franchisor of all things relating to puppies, entered into a franchise agreement. Pupdog Limited's attorney insisted that the franchise agreement contain an arbitration clause. His sage advice to the franchisor, Pupdog's president: "Everyone knows arbitration is cheaper and faster than litigation. There is no downside. And it reduces legal fees." The franchisor also followed counsel's advice when he told her to "keep it simple."

The result? The franchise agreement dealt with arbitration in one sentence, stating only that "franchisor and franchisee shall arbitrate any disputes arising out of or relating to their agreement." The agreement was silent on the "details."

Pupdog Limited now believes that its franchisee has breached the franchise agreement. The franchisee's three franchise stores are always dirty, the merchandise is not well-displayed, and the lights are so dim that the puppies look sickly. Plus, the employees know nothing about dogs. In addition, the franchisee has not paid his franchise fees for three months. The kicker: According to two former employees, the franchisee has siphoned his profits into a secret bank account and, therefore, his monthly franchise reports are shams.

**Charles F. Forer** is a member in the Philadelphia office of Eckert Seamans Cherin & Mellott, LLC, where he practices all types of alternative dispute resolution, both as a neutral and as counsel to parties engaged in ADR. He is a former co-chair of both the Philadelphia Bar Association's Alternative Dispute Resolution Committee and the Fee Disputes Committee. He can be contacted at 215-851-8406 and cforer@eckertseamans.com.

Under the one-sentence governing arbitration clause, Pupdog Limited must arbitrate its claims against the franchisee. No matter, thinks the franchisor. The arbitration will reduce costs and speed up resolution of the dispute. That is what the attorney said, right?

At the pre-hearing conference with the arbitrator, the franchisor's counsel said he wanted to depose the two former out-of-state employees whose testimony not only will demonstrate how the franchisee's fraudulent scheme has operated, but also how much money he has diverted from his franchise stores to his personal accounts. "This is critical testimony for proving liability and for calculating damages," the attorney told the arbitrator.

The franchisee's lawyer objected to the franchisor's attempt to "introduce litigation tactics into arbitration." Pointing out that "arbitration is cheaper and faster than litigation" — echoing what counsel told the franchisor — the franchisee's lawyer insisted there should be no depositions. "My client bargained for arbitration to avoid the costs, expenses and delays of litigation. Why is counsel seeking to undermine the very purpose of the arbitration provision that he drafted?"

The arbitrator agreed with the franchisee. "No depositions," said the one-sentence order, which was even shorter than the arbitration provision that the franchisor's lawyer had drafted.

The lawyer now must tell the franchisor that the arbitration will be a lot cheaper and faster than litigation. That is the good news. However, the bad news is very bad indeed: The franchisor's inability to depose these two former employees probably will prevent Pupdog Limited from getting to the bottom of the franchisee's fraudulent scheme.

## Preserving a Franchisor's Rights to Take Discovery in Arbitration

Where did the franchisor's counsel go wrong? Should Pupdog Limited have refused to insert an arbitration clause into the franchise agreement? Could Pupdog Limited have preserved the right to arbitrate *and* take depositions?

Drafters of arbitration provisions sometimes forget that arbitration is a matter of agreement. The parties can tailor all aspects of the arbitration clause, including the discovery process, to fit their anticipated needs and budgets. They can agree to lots of discovery, no discovery or limited discovery. Or, as the franchisor's attorney did, they can ignore the issue and hope they get the discovery they need when they need it.

However, "hoping" is not a reliable strategy when it comes to dispute resolution. As an incredulous franchisor screamed before slamming her attorney's office door, "Pupdog may have to walk away from a claim worth millions because it is not allowed to take depositions?"

In drafting arbitration agreements, parties and their lawyers must consider the type and amount of discovery they will need if a dispute ever arises. Parties can enter into broad arbitration discovery clauses ("to engage in any discovery permitted by the Federal Rules of Civil Procedure"). They can agree to narrow discovery clauses ("the parties shall not be permitted to take any pre-hearing discovery whatsoever"). Or they can enter into something in between that balances the need for discovery with the goal of minimizing the cost of dispute resolution.

At the time of drafting, parties cannot foresee the various disputes that may arise down the road. How would Pupdog Limited have known, two years ago, that it would now be involved in a seven-figure dispute with its franchisee?

However, parties and their counsel should resist the temptation to insert a one-size-fits-all discovery clause that permits lots of discovery. Why? Because a broad discovery clause might undermine the it-will-reduce-your-legal-fees rationale for choosing arbitration in the first place. Would Pupdog Limited now be happy with a broad arbitration clause, permitting many depositions, if the amount in controversy were less than $25,000?

The fatal mistake of the franchisor's attorney stemmed from his failure to consider these issues. He did not anticipate potential

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## *Arbitration*

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disputes, and he did not figure out how to draft an arbitration clause that sought to achieve Pupdog Limited's objectives. He surely did not respond to his client's needs.

One solution would have been to write the contract to allow for broad discovery for specified types of claims or for claims where the amount in controversy exceeded a specified amount. This strategy would have ensured that the franchisor would be able to take discovery in big cases, but would have limited discovery in small cases.

Another solution: Kick the can down the road by permitting limited document production and empowering the arbitrator to decide whether the parties can seek additional discovery. This solution does not guarantee the right to take depositions. However, it prevents the other side from saying what the franchisor's adversary said: that nothing in the arbitration agreement allows either side to take depositions. A sample kick-the-can-down-the-road clause could look something like this:

> (a) Within ___ days after the filing of the response to the arbitration demand, each party shall provide the other with copies of all documents that are likely to bear significantly on their respective claims and defenses.
>
> (b) The arbitrator may allow the parties to engage in other discovery, including depositions, if the arbitrator determines that the likely benefit of the proposed discovery outweighs the burdens and expenses of the proposed discovery, taking into account the needs of the case, the amount in controversy, the importance of the issues at stake in the arbitration, and the importance of the proposed discovery in resolving the issues.

Pupdog Limited would not be in its present predicament if its counsel had considered these issues two years ago. His failure to do so left the franchisor with the mere hope that it could take depositions — a hope that fell on the deaf ears of an arbitrator who was unsympathetic to broad arbitration discovery.

## *Bankruptcies*

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could not block the debtor's assumption of the franchise agreement.

Another bankruptcy possibility is that the debtor or bankruptcy trustee will "reject" the franchise agreement. Under the Bankruptcy Code, a rejected franchise agreement is treated as if the debtor had breached the agreement just prior to filing its bankruptcy petition. This means that the franchisor is left with a general unsecured claim against the debtor franchisee's bankruptcy estate in an amount of the damages that it can prove it suffered as a result of the franchisee's non-performance of the franchise agreement. A general unsecured claim, under these circumstances, is often worth very little.

### Foreclosures and Receiverships

Since bankruptcy is a federal proceeding, aside from circuit differences such as the ones discussed above, the proceeding is the same throughout the United States. Foreclosure laws, however, are state law alternatives to bankruptcy, and while the general process is the same, local variations need to be considered. The following is a general overview of state foreclosure laws.

The franchisor's treatment in a foreclosure action initiated by the franchisee's lender is not much different from what happens in a bankruptcy. Once the court appoints a receiver to manage the franchisee's operations, whether the franchisor can terminate the franchise agreement becomes a question of state law. In the absence of a state law preventing termination of the agreement, the receiver may seek an order of the court enjoining any termination during the pendency of the receivership or for a certain period of time to permit the receiver to realize maximum value from the franchisee's operations for the benefit of its creditors — including the lender that initiated the action in the first instance.

While the franchisor's right to terminate a franchise agreement may be restricted in a similar fashion in bankruptcy and foreclosure, there are other significant differences between the two types of proceedings. The most significant difference might be the management of the franchisee's business during the proceeding. In bankruptcy, at least in so-called Chapter 11 cases, the debtor usually remains in possession of its assets and continues to manage the day-to-day operations of its business, albeit with court supervision.

In that regard, a foreclosure proceeding is more onerous on the franchisor because the court-appointed receiver manages all of the assets subject to the proceeding. The franchisor faces many issues that need to be quickly addressed to avoid the interruption of the foreclosed franchisee's operations. For example, depending on the level of sophistication of the operations, the receiver or the court-appointed management company might not have the necessary expertise and skills to properly operate the franchised business. Confidentiality is another important issue: Most likely the management company will need access to the franchise system operations manual, and other proprietary documents and information. Since foreclosure proceedings can drag out for as long as bankruptcy proceedings, it is usually advisable for the franchisor and receiver to consider some type of operating agreement as well.

### Practical Considerations

Of course, there are many different reasons why a franchisee files for bankruptcy or ends up in foreclosure. In many cases, the franchisor might not want to terminate the franchise agreement, but rather hope that the franchisee can work its way through its financial issues.

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# COURT WATCH

**By Cynthia M. Klaus and Susan E. Tegt**

## CA Federal Court Seeks to Clarify *eBay*'s Application Of the Presumption of Irreparable Harm

A California federal district court recently declined to apply a presumption of irreparable harm when it granted a franchisor's motion for a preliminary injunction on the franchisor's trademark infringement claim. *7-Eleven, Inc. v. Dhaliwal*, No. 12-CV-02276-KJM-GGH, 2012 WL 5880462 (E.D. Cal. Nov. 20, 2012). The district court's conscious decision not to apply the presumption marks a step in the Ninth Circuit in clarifying whether the U.S. Supreme Court's determination in *eBay Inc. v. MercExchange, LLC*, 547 U.S. 388, 394 (2006), holding courts should not presume irreparable harm in patent infringement cases, applies also to trademark infringement claims. The *7-Eleven* decision is important because its interpretation of the applicability of the *eBay* decision to trademark and copyright infringement actions is, and will continue to be, a recurring issue before courts nationwide.

In *7-Eleven*, a 7-Eleven franchisee was terminated for breaching his franchise agreement with the franchisor, but continued to operate his store using the franchisor's trademarks. The franchisor filed suit and shortly thereafter moved for a preliminary injunction, seeking to eject the former franchisee from the store, enjoin the former franchisee from using the trademarks, and require the former franchisee to cease holding himself out as a 7-Eleven franchisee.

In holding that the franchisor satisfied the requirements for injunctive relief, the district court explicitly declined to apply a presumption of irreparable harm to the franchisor's request for injunctive relief. The district court noted that although Ninth Circuit precedent previously held that once a likelihood of success on the merits was established in a trademark case then a presumption of irreparable harm could be applied, such precedent had been called into question by the Supreme Court's decision in *eBay*. In *eBay*, the Supreme Court held that courts should not categorically apply a presumption of irreparable harm in patent infringement cases based on a successful showing of likelihood of success on the merits.

The district court in *7-Eleven* discussed the Ninth Circuit's struggle with the application of *eBay* to trademark and copyright infringement cases, noting that since *eBay*, Ninth Circuit courts have both applied and rejected the application of the presumption in copyright and trademark infringement cases. The *7-Eleven* court ultimately concluded that application of the presumption under the facts was not appropriate, and that the "viability of the presumption of irreparable harm caused by trademark infringement is at best still an open question." Even though it declined to apply the presumption of irreparable harm, the district court nonetheless found that the franchisor satisfied its burden by providing sufficient evidence of irreparable harm, namely that it would suffer a loss of control over its trademarks and the likelihood that customers would be confused by the misuse of the marks.

## Covenant Not to Compete in 25-Year-Old Contract Held Void Due to Later Addition Of Choice-of-Law Provision

A bankruptcy court in the Eastern District of Texas recently held that through a series of contract amendments, a franchisor unknowingly rendered a covenant not to compete unenforceable. *Allegra Network, LLC v. Ruth*, Bus. Franchise Guide (CCH) ¶14,966 (Bankr. E.D. Tex. Jan. 10, 2013). In 1984, Insty-Prints, a Minnesota franchisor, entered into a 10-year franchise agreement with Michael and Elinoria Ruth for the operation of a printing shop in Texas. In 1995, the parties entered into an addendum agreement which extended the 1984 franchise agreement for another 10 years, changed the royalty provisions, and enlarged the franchisee's exclusive territory. During the second term, Insty-Prints assigned the franchise agreement to Allegra Network as part of a larger asset transfer. At the conclusion of the second term, in 2006, the parties entered into another renewal addendum agreement, which extended the franchise agreement for a third 10-year term. This 2006 addendum added a Michigan choice-of-law provision.

The Ruths then failed to make royalty payments, which led to the termination of the franchise agreement by Allegra Network in 2008. After termination, Allegra Network commenced a lawsuit against the Ruths for violation of the covenant not to compete, which was part of the original 1984 franchise agreement. The Ruths then filed a voluntary bankruptcy petition, Allegra Network's federal court action was stayed, and Allegra Network filed a complaint in the bankruptcy court based on the covenant not to compete.

At the trial of Allegra Network's claim, the bankruptcy court first considered the enforceability of the covenant not to compete. The insertion of the Michigan choice-of-law provision in 2006 made this question more interesting because Michigan considered covenants not to compete absolutely void before 1985. Without the addition of the Michigan choice-of-law provision, which was done at the insistence of Allegra Network, it is likely that either Minnesota or Texas law would have governed. Covenants not to compete were enforceable in 1984 under both Minnesota and Texas law. Because Michigan law applied and voided covenants not to compete before 1985, the court needed to determine whether the renewal agreements were new, distinct contracts or whether they constituted extensions of one, continuing contract that was effective in 1984.

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**Cynthia M. Klaus** is a shareholder and **Susan E. Tegt** is an associate with Larkin Hoffman. They can be contacted at cklaus@larkinhoffman.com and stegt@larkinhoffman.com, respectively.

## *Court Watch*

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The court explained that this issue required an examination of the parties' entire contractual relationship to determine their intent. The language of the renewal contracts specifically states that their purpose was to "amend and revise certain provisions of the Franchise Agreement ... dated October 23, 1984." The court found that in both renewals the parties supplemented, rather than supplanted, the original franchise agreement, and that they clearly intended to create one continuous contract. Therefore, because the covenant not to compete would have been void under Michigan law in 1984, it could not be revived later and remained unenforceable.

Even though the court found that the covenant not to compete was void, it also considered the issue of whether Allegra Network's alleged equitable remedy of enforcement of the covenant not to compete was discharged in bankruptcy. Under Fifth Circuit precedent, the court must analyze whether under the applicable state law the payment of money is an available alternative to equitable relief. If monetary damages are an available alternative, it is a dischargeable claim. The bankruptcy court determined that under Michigan law, monetary damages were available as an alternative to equitable relief, and that Allegra Network had not sustained its burden to show by a preponderance of the evidence that monetary damages were inadequate to compensate it for its harm. Therefore, even if the covenant were enforceable, the court held that it would be discharged in bankruptcy.

### No Damages Awarded to Plaintiff After Wrongful Termination

The case of *FECO, Ltd. v. Highway Equipment Co., Inc.*, Bus. Franchise Guide (CCH) ¶14,967 (Iowa App. Jan. 9, 2013), arose out of the termination of a dealership agreement between a manufacturer, Highway Equipment, and an agricultural equipment dealer, FECO. Highway Equipment admittedly did not have good cause, as defined by the Iowa statute, to terminate and had not provided FECO with the notice period required by the statute. Therefore, FECO filed suit against Highway Equipment seeking monetary damages for wrongful termination of the dealership agreement. After a 2009 bench trial, the district court decided that the statute provided for equitable relief only, and that monetary damages were not available. The Iowa Court of Appeals reversed and remanded for a determination of damages.

On remand, the district court reviewed the trial testimony of the parties' competing damages experts and declined to award any damages, based on a finding that FECO had fully mitigated any loss suffered due to the wrongful termination. The court noted that FECO appeared to be in no worse situation, or possibly even a better situation, than before the termination.

In addition to arguing on appeal that the court should have credited its expert's testimony, FECO argued that Highway Equipment should not have been allowed to offer testimony regarding mitigation of damages because it had failed to plead mitigation as an affirmative defense. The district court rejected this argument, noting that the required affirmative defense is for failure to mitigate damages. A defendant may present evidence that a plaintiff has mitigated its damages, and thus the damages amount should be reduced, without pleading mitigation as an affirmative defense.

The district court also refused to award attorneys' fees and costs to FECO. On appeal, FECO argued that it should be allowed to recover attorneys' fees, despite the fact that it failed to recover any actual damages. Highway Equipment, on the other hand, argued that an award of attorneys' fees should be contingent on an award of damages. The court looked at the statute, which states that "[a] supplier violating this chapter shall compensate the dealer for damages sustained by the dealer as a consequence of the supplier's violation, together with … reasonable attorneys' fees." Iowa Code § 322F.8(1). The court held that if attorneys' fees were awarded without an accompanying damages award, the "together with" language of the statute would be rendered irrelevant. Accordingly, the court held that attorneys' fees were not available to FECO.

## *Wage and Hour*

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wage and hour laws typically forbid mandatory tip sharing.

**Megan L. Anderson** is a principal in the Minneapolis office of Gray Plant Mooty, and **Maisa Jean Frank** is an attorney in GPM's Washington, DC, office. Anderson can be contacted at 612-632-3004 or megan.anderson@gpmlaw.com, and Frank can be contacted at 202-295-2209 or maisa.frank@gpmlaw.com.

The named plaintiffs in *White* sought to conditionally certify a putative class of plaintiffs consisting of all employees who participated in a tip pool or who worked as a tipped employee at any Hotshots location, including franchised locations. Unlike a typical class action brought under Federal Rule of Civil Procedure 23, the FLSA permits "collective" actions in which putative class members must affirmatively opt in to the case rather than being automatically included in the case unless they opt out. FLSA plaintiffs may seek early conditional class certification for purposes of providing notice to potential class members of their right to opt in to the case. A defendant may then move at a later date to decertify the class on the grounds that a class action should not be permitted.

In *White*, the Missouri federal district court held that the plaintiffs met the standards for conditional class certification because they alleged a common tip-pooling policy or practice and were, therefore, "similarly situated" under the FLSA.

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## NEWS BRIEFS

### Burger King Franchisee Settles EEOC Lawsuit for Religious Discrimination

In January, a Burger King franchisee settled a lawsuit filed in August 2012 by the U.S. Equal Employment Opportunity Commission ("EEOC") on behalf of a former cashier who alleged religious discrimination. The settlement does not include an admission of liability on the part of the franchisee. *EEOC v. Fries Rest. Mgmt., LLC*, No. 12-3169 (U.S. Dist. Ct., N.D. Tex., Dallas Div., filed Jan. 16, 2013).

Ashanti McShan was hired as a cashier at a Burger King in Grand Prairie, TX, owned by Fries Restaurant Management. During the interview process, she informed the restaurant's manager that, because she is a Pentecostal Christian, she would need to wear a long skirt instead of the pants that are the standard Burger King uniform. Although McShan was initially told that she would be accommodated, the job offer was retracted when she arrived for training.

Fries Restaurant Management agreed to pay $25,000 to McShan, which covered lost wages ($5,000) and claims of mental anguish and suffering ($20,000). The franchisee agreed to post on employee bulletin boards its policy against religious discrimination and information regarding the duty to accommodate. Also, it will conduct training sessions in 2013 and 2014 for all district managers and general managers about federal anti-discrimination laws, with a special emphasis on religious discrimination.

### Domino's Franchisee Settles Robo-Call Lawsuit

RPM Pizza LLC, which calls itself the nation's largest franchisee of Domino's Pizza, has settled a lawsuit that alleged that prospective customers in Alabama, Louisiana and Mississippi received unwanted robo-calls on their cell phones. The $9.75 million settlement includes cash payments of up to $15 for people who received unwanted calls between May 20, 2009 and May 20, 2010, and free large one-topping pizzas for people who received calls between May 20, 2006 and May 19, 2009.

As part of the settlement, RPM Pizza did not admit wrongdoing. Both RPM and the Bohrer Law Firm (Baton Rouge), which filed the lawsuit, are prohibited from commenting on the settlement.

### U.S. Loan Guarantees to Back Franchising in Tunisia

In late January, the International Franchise Association ("IFA") announced a unique private-public partnership to support the formation of franchise businesses in Tunisia. IFA is joining with the Overseas Private Investment Corporation, the international development finance arm of the U.S. government, and the Middle East Investment Initiative ("MEII"), a nonprofit organization dedicated to stimulating economic growth and job creation in the region, to develop a credit facility that will partially guarantee loans to Tunisian businesses to enable them to acquire and operate franchises, produce goods and services to supply the franchise businesses, and establish Tunisian businesses as franchisors. The loan guarantees represent the first time that U.S. franchisors will be able to enter a foreign market with the backing of their franchisees by U.S. government funds, according to IFA President and CEO Steve Caldeira.

The partnership will include technical assistance for Tunisian partner banks to build their capacity to effectively lend to franchise businesses and a credit facility managed by MEII.

### VA's Changes to Franchise Rule Effective March 1

Rules to harmonize the Virginia Retail Franchising Act with the guidelines adopted by the North American Securities Administrators Association ("NASAA") are effective on March 1. A six-week comment period generated one comment from the International Franchise Association that did not result in any changes to the proposed rules revisions.

Key revisions will require franchisors to use NASAA's Guarantee of Performance form; provide the Franchise Disclosure Document in CD-ROM format; give franchisees copies of each "materially different" FDD used in the last three years; and file amendments to a franchise registration with the securities division when a material change is made (file within 30 days of the change). The rules also prohibit franchisors from using the "seasoned franchisee" exemption if their audit report contains a "going concern" comment.

The rules can be found at www.scc.virginia.gov/srf/bus/franch_regis.aspx.

## *Wage and Hour*

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The court rejected the franchisor's argument that certain putative class members were employed by independent franchisees, not the franchisor, and were therefore not similarly situated. The court held that the FLSA broadly defines an "employer" to include any person "acting directly or indirectly in the interest of an employer in relation to an employee." In addition, the court noted that the plaintiffs alleged that the franchisor exercised control by sending its employees to help open the franchised locations. The court held that, given these allegations and the FLSA's broad definition of "employer," the franchisor had sufficient control over the plaintiffs to be their employer, at least for purposes of conditional class certification.

### Franchisor 'Control'

The *White* court's ruling is concerning, because the type of "control" discussed by the court is present in most franchisor-franchisee

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## Bankruptcies

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And for the duration of the proceedings an insolvent franchisee that can pay its bills on a going-forward basis might be better than no franchisee at all. Even if the franchisee is not the right person to operate the franchised business long-term, a patient franchisor might be able to replace the insolvent franchisee with a more reliable, and financially able, party. Therefore, a franchisor should weigh all of its options before engaging in costly and uncertain attempts to terminate a franchise agreement that has been wrapped in the additional protections of a federal bankruptcy case, or a state court receivership.

## Wage and Hour

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relationships and does not involve any day-to-day control by the franchisor over the franchisee's operations or employees. If the preliminary ruling in *White* stands, controls that a franchisor typically includes in its franchise agreement and operations manuals could be found to create employment law liability for the franchisor under the FLSA even if the franchisor exercises no control over the franchisee's employees. Similarly, guidance or training provided by the franchisor to help a franchisee open a location and to understand and meet system standards could lead to FLSA liability. These types of controls are critical for franchisors, because they help ensure that franchisees maintain system standards necessary to protect the franchisor's brand, trademarks and customer goodwill.

It is hoped that the *White* court will reverse its ruling when the Hotshots franchisor seeks, as it presumably will, to decertify the FLSA class. The legal burden for FLSA plaintiffs to obtain conditional class certification is less onerous than at the class decertification phase. This lower legal burden may have affected the *White* court's conditional certification ruling, and a different result might occur when the *White* court conducts a more stringent analysis of the franchisor's arguments and any evidence regarding control exercised by the franchisor. Since issuing its conditional class certification ruling, the *White* court has already shown some receptiveness to the Hotshots franchisor's arguments, issuing a ruling on Dec. 18, 2012, that the franchisor did not have to produce employment records for individuals that it claimed were employed independently by franchisees. This ruling might be a sign that the court is open to further analysis of the franchisor's "employer" arguments at a later phase of the case.

In the meantime, franchisors should continue to take preventive steps to minimize their risk of being held liable for claims by a franchisee's employees. While not an exhaustive list, franchisors should consider the following:

- Limit controls over a franchisee to only those controls necessary to maintain franchise system standards and to protect the franchisor's brand, trademarks, and proprietary data and consumer confidence, satisfaction, and safety;
- Maintain carefully drafted franchise agreements and operations manuals that avoid any language providing for unnecessary controls over a franchisee's day-to-day operations or employment practices;
- Include language in franchise agreements and operations manuals that affirmatively states that franchisees are solely responsible for their day-to-day operations and employment practices, including hiring, managing, compensating, disciplining and firing employees;
- Require franchisees to conspicuously disclose to the public and to employees that the franchisee is an independently owned and managed operation;
- Include appropriate defense and indemnity provisions in franchise agreements so that if a franchisor is held to be liable as an employer of a franchisee's employees, the franchisor has a contractual claim against the franchisee;
- Require appropriate insurance coverage by franchisees for claims; and
- Regularly train the franchisor's employees that franchisees are solely responsible for their day-to-day operations and employment practices and that, as much as practicable, the franchisor's employees should not, during franchise location openings or at other times, control or participate in a franchisee's day-to-day operations, practices or decisions.

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