# Franchise Litigation in California

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While franchise cases involve many of the same types of civil procedure and substantive law issues addressed in other litigation, the contractual nature of the relationship between franchisor and franchisee, combined with the statutory obligations imposed on the parties by California law, creates a unique and evolving area of legal practice. This article addresses the principal franchise law cases in California (and, in one case, an out-of-state authority addressing California franchise law) in 2011. The cases range from threshold challenges to the arbitrability of disputes, forum selection and choice of law, to injunctive relief for the protection of franchisor trademarks and, ultimately, to the scope of cognizable claims and damages.

## Arbitration

*MKJA, Inc. v. 123 Fit Franchising, LLC*, 191 Cal. App. 4th 643 (2011).

Three groups of California franchisees filed a complaint against a Colorado-based franchisor in California state court alleging fraudulent inducement to enter into franchise agreements. Subsequently, franchisor filed a petition in Colorado seeking an order compelling arbitration pursuant to clauses contained in the franchise agreements. Franchisor also filed a motion to stay the California action pursuant to California Code of Civil Procedure ("CCP") section 1281.4, which mandates such relief when a court of competent jurisdiction is considering ordering arbitration of the dispute. In return, franchisees filed a motion to declare the arbitration provision unenforceable.

The trial court granted franchisor's motion to stay, and also ruled that the subject of enforceability of the arbitration agreement was for the Colorado court to determine.

A year later, franchisees filed a motion to lift the stay and to declare the arbitration agreements unconscionable based on a claim that the costs to arbitrate the dispute in Colorado were excessive. Franchisees submitted declarations testifying to the financial reverses they had suffered as franchisees and their inability to afford the costs of the arbitration in Colorado. Franchisor opposed the motion, arguing that CCP section 1281.4 mandated that the stay remain in effect until franchisees had complied with the Colorado order compelling arbitration.

The trial court granted franchisees' motion to lift the stay and declared the franchise agreement unconscionable based on the financial inability of the franchisees to bear the expense of arbitrations in Colorado. Franchisor appealed.

The court of appeal ruled that the scope of the trial court's jurisdiction after granting a stay pending arbitration is "extremely narrow." Because the purpose of section 1281.4 is to "protect the jurisdiction of the arbitrator by preserving the status quo until the arbitration is resolved," the stay can be lifted "only under circumstances in which lifting the stay would not frustrate the arbitrator's jurisdiction." Examples provided by the court were when the arbitrable controversy is removed from the litigation by amendment or agreement. In contrast, the court stated that lifting a stay of litigation based on financial inability of a party to afford the costs of an arbitration would "directly and materially impede the arbitrators' jurisdiction" and contravene the purpose of section 1281.4.

Accordingly, the court reversed the trial court order lifting the stay of litigation. Because the stay was improperly lifted, the court found that the trial court lacked jurisdiction to declare the arbitration provisions unconscionable.

*Htay Htay Chin v. Advanced Fresh Concepts Franchise Corporation,* 194 Cal. App. 4th 704 (2011).

A franchisor moved to compel arbitration of a breach of contract claim based on an arbitration clause in a franchise agreement. Franchisee argued the provision was unconscionable because it (1) delegated to the arbitrator the task of resolving disputes over the validity of the agreement; and (2) limited damages to actual or compensatory damages and required that the award be based on established law, not on broad principles of equity or justice. The trial court agreed and denied the motion to compel arbitration. Franchisor appealed.

The court of appeal noted that clauses delegating the issue of arbitrability to the arbitrator are generally upheld unless they appear in contracts of adhesion. However, even though a franchise agreement may have some of the characteristics of an adhesion contract because of the franchisor's greater bargaining power, because the agreement is made in a commercial context in which

arbitration clauses are common, the agreement typically will be enforced. Although the court found that the delegation clause was likely unconscionable, it found that so declaring would serve no purpose as it found no other term of the clause unconscionable. The court found that the damages limitations in the arbitration clause were not unconscionable. It also rejected an argument raised by franchisee that the requirement of a three-arbitrator panel if the claims exceeded $150,000 made arbitration prohibitively expensive for the franchisee. Accordingly the order denying the motion to compel arbitration was reversed.

### Forum Selection

*Basalite Concrete Products, LLC v. Keystone Retaining Wall Systems*, 2011 U.S. Dist. LEXIS 28682 (E.D. Cal. Mar. 17, 2011).

Defendants moved to dismiss this case or transfer venue to Minnesota. The agreement in question between the parties contained a forum selection clause designating Minnesota as the exclusive venue for litigation and, relying on this provision, defendants had filed an action against plaintiff in Minnesota for breach of contract nineteen days before plaintiff filed this case in U.S. district court in California. The issue before the court was whether the California Franchise Relationship Act mandated litigation of the matter in California.

The district court granted the motion, giving significant weight to the "first to file" rule, finding that permitting the action in California to proceed would create a situation in which two courts were deciding the same issues involving the same parties.

The district court declined to hold whether plaintiff was a franchisee under California law but ruled that California's public policy in the franchise field would not dictate a different result. California Business and Professions Code section 20040.5 renders void any provision in a franchise agreement requiring a California franchisee to litigate in an out-of-state forum. However, the court found that this statute does not require a court to ignore the "first to file" rule. In making this finding, the court determined that the public policy of a state was only one factor of many to consider on a motion to transfer venue. In addition, the court appeared to hold that forcing a California franchisee to litigate in Minnesota due to the "first to file" rule, as opposed to a venue selection clause in the franchise agreement, did not run afoul of the statute.

### Choice of Law

*Red Lion Hotels Franchising, Inc. v. MAK, LLC*, 663 F.3d 1080 (9th Cir. 2011).

Washington state franchisor sued California franchisee for breach of contract in Washington district court. Franchisee counterclaimed and asserted rights under the Washington Franchise Investment Protection Act ("FIPA"), as the contract provided it was to be governed by Washington law. The district court granted summary judgment for franchisor on the state law claims, holding they were not applicable to a California franchisee. The franchisee appealed, and the U.S. Court of Appeals for the Ninth Circuit reversed the decision of the district court.

The court found that FIPA contained no language limiting its application to franchisees within the State of Washington. The court noted that FIPA's "bill of rights," which prohibits unfair and deceptive practices, is addressed to "franchisors" and "franchisees" and contains no territorial restrictions. The court contrasted this to specific geographic limitations that appear in other provisions of the statute, such as those governing sales of franchises.

### Definition of a Franchise

*Galardi Group Franchise & Leasing, LLC v. City of El Cajon*, 196 Cal. App. 4th 280 (2011).

Plaintiff Galardi entered into an arrangement with Mark Bingham which Galardi called a "limited franchise." In this arrangement, Galardi subleased premises for a Wienerschnitzel restaurant to Bingham. Bingham was granted the right to use the Wienerschnitzel name and operating system, and had to comply with Galardi's operations manual and purchase supplies only from Galardi. Galardi had no right to control the management of the business. Unlike the case with a franchise, however, there was no franchise fee charged and the operator agreement was terminable on short notice, not the 180 days notice required under California law.

The city of El Cajon condemned the premises in order to acquire it for a police facility. Bingham signed an agreement waiving any rights he had and assigning any such rights to Galardi. Galardi then sued the City in an inverse condemnation proceeding for the value of the lost goodwill.

The trial court denied Galardi's claim for lost goodwill, relying on *Redevelopment Agency v. IHOP*, 9 Cal. App. 4th 1343 (1992), finding that Galardi, as a non-owner franchisor, was not entitled to compensation for lost goodwill. The court also interpreted the assignment agreement between Galardi and Simpson as waiving Simpson's rights to such lost goodwill, even though Simpson was the actual owner of the business who would normally have such rights to compensation.

On appeal, Galardi attempted to distinguish the IHOP case by arguing that Galardi was not a franchisor. The court of appeal found that the analysis was not simply whether Galardi was a

franchisor, but whether Galardi was the owner of the business on the taken premises. As in *IHOP*, the court found that there was no indicia of ownership by Galardi. However, it also found that the trial court had misread the assignment agreement and that as to the city, Bingham, the true owner, had not waived his rights to compensation for lost goodwill, and that these rights had been properly assigned to Galardi. Accordingly, the court remanded the action to the trial court for proceedings consistent with its ruling.

### Existence of Binding Franchise Agreement

*Good Feet Worldwide, LLC v. Larry Schneider*, 2011 U.S. Dist LEXIS 83865 (S.D. Cal. Aug. 11, 2011).

Plaintiff, purporting to be a franchisor, brought an action for various claims against defendant, which plaintiff purported to be a franchisee, in the Southern District of California, the location specified in the forum selection clause of the agreement. Defendant moved to transfer venue, arguing it never entered into a franchise agreement and thus cannot be bound by the forum selection clause. The district court found that, if there is a franchise agreement that binds the parties, the forum selection clause controls venue. Accordingly, the only question was whether there was a franchise agreement between the parties.

Plaintiff produced a copy of a franchise agreement, but it was signed only by the plaintiff and not by the defendant. Plaintiff argued that the agreement was nevertheless enforceable because the statute of frauds was satisfied. Plaintiff pointed to a number of ancillary documents that defendant did sign that referenced the franchise agreement. The court found that such documents clearly evidenced defendant's intent to be bound by the franchise agreement and constituted an adequate memorandum of the franchise agreement's terms. The court concluded that the signed exhibits satisfied the statute of frauds as constituting a signature to the franchise agreement by the party to be charged—defendant. The court denied the defendant's motion to transfer venue.

### Injunctive Relief/Trademark Issues

*Century 21 Real Estate LLC v. All Prof'l Realty, Inc.*, 2011 U.S. Dist LEXIS 6604 (E.D. Cal. Jan. 24, 2011).

Franchisor Century 21 terminated franchisee's brokerage for non-payment of royalty fees. Despite the termination, franchisee continued to use franchisor's trademarks and filed an action in Sacramento superior court seeking to remain a franchisee. Century 21 successfully moved to have the franchisee's action removed to the eastern district of California and filed its own lawsuit for trademark infringement and breach of contract.

After an initial hearing on franchisor's motion for preliminary injunction, the district court ordered an evidentiary hearing. After the hearing, the court ruled that the applicable standard for granting preliminary injunctions is set forth in *Alliance for the Wild Rockies v. Cottrell*, 622 F.3d 1045, 1053 (9th Cir. 2010), stating, "serious questions going to the merits and a hardship balance that tips sharply towards the plaintiff can support issuance of an injunction, so long as the plaintiff also shows a likelihood of irreparable injury and that the injunction is in the public interest." On the merits, the court found that Century 21 properly terminated the franchise agreement for good cause under the terms of the agreement and the California Franchise Relations Act. Based on the testimony elicited at the evidentiary hearing, the court determined that the franchisee did not pay fees owed and had no excuse for not doing so. The court found irreparable injury as the franchisee's continued use of the trademark resulted in a loss of control of the mark by Century 21 and a loss of control of its reputation and goodwill. With respect to balancing equities and the public interest, the court found that franchisee's continued use of the marks would falsely represent to the public that the franchisee was in good standing with Century 21 when, in fact, it was not. Accordingly, the court granted a preliminary injunction against the franchisee's use of any Century 21 marks.

*Wetzel's Pretzels, LLC v. Tito Johnson*, 797 F. Supp. 2d 1020 (C.D. Cal. 2011).

Plaintiff Wetzel's Pretzels brought a trademark infringement action against defendant franchisees that had been terminated due to a failure to follow system standards. Because the franchisees continued to use the Wetzel's trademarks and processes, Wetzel's moved for a preliminary injunction to force defendants to cease such activity and to de-identify. Defendants asserted that the termination was improper as being based on "unfounded, inconsistent and arbitrary" reasons. In addition, because a year had passed between the termination and the lawsuit, defendants argued that Wetzel's motion was, in fact, an attempt to disrupt the status quo rather than preserve it. In addition, they claimed that Wetzel's could not demonstrate the irreparable injury required for the injunction to issue because Wetzel's had permitted the defendants to operate the franchise for a year post-termination.

The court found that Wetzel's had demonstrated that the use of its mark by defendants was unauthorized and that it accordingly met the "likelihood of success on the merits" requirement for issuance of a preliminary injunction. The

court then focused on the propriety of the termination under the franchise agreement. The court found that Wetzel's had inspected the store on four separate occasions and each visit was followed by a letter notifying defendants of deficiencies. After the last inspection, franchisees were given thirty days to cure, and, after further warnings without cure, the franchise was terminated. The court concluded that the termination complied with the notice periods in the franchise agreement and that any use after that time was unauthorized.

With respect to the balance of hardships, defendants argued that being put out of business would cause them to suffer a loss of revenue and employees would lose their jobs. However, the court found "it is defendants who brought on those risks."

In regard to the public interest, the court held that the public has a strong interest in being free from the confusion caused by authorized use of the Wetzel's marks.

Finally, although the court noted that "at first blush" there could be a significant issue as to whether equitable relief was warranted after the lapse of a year from termination, it found that Wetzel's was engaged in good faith settlement discussions during this time pursuant to the franchise agreement. In fact, the franchise agreement mandated certain mediation procedures prior to the filing of any litigation, and Wetzel's had been engaged in such procedures during that time period.

Accordingly, the court ordered that a preliminary injunction be entered requiring defendants to de-identify themselves as being associated with Wetzel's, to be enjoined from any further use of Wetzel's marks or systems, to destroy any items with Wetzel's marks and to cancel or discontinue any phone or internet listings using Wetzel's marks.

### Fraud

*Toyz, Inc., etc. v. Wireless Toyz, Inc.*, 2011 U.S. Dist LEXIS 70623 (E.D. Mich. June 30, 2011).

Plaintiffs were California franchisees of defendant, a Michigan-based franchisor of stores selling wireless products. Plaintiffs filed an action against defendant primarily based on claims that they were given false and misleading information to induce them to enter into the franchise agreements. Defendant filed motions to dismiss.

Defendant argued that the four-year statute of limitation in the Michigan Franchise Investment Law ("MFIL") barred many of plaintiffs' claims and that the statute begins to run from the date of the act or transaction in dispute, not from discovery. Plaintiffs argued that the statute was tolled based on the fraudulent concealment of the claims by defendants. The court agreed with plaintiffs and denied this portion of defendant's motions.

Defendant also moved to dismiss plaintiffs' common law fraud claims, alleging that they were inadequately plead. The court noted a recent decision by a Michigan state trial court (*R & B Communications, Inc. v. Wireless Toyz Franchise, LLC*, case no. 2010-113623-CK) finding that the MFIL preempts common law fraud claims. That case relied on the California district court decision in *Samica Enterprises, LLC v. Mail Boxes Etc. USA, Inc.*, 637 F. Supp 2d 712 (C.D. Cal. 2008), which held that the California Franchise Investment Law ("CFIL") preempts common law fraud claims that arise from the CFIL. The language in the MFIL and CFIL on this subject are basically identical and both provide: (1) except as explicitly provided in the statute, no civil liability shall arise from the statute; and (2) the foregoing does not limit liability from any other statute or common law. The latter provision is referred to as a "savings clause." The *Samica* court held that the CFIL "displac[es] those claims that rest on misrepresentations or omissions covered by the several provisions of the CFIL, and the savings clause merely clarifies that the CFIL does not completely preempt the field." However, the court in *Toyz, Inc.* disagreed with the analysis in *Samica* and pointed to the savings clause to find that common law claims were not preempted by the MFIL.

### Damages

*Passport Health, Inc. v. Travel Med, Inc.*, 2011 U.S. Dist LEXIS 99959 (E.D. Cal. Sept. 6, 2011).

Franchisor terminated franchisee for cause and then brought suit for, among other things, lost future profits that would have been owed under the franchise agreement if franchisee had complied with its terms. Interestingly, *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704 (1996) was apparently not cited to the court by counsel for franchisee. *Postal Instant Press*, which is the subject of some controversy, held that lost future profits are too speculative for recovery when a franchisor has terminated a franchisee. It also held that the "cause" of the lost future profits is franchisor's own termination, thus creating issues for recovery. In any event, the *Passport Health* court did not delve into that case but held that franchisee cannot complain of the speculative nature of the recovery because it was franchisee's own conduct that caused the damage. The court found that evidence of franchisee's gross revenues for three and half years was sufficient to project revenues forward six years for damages purposes. The court then mitigated these damages slightly based on estimated

future royalties from a replacement franchisee. Finally, the court awarded franchisor additional damages in an amount equal to three months of franchisee's profit during the time when franchisee was infringing on franchisor's trademarks.

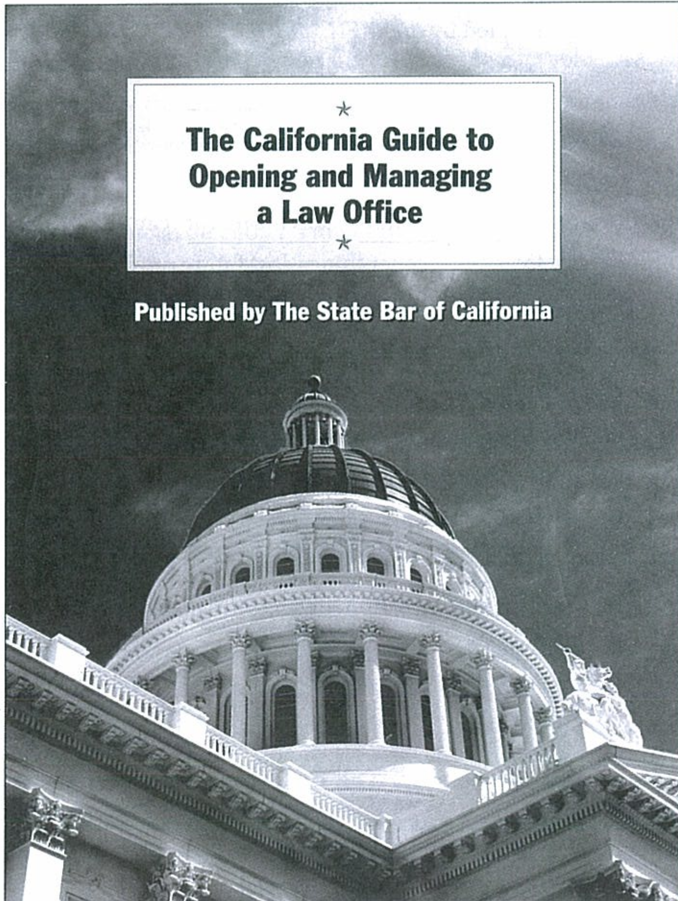
### Employment Issues

*Alejandro Juarez v. Jani-King of California*, 2011 U.S. Dist LEXIS 280684 (N.D. Cal. Mar. 4, 2011).

Defendant Jani-King offers franchises that provide cleaning and janitorial services to commercial clients in office buildings, healthcare facilities and retail outlets. Plaintiffs were four franchisees of Jani-King who brought a putative class action arguing that they were essentially employees entitled to protections under the California Labor Code.

Plaintiffs claimed that Jani-King so tightly controlled the actions of franchisees' as to create an employer-employee relationship. As evidence of this, they set forth that Jani-King directed the franchisees method of cleaning, their cleaning schedule, their contact with customers and their manner of dress (they are required to wear uniforms with the Jani-King logo). Plaintiffs also set forth various other requirements franchisees were obligated to meet under the franchise agreements and policy manual. Jani-King argued that this "proof" was simply evidence of the existence of a franchise. The court agreed that generally once a plaintiff comes forward with proof that they provided services to an employer, a prima facie case for employment has been established. However, the court found that "[p]laintiffs cite no authority suggesting that this rebuttable presumption applies to franchisees." The court noted that although employees have the benefit of protections under California's Labor Code, the sale of franchises are also subject to a considerable amount of regulation.

Citing *Cislaw v. Southland Corporation*, 4 Cal. App. 4th 1284 (1992), the court concluded that a franchisee must show that a franchisor exercised control beyond that necessary to protect its trademark and goodwill in order to establish a prima facie case of an employer-employee relationship. The court found that, after it set aside such policies of Jani-King, there was little, if any, evidence common to all the plaintiffs tending to prove an employer-employee relationship. For these reasons, the court ruled that individual questions predominated over common questions and that class treatment of the Labor Code claims was not superior to individual actions. Accordingly, the court denied class certification. ■

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