Developments In Franchise Litigation – 2010

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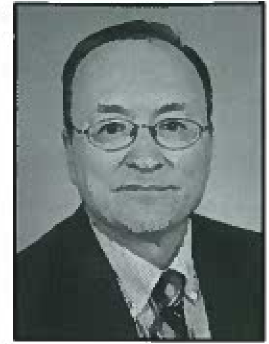

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As the business of franchising continues to grow, so does the volume of case law generated by disputes between franchisors and franchisees and other related litigation. As is true of litigation generally, many cases in the franchise field address non-franchise issues of civil procedure. The cases addressed in this article focus on subjects of particular interest to franchise law practitioners. This article includes discussion of a number of unpublished cases. It is our belief that these cases are worth including because they reference published decisions that can provide guidance in the areas analyzed by the respective courts.

The case law this year illustrates that the franchise bar focuses on resolving certain threshold issues early in litigation, with the likely expectation that resolution of these issues in their favor will have a positive effect on the eventual outcome of the case on the merits. The subjects covered in the cases summarized below include choice of law, enforcement of arbitration clauses, forum selection, personal jurisdiction, and failure to name an indispensable party. Almost all of these cases arise from attempts to enforce or avoid specific provisions of franchise agreements.

Choice of Law Provisions in Franchise Agreements

1-800-Got Junk? LLC v. Superior Court, 189 Cal. App. 4th 500 (2010)

Millennium Asset Recovery, a California franchisee of 1-800-Got Junk?, sued its franchisor in California state court for wrongfully terminating its franchise. The franchise agreement called for the application of Washington law. In an odd twist, the franchisor contended that the choice of law provision (which the franchisor presumably drafted) was unenforceable and urged the application of California law to the dispute. The trial court agreed with franchisee that Washington law applied and franchisor appealed.

The court of appeal considered whether enforcement of the Washington choice of law clause was barred by the California Franchise Relations Act's (CFRA) provision that "[a]ny condition, stipulation or provision purporting to bind any person to waive compliance with any provision of this law is contrary to public policy and void." Cal. Bus. & Prof. Code § 20010 (West 2010).

The reason for franchisor's challenge to its own franchise agreement became clear in the Court's discussion: With regard to termination, Washington franchise law is more protective of franchisee rights than is California law. Washington's Franchise Investment Protection Act restricts the franchisor to only four situations in which it can summarily terminate a franchisee without providing notice and an opportunity to cure. Wash. Rev. Code § 19.110.180. Under the CFRA, immediate termination without an opportunity to cure is permitted in the same four situations as well as in numerous other circumstances. Cal. Bus. & Prof. Code § 20021 (a) – (k).

The court of appeal found that because Washington law gave the franchisee superior protection, the choice of law provision could not be construed as a waiver of any provisions of the CFRA.

Of greater significance is that this appears to be the first published California state court decision explicitly stating that a choice of law provision in a franchise agreement cannot effect a waiver of the protections of California's franchise laws. In this particular case, the court enforced the choice of law provision because applying Washington law (giving more protection to the franchisee) did not amount to the franchisor's waiver of compliance with the CFRA.

Enforceability of Arbitration Clauses in Franchise Agreements

Bridge Fund Capitol Corporation v. Fastbucks Franchise Corporation, 622 F.3d 996 (9th Cir. 2010)

Plaintiffs entered into a franchise agreement with defendant Fastbucks for operation of a payday loan franchise in California. Fastbucks is a Nevada corporation with its principal place of business in Texas. The franchise agreement had a Texas choice of law provision and required AAA arbitration for disputes.

Plaintiffs filed an action in state court against Fastbucks alleging, among other things, breach of the franchise agreement and the California Franchise Investment Law (CFIL), including allegations of material misrepresentations in the Uniform Franchise Offering Circular (UFOC). Fastbucks removed to federal court based on diversity and then moved to dismiss or stay pending arbitra-

tion. Plaintiff opposed, arguing that the arbitration clause was unconscionable. The arbitration clause required arbitration in Dallas, prohibited class wide arbitration, made injunctive relief available only to the franchisor, and imposed a one year statute of limitations for all claims and a waiver of any right to punitive damages. The district court denied Fastbuck's motion and Fastbucks appealed.

On appeal, Fastbucks alleged three errors that the Ninth Circuit then ruled on:

1. **The arbitrator should decide the threshold issue of arbitrability.** The Ninth Circuit ruled that since the challenge to the arbitration clause was distinct from any challenges to the validity of the contract as a whole, the issue of arbitrability was one for the court.
2. **The district court erred in applying California law on unconscionability rather than Texas law.** The forum state's choice of law rules are applied in diversity cases. Thus, the Ninth Circuit ruled that under California's choice of law analysis, enforcement of the arbitration clause in the franchise agreement would contravene California's fundamental public policy expressed in the CFIL of protecting franchisees from unfair and deceptive business practices.
3. **The district court abused its discretion in refusing to sever the unconscionable arbitration provisions from the balance of the clause.** Since the district court found virtually all the provisions of the arbitration clause unconscionable, the Ninth Circuit held that nothing of substance would remain after severance.

The case was remanded to the district court for further proceedings.

Gold v. Melt, Inc., No. B210452, 2010 WL 1509795 (Apr. 16, 2010)

Fifteen franchisees filed a putative class action against franchisor alleging they had been fraudulently induced into purchasing franchises. The dispute resolution provision in each franchise agreement called for the arbitration of disputes on an individual basis and prohibited class actions or joinder of claims among franchisees. Based on the dispute resolution provision, the franchisor filed a demurrer to the original complaint and the trial court sustained it without leave to amend. On appeal, the franchisees argued that the clause prohibiting class actions and multiparty litigation was unconscionable and therefore unenforceable.

First, franchisees relied upon *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704 (1996), to support their argument that the trial court erroneously distinguished between commercial contracts, like franchise agreements, and consumer contracts. However, the California Court of Appeal for the Second District dismissed franchisees' attempt to draw similarities with *Sealy*. In particular, the court stated:

> Sealy involved a franchisor's suit for breach of contract against a franchisee, as distinct from the plaintiff franchisees' suit here against franchisor. The issue in Sealy was whether a judgment could properly award damages for unpaid future royalties and advertising fees for the unexpired term of the franchise agreement, an issue not present in this dispute between [franchisees] and [franchisor]. The determination in Sealy that the damages award of future profits was unreasonable, unconscionable or grossly oppressive...did not depend on attributes shared by commercial and consumer contracts.

Next, franchisees cited *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005), in support of their argument that the provision was unconscionable. There, the California Supreme Court invalidated class action waivers in credit card agreements. However, the court dismissed franchisees' *Discover Bank* arguments because that case involved numerous consumers damaged in minor amounts. Specifically, the court stated:

> [C]lass action waivers in contracts of adhesion are unenforceable as unconscionable in the limited circumstances described in Discover Bank. Those circumstances are not present in the franchise agreements between [franchisor] and [franchisees]. Those franchise agreements are not consumer contracts involving large number of consumers. They do not involve small amounts of damages for each of those consumers. [Footnote omitted.] The franchise agreements do not show that [franchisor], a party with superior bargaining power, deliberately cheated large numbers of consumers of individually small sums of money. (Emphasis added.)

Accordingly, the appellate court affirmed the trial court's ruling under California law. Because the franchisees were also located in Florida and Massachusetts, the court also analyzed the provision under the law of those states and concluded the provision was not unconscionable under either states' laws.

Forum Selection Clauses in Franchise Agreements

Budget Blinds, Inc. v. Waqar Mahmood, No. 10-0552 PSG, 2010 U.S. Dist. LEXIS 86925 (C.D. Cal. July 29, 2010)

Franchisor was headquartered in Orange County, California while franchisee operated his franchise in Texas. The franchise agreement contained a forum selection clause requiring litigation in the Central District of California. Franchisor bought an action in that district against franchisee and franchisee moved to dismiss for improper venue, or in the alternative, to transfer venue. The district court ruled that forum selection clauses are prima facie valid unless enforcement of the clause would be unreasonable and unjust. Franchisee argued that the clause was unconscionable under California law but the court held that federal law controlled the issue and that forum selection clauses are not invalid under federal law. The court proceeded to determine that there was no fraud or overreaching by franchisor. The court also found that the convenience of the non-party witnesses, the state most familiar with the governing law, and other factors also weighed in favor of maintaining venue in California. Accordingly, the court denied the motion.

T-Bird Nevada LLC v. Outback Steakhouse, Inc., No. B219861, 2010 Cal. App. LEXIS 3510 (May 17, 2010)

Franchisee sued franchisor in California state court alleging fraudulent inducement to enter into a series of franchise agreements. Franchisor moved to dismiss based on a Florida forum selection clause in the agreements and the superior court granted the motion. On appeal, franchisee argued that the forum selection clause was void under California franchise law. The court of appeal agreed and reversed the order of the lower court. The court began with an overview of California franchise law, including a discussion of the Franchise Investment Law and the Franchise Relations Act. The court cited California Corporations Code section 20040.5, which invalidates any provision in a franchise agreement restricting venue to a forum outside California, as rendering the Florida forum selection clause void. The only remaining issue was whether claims arising out of a related borrowing agreement would also be subject to this ruling. The court ruled that the related agreement amended portions of the franchise agreement and therefore was considered a part of the agreement. Accordingly, the prohibition in the California franchise laws against out of state forum selection clauses was also applicable to disputes attributable to the related borrowing agreement.

Personal Jurisdiction

Toyz, Inc. v. Antelope Toyz, LLC., No. 09-05091, 2010 US Dist. LEXIS 12032 (N.D. Cal. Jan. 25, 2010)

California franchisee sued Michigan franchisor and its past and present officers in California state court (later removed to federal court) for fraudulent inducement to enter into franchise agreements. In particular, franchisee alleged that the UFOC overstated revenue and understated expenses. Michigan franchisors moved to dismiss or transfer based on a lack of personal jurisdiction over them in California. Certain franchise agreements were executed in California, others were executed in Michigan, but negotiations took place primarily in Michigan. None of the individual defendants came to California to meet with the franchisee prior to the execution of the franchise agreements. The court ruled that, despite California's strong policy interest in adjudicating disputes involving franchise agreements, the exercise of personal jurisdiction over the individual defendants would be unreasonable given the minimal extent to which they injected themselves into the forum. Further, the court held that there was greater judicial efficiency in having the matter heard in a forum where the majority of third party witnesses reside. Accordingly, the court ordered transfer of the action against the individual defendants to Michigan.

Indispensable Party

Xuan T. James v. Days Inn Worldwide, No. A127669, 2010 Cal. App. LEXIS 9152 (Nov. 18, 2010)

Plaintiff filed suit in California against Days Inn Worldwide ("Days Inn") and one of its franchisees for personal injuries suffered at one of their locations in Minnesota. Franchisee successfully moved to quash service of summons for lack of personal jurisdiction in California.

Days Inn did not contest jurisdiction, but after the motion to quash was granted, it moved to dismiss for failure to join an indispensable party. Days Inn argued that it could not receive complete relief without the franchisee because it would be precluded from seeking indemnity. It also argued it should not be liable for the personal injuries suffered by plaintiff as it did not have day to day control over the operation of the hotel at which the accident occurred. Finally, Days Inn argued it might be subject to multiple or inconsistent rulings. The trial court granted Days Inn's motion and dismissed the action.

The court of appeal held that the requirement of "complete relief" underlying the need for indispensable parties refers only to relief between the existing parties, regardless of any claims the

existing parties may have against absent parties. In particular, the court held that in a vicarious liability case such as this one, a judgment can be rendered against the principal without the presence of the agent (i.e., the claim that Days Inn was only vicariously liable was not a factor in the indispensible party analysis). The court found that Days Inn could pursue a separate indemnity action against the franchisee. The court also found that there was no real possibility of inconsistent rulings arising from the California action and any subsequent Minnesota action by Days Inn against the franchisee.

The court of appeal ruled that it was an abuse of discretion for the trial court to dismiss Days Inn based on a ruling that the franchisee was an indispensable party.

Other Issues

Prudence Corporation v. Shred-It America, Inc., No. 08-56759, 2010 WL 582597, 2010 U.S. App. LEXIS 3214 (9th Cir. 2010)

The district court determined that franchisor had breached the franchise agreement by failing to timely submit proposed renewal terms to franchisee. The court ordered renewal of the franchise agreement. Franchisor challenged this ruling as an improper rewriting of the contract. The Ninth Circuit affirmed the district court ruling and found that there was substantial evidence that franchisor's delay of well over a year in attempting to renew the franchise agreement was unreasonable and that none of its excuses for delay were legitimate. Further, the court found that specific performance requiring renewal at the original royalty rate was not an abuse of discretion under its equitable powers.

Ali Safaei v. IHOP Corp., No. E046996, 2010 Cal. App. LEXIS 7700 (Sept. 28, 2010)

This case involved complicated facts about an IHOP franchisee that was in perpetual default. IHOP originally sued for unlawful detainer as the franchisee was in breach of a sublease. A settlement was negotiated that included a stipulated judgment should franchisee default again. Default ensued and franchisee was evicted and then filed an action against IHOP for, inter alia, breach of contract.

The franchisee contended that he was entitled to stop making royalty payments because IHOP had breached the franchise agreement by pursuing improper claims against him. He also contended that he was not required to begin making payments again until the dispute was resolved but was nonetheless allowed to maintain the franchise relationship. The trial court granted summary judgment to IHOP on this claim, and the court of appeal affirmed.

The court of appeal cited *Jay Bharat Developers, Inc. v. Minidis*, 167 Cal. App. 4th 437 (2008), in which franchisees stopped making royalty payments but continued to operate the business. That court held that the franchisees were not entitled to the benefits of the franchise agreement after they withheld their payments. That court ruled that the victim of a breach of contract has two choices – either stop performance and assume the contract is avoided or continue performance and sue for damages. Under no circumstances could the franchisee stop performance and continue to take advantage of the contract's benefits. *Id.* at 443-44.

As such, the court of appeal found that franchisee could not continue to operate the restaurant while simultaneously claiming IHOP was in breach and withholding franchise fees. ■