FEATURE

Big-impact cases seen in 2003

Although obesity suit was dismissed, it sparked a revolution in fast food; system change was last year's theme.

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In a year of obesity lawsuits, mass terminations, allegations of systemwide fraud and criminal conduct, and considerations of legal standing, the theme of 2003's franchise litigation appeared to be system change-fundamental issues and decisions that affect entire franchise chains.

In September 2003, McDonald's achieved a significant victory for franchisors and food manufacturers when a New York federal court dismissed for the second time *Pelman v. McDonald's Corp.*, 2003 WL 22052778 (S.D.N.Y. Sept. 3, 2003), the obesity lawsuit that sparked a revolution within the fast food industry. In *Pelman*, two teenagers, who purported to represent an entire class of minors residing in New York state, claimed that consumption of McDonald's fare on a regular basis caused them to suffer a variety of health problems, including morbid obesity.

The court initially dismissed the complaint with leave to amend to include specific allegations that McDonald's processing of its food somehow rendered the products more dangerous than a consumer would expect. In its opinion, the court identified the critical line in the debate "between an individual's own responsibility to take care of herself and society's responsibility to ensure others shield her." *Pelman v. McDonald's Corp.*, 237 F. Supp. 2d 512, 516 (S.D.N.Y. 2003). In the amended complaint, the plaintiffs alleged that McDonald's advertisements targeted "heavy users" and "super heavy users" of McDonald's products and depicted the products as nutritious and as fitting within a healthy diet. After another round of motions, the court dismissed the amended complaint with prejudice, holding that the plaintiffs failed to allege causation between their injuries and the consumption of McDonald's food and that the plaintiffs did not allege that McDonald's advertising was deceptive.

Although the court dismissed the plaintiffs' complaint with prejudice, the claims and the fast food frenzy that followed accounted in large part for a national menu shift across a number of franchise brands in the last year. Franchisors introduced salads, low-fat fare and low-carb, Atkins-friendly offerings to keep consumers coming back to fast food restaurants and perhaps to keep plaintiffs away from the courthouse.

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In the midst of the fast food diet crusade, legislators also took action at state and federal levels to introduce bills banning litigation based on food consumption-related illnesses and conditions. On March 11, the House of Representatives passed the Personal Responsibility in Food Consumption Act, or the so-called cheeseburger bill, which banned obesity lawsuits. The bill has been sent to the Senate. As the case that reformed fast food menus, drew national attention to weight-management and obesity issues, and also fired up legislators, *Pelman* ranks at the top of the franchise litigation list for 2003.

At a smaller fast food chain, the obesity debate took a back seat to the franchisee class action litigation that threatens the viability of a 50-year-old pizzeria brand. Shakey's Inc., the franchisor of a 54-unit pizza chain based in California, is defending a class action in California state court filed by 39 franchisees. The lawsuit seeks $20 million in damages from the franchisor and Chin-Yong Wong, the CEO of its parent company. *Ahmed v. Shakey's Inc.*, No. BC287817 (Los Angeles Co. Super. Ct.).

The suit against Shakey's

In court papers, the franchisees claim that despite ongoing negotiations between Shakey's and the franchisee association, Shakey's demanded in December 2002 that its renewing franchisees immediately sign a new 20-year franchise agreement (that did not include certain previously negotiated changes) or leave the Shakey's system. By the end of December, the franchisor relented and allowed the franchisees to sign 20-year extensions of their existing franchise agreements. Notwithstanding the concession by Shakey's, the franchisees sued Shakey's for breaching the franchise agreements by failing to support its franchisees, failing to negotiate with the franchisee association as required by contract and using the franchisees' royalties to attend to the financial problems of Shakey's parent company, Singapore-based Inno-Pacific Holdings Ltd. The franchisees also asserted claims of fraud and negligent misrepresentation.

In the same suit, the franchisees allege that Wong committed fraud and negligent misrepresentation when he negotiated the franchise agreement renewals with the franchisee association. On April 6, the judge entered an order dismissing the case against Wong without allowing the plaintiffs leave to amend their third amended complaint.Then on April 7, the court entered summary judgment against the plaintiffs on their fraud, breach of implied covenant of good faith and fair dealing and negligent misrepresentation claims. The breach of contract, accounting and declaratory judgment claims will likely proceed to trial.

While these rulings were extremely favorable, Shakey's still faces an uncertain future. The California Department of Corporations has notified the company that its renewal application for its federal- and state-mandated disclosure document was officially "abandoned" in May 2003. The application was abandoned because the company failed to enter into required impound procedures whereby Shakey's would place any new franchisee's initial fee into an escrow account until the franchisee was open. These procedures are typically required by franchise examiners when a franchisor's financial stability is in question. As a result, Shakey's can no longer offer or sell franchises, and the class action plaintiffs now claim that Shakey's deliberately concealed the abandonment of the franchise registration and Shakey's financial condition when it was negotiating renewal agreements with the franchisee association. The trial in Los Angeles is scheduled to begin on May 12.

As Shakey's franchisees move ahead with their class action, another set of franchisees has received a ground-breaking decision in a case instituted by its franchisee association. In late 2002, a Washington trial court in *National Association of State Farm Agents Inc. v. State Farm Mutual Automobile Association Co.,* No. 02CA-4089 (D.C. Super. Ct.), held that a franchisee association had standing to sue its franchisor. In other jurisdictions, franchisee-association lawsuits on behalf of their members have been challenged and dismissed on the grounds that the association had no relationship with the franchisor and no rights under the franchise agreements, and that it did not adequately represent the franchisees.

In *State Farm*, the court rejected State Farm's argument that the association must demonstrate that it represents the interests of all franchisees to have legal standing. Holding that the franchisee association represented a majority of franchisees and met the three-part standing test, the court denied State Farm's motion to dismiss and allowed the association to proceed against the franchisor for breach of contract, tortious interference and violation of various franchise relationship laws. As a case that recognizes representational standing of a franchise, association, *State Farm* was significant.

H&R Block Inc. has seen its share of franchise litigation battle scars over the last year based in part on a strategy formulated more than three years ago. In 2000, Block advised many of its franchisees that it would not renew their franchise agreements when they expired in 2004 and 2005. Not surprisingly, this announcement produced a host of franchisee lawsuits. At the end of 2002, Block received a crucial ruling from a Missouri court in a case initiated by 200 Block franchisees. *Armstrong Business Servs. v. H&R Block*, 2002 WL 31863337 (Mo. Ct. App. Dec. 24, 2002). The court held that Block could refuse to renew the plaintiffs' franchise agreements because the agreements had indefinite terms and were therefore terminable at will.

While this ruling dealt a blow to the franchisees on an individual basis, former Block franchisees continue to battle the franchisor over the "fair and equitable price" that Block is required to pay for expired franchises. Some franchisees sued Block, alleging that the franchisor breached the franchise agreement by paying less than a fair and equitable price for their businesses.

In October 2003, in the first of many franchisee lawsuits, a jury awarded a former Block franchisee $3.2 million, finding that Block's $4.9 million payment for the 30-year-old franchise was insufficient. *Angel v. H&R Block*, No. 99CV206379 (Jackson Co., Mo., Cir. Ct.). The award, however, which represented just 10% of the franchisee's damages estimate, was viewed as a victory for Block. In 2004, Block faces other suits, including more franchise disputes and consumer protection lawsuits. Based on the jury decision in October, Block's CEO estimated that Block may spend as much as $60 million in resolving its franchisee litigation. Once it emerges from this dispute, however, Block will have substantial assets and a tremendous corporate presence from the acquisition of these expired franchise locations.

Dunkin' Donuts suits

As the H&R Block suits demonstrate, changing a franchise system is challenging and often litigious work-witness the efforts of Dunkin' Donuts Inc. and other franchisors to improve franchisee accountability and adherence to quality standards within their franchise systems. In 2003, in addition to its standards enforcement actions, Dunkin' brought termination actions against its franchisees for various forms of misconduct, including alleged criminal conduct. In some cases, Dunkin' discovered accounting inconsistencies between the income that a franchisee reported to Dunkin' and the income reported to the Internal Revenue Service. In other cases, Dunkin' learned that the franchisee had allegedly engaged in criminal conduct. Based on this conduct, Dunkin' terminated the franchisees for breach of the franchise agreement obligation to "obey all laws." Although in each case the franchisee was not yet convicted (or prosecuted) for any crime, courts generally agreed with Dunkin' that this conduct was good cause for termination.

In *Dunkin' Donuts Inc. v. Barr Donut LLC*, 242 F. Supp. 2d 296 (S.D.N.Y. 2003), a judge in the Southern District of New York determined that the franchisee's testimony in a U.S. attorney's proffer session established that the franchisee used the proceeds from drug sales to purchase the franchise. The court held that this criminal conduct violated the franchise agreement's "obey all laws" clause and provided good cause for termination. Likewise, in *Dunkin' Donuts Inc. v. Martinez*, 2003 WL 685875 (S.D. Fla. Feb. 21, 2003), a Florida federal judge held that the franchisee's tax fraud alleged by Dunkin'-and not yet proven in criminal court-was good cause for termination because the conduct was potentially injurious to Dunkin'. The 11th U.S. Circuit Court of Appeals recently affirmed the *Martinez* decision. *Dunkin' Donuts Inc. v. Philomar*, No. 03-11569-CC (11th Cir. Dec. 12, 2003).

While judges generally supported Dunkin's right to terminate, one federal jury appears to have viewed the franchisor's rights somewhat differently. A Massachusetts jury rejected Dunkin' Donuts' argument in *Dunkin' Donuts Inc. v. H&Z Donuts Inc.*, 2003 WL 21185684 (D. Mass. Feb 4, 2003), finding that the franchisees (whom Dunkin' terminated for alleged tax fraud) did not materially breach the franchise agreement. The basis for this decision, however, remains unclear because the verdict sheet did not indicate whether the jury found that Dunkin' did not prove the alleged tax fraud or that tax fraud was not a material breach of the franchise agreement. Although Dunkin' appealed the jury's verdict, it recently abandoned that appeal. Notwithstanding this aberration, 2003 was generally a successful year for Dunkin' Donuts' fraud-termination program, and, in a more global sense, for the franchisor's right to terminate for a franchisee's illegal conduct.

Viewed as a whole, franchise litigation in 2003 presented a mixed bag of decisions. While franchisor efforts to control the franchise relationship drew conflicting reactions from courts and juries, franchisors won some notable cases, defeating obesity claims against Big Food and establishing the right to end the franchise relationship upon expiration of the franchise agreement. Having established that right (under limited circumstances), however, franchisors should be cautious in exercising these sweeping powers. If other courts agree with the D.C. trial court that franchisee associations have standing to sue a franchisor, the complications of mass franchisee litigation may be a thing of the past. The real threat to a franchisor's financial health may come from an association with which the franchisor has no contractual relationship. As an organization that represents and unites franchisees, the franchisee association may have just been handed substantial new leverage for negotiating franchise deals.

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