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Meat House Franchisees Thrown Out of Court, Even Though They Might Have Been Defrauded By Their Franchisor

Schwartzco Enterprises LLC, a New York Limited Liability Company v. TMH Management, LLC, ¶15,420. U.S. District Court, E.D. New York. No. 14-CV-1082 (November 17, 2014.)

Beginning in early 2010, the franchisor-Defendants allegedly pursued Schwartz, the sole investor in Schwartzco, the franchisee, to induce him to invest in acquisition rights to franchise and develop The Meat House stores in Westchester, New York; New York City; and Long Island. The Defendants allegedly targeted Schwartz through his nephew, Cary Tober, a low-level employee in the Meat House franchise system. The franchisee-Plaintiffs ultimately invested more than $2 million in The Meat House franchise system.

According to the franchisee Plaintiffs, the Defendants made "material false misrepresentations (and/or omissions)" verbally and in writing to the Plaintiffs; and "used false, inflated, and misleading cherry-picked information, and generated numerous fraudulent financial spreadsheets and financial statements about the Meat House's current business and profitability (including false earnings claims), and what Plaintiffs could expect to generate in New York, with [the] Defendants operating the business." The Plaintiffs also asserted that the

Franchise Law – Franchise Discrimination 1:2 - Jeff Goldstein: Franchise Lawyer

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Franchise Discrimination - Video 1 of 2

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Franchise Law: Fraud and Good Faith in Franchise Law

Franchise Law – Franchisees' Franchise Termination Damages

Defendants violated federal franchise disclosure law, including the "FTC Act", and the NYFSA by failing to provide sufficient franchise disclosures.

The franchisee Plaintiffs contended that, as a result of the Defendants' fraudulent scheme, they entered into various agreements with certain of the Defendants and opened an area development entity and ultimately one franchised location, TMH-NY, in Roslyn, New York.

Despite the fact that TMY-NY was fully funded by Schwartzo, TMH Ventures reserved a 5% ownership interest for itself and the Defendants appointed TMH Management as its sole "manager." In this way, the Defendants retained equity and control over TMH-NY without bearing any financial risk. The Defendants allegedly abused their fiduciary responsibilities and funneled Schwartz's money towards opening TMH-NY as an expensive "show piece" location unable to operate at a profit.

According to the franchisor Plaintiffs, defendants' representatives Brown and Rosberg were "directly responsible" for feeding Tober with much of the data that was utilized in misrepresentations to Schwartz, including financial information regarding operational expenses, profits, and build-out costs, in order to create a false and overly favorable impression of The Meat House franchise system. As stated in the proposed amended complaint, Brown, Rosberg, and Parent allegedly had access to complete information regarding how each of the franchise and company-owned units were performing, as well as the costs associated with opening and operating a franchise unit. With regard to Brown, he allegedly knew what the true profit and loss information, as well as the true cost of building-out and operating a unit was. He also allegedly knew what was permissible under the FTC Act, and the NYFSA, with respect to prohibited "earnings claims," and the requirement for adequate disclosure before offering to sell or selling a franchise (or at least should have known, although ignorance of the law is no excuse).

Defendant Brown, according to the franchisees, personally, repeatedly and directly presented Plaintiffs with fraudulent information in order to induce Plaintiffs into entering a joint venture with Defendants, entering into an Area Development Agreement, and signing multiple Franchise Agreements. Mr. Brown also allegedly omitted information from in-person and e-mail discussions with Plaintiffs that rendered the information presented to Plaintiffs materially misleading. Specifically, this information included profit and loss figures, revenue figures, profit margins for specific Meat House locations, anticipated costs including opening and "build out" costs for a new Meat House location, and the profitability and viability of the business as a whole.

According to the allegations, Mr. Brown was directly involved in providing (or failing to properly provide) Plaintiffs with the required Franchise Disclosure Documents (FDDs) - documents that contained materially false or inaccurate information which he knew to be false. Mr. Brown was also allegedly involved in the mismanagement of the

Real Estate Franchisees Have their Clocks Cleaned in Protracted California Federal Court

Century 21 Real Estate LLC v. All Professional Realty, Inc., 2015 WL 191502 (9th Cir. 2015) affirming Century 21 Real Estate LLC v. All Professional Realty, Inc., 889 F.Supp.2d 1198 (E.D. Cal. 2012).

Last week, the United States Appeals Court for the Ninth Circuit affirmed a California federal district court's expansive ruling in favor of a real estate franchisor against its multi-unit franchisee. The procedural posturing in both the state and federal courts by both parties was complex, costly and protracted.

In Century 21, former franchisees of a real estate brokerage services franchise filed an action in state court against their franchisor for breach of a termination provision of the franchise agreement, violation of the California Franchise Relations Act (CFRA), violation of California's Unfair Competition Law (UCL), intentional interference with business advantage, breach of contract, breach of the implied covenant of good faith and fair dealing, fraud, negligent interference with business advantage, and interference with contract. The Franchisor then removed the action to federal court, and filed a trademark infringement claim. In a separate state court action against the franchisees, Century 21 alleged claims of trademark infringement, false designation of origin/false advertising, trademark dilution, common law unfair competition, breach of contract, breach of guaranty, accounting, and unjust enrichment. The franchisees removed the action to federal court and the cases were consolidated. Following issuance of a preliminary injunction prohibiting the franchisees from further unauthorized use of franchisor's marks, the franchisor

joint venture (e.g. hired an incompetent manager a full year before it was appropriate to do so; involved himself in daily operations and planning of the joint venture under the Operating Agreement.)

The Defendants, according to the franchisees, further allegedly extrapolated "averages" from cherry-picked store locations and periods of time; annualized those amounts to create highly inflated revenues and profits; and grossly underestimated costs of opening units in expensive markets by utilizing average rents from locations that were not indicative of what it would cost to operate a franchise in more expensive markets.

The Court acknowledged the various emails, spreadsheets, and power-point files that the Plaintiffs contended contained falsified or misleading figures regarding the profitability of The Meat House franchise system, and it further recognized that while the Plaintiffs did not set forth specifics as to Brown's individual role in the alleged fraudulent scheme - the proposed amended complaint is peppered with the following terms: "defendants"; "individual defendants;" "The Meat House Parties;" and the "Meat House Princip[als]" and when the Plaintiffs attempted to set forth specific names, they repeatedly did so through collective phrases such as "Mr. Parent, Mr. Brown, and Mr. Rosberg."

The Court concluded that even though this type of "group pleading" is appropriate where, as here, the Plaintiffs sought to state a common law fraud claim, as opposed to a federal securities law claim, it does not follow that Rule 9(b) grants an aggrieved party "license to base claims of fraud on speculation and conclusory allegations." Nor are the Plaintiffs relieved of their obligation, at this stage of the litigation, to adequately allege "how" and/or "why" the statements were fraudulent. In this regard, the Court held that while the Plaintiffs have identified a number of financial figures in emails and spreadsheets which they contend were fraudulent in content, they failed to plead the circumstances constituting the fraud with the specificity required of Rule 9(b). In other words, although the Plaintiffs identified the "who", the "what;" and the "when" of the fraudulent scheme, they failed to adequately allege "how" and/or "why" the relevant statements or representations were fraudulent, "conclusory assertions notwithstanding."

In this regard, the Court stated that "the Plaintiffs maintain that the Defendants' representations to them relied on faulty "assumptions;" "misrepresentative sampling" and "cherry picked data" but do little, if anything, to point to specific numbers that were falsified or misleading." Rather, according to the Court, the Plaintiffs cast an exceedingly wide net such that "[a]ccording to the Plaintiffs, it seems each single figure fed to them by the Defendants was fraudulent." In rejecting the Plaintiffs' pleading, the Court stated that Plaintiffs' "everything but the kitchen sink" pleading ... does little to explain the ways certain figures touted by the Defendants were inflated or distorted."

Finally, incredibly, the Court refused to allow the Plaintiffs' an moved for summary judgment.

The district court's ruling, which can only be characterized as devastating for the franchisees, thoroughly deconstructed and rejected every solitary argument made by the franchisees. At the end of the day, the franchisees were left owing the franchisor close to $1 Million. Specifically, the district court made the following rulings:

1. New Jersey (not California) law applied to actions;
2. the liquidated damages clause in franchise agreement was reasonable;
3. the franchisees' trademark infringement was willful;
4. the franchisor was entitled to treble damages;
5. there was no evidence that franchisor acted with malice when terminating franchise agreements;
6. the franchisees failed to demonstrate a valid reason for departing from the requirement of full supersedeas bond pending appeal of monetary judgment; and
7. the franchisees would not be granted a stay pending appeal of injunction.

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Ninth Circuit Derails Auto Dealers' Termination Challenges

Chrysler Group LLC v. Fox Hills Motor Sales, Inc., 2015 WL 221056 (6th Cir. 2015)

In Fox Hills Motor Sales, the United

opportunity to re-submit a sufficient pleading stating that "the Plaintiffs [already had] attempted to cure defects in their initial complaint with respect to these newly-amended claim but have still failed to state a claim for relief."

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Franchisor Control Problems and the Alexander Haig Solution

By: Jeffrey M. Goldstein

A recent case in California federal court, Vann v. Massage Envy Franchising LLC, 2015 WL 74139 (S.D.Cal. 2015), has given franchisors a win on a fact-specific application of the "employer control" issue in a vicarious liability setting. In this case, Mr. Vann, a massage therapist who worked at various Massage Envy franchisee spa locations, filed a class-action complaint against the franchisor MEF, and two franchisees, alleging violations of California's minimum-wage laws.

The Court in Vann, in ruling that the facts did not support finding the franchisor to be an employer under the minimum-wage laws, noted that "California courts analyze the employment relationship between franchisors, franchisees, and employees under an agency theory" and that "the question of whether the franchisee is an independent contractor or an agent is ordinarily one of fact, depending on whether the franchisor exercises complete or substantial control over the franchisee."

Although the Vann decision is indisputably a franchisor victory, it would be an expensive mistake for franchisors and their advocates to interpret the case as signaling any serious shift in the way that agencies, courts and legislatures around the country (or even other courts and agencies in California) view the issue of franchisor vicarious liability, conceptually or practically. The limited comments in this article, in discussing franchisor vicarious liability, focus solely on upon the situation where the franchisee (or its employee) indisputably violates some common law or statutory duty (e.g., acts negligently, discriminates or fails to pay certain taxes based on employment), and not on the circumstance where the franchisor has itself directly violated a common law or statutory standard. Further, the franchisor vicarious liability discussed herein is not meant to include its close cousin, strict liability, since the underlying conduct associated with franchisor vicarious liability (as carried out by the franchisee) is assumed to itself have been independently wrongful.

States Court of Appeals for the Fourth Circuit upended the car dealer plaintiffs' carts in ruling that Consolidated Appropriations Act (protecting car dealers to some extent from terminations by car manufacturers during and after bankruptcy) did not entitle car dealerships, whose franchise agreements were rejected by automobile manufacturer as part of its bankruptcy and reorganization, and who prevailed in arbitration under the Act against their manufacturer, to unconditional reinstatement to the automobile manufacturer's dealership network; rather, the sole remedy available to the dealers under the Act was merely that manufacturer issue customary and typical letter of intent to enter into sales and service agreement.

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At bottom, the perennial dispute in franchisor vicarious liability cases pivots off of application of what can be characterized as the "control test," which basically asks whether the relevant franchisor has sufficient existing and potential control over its franchisees' operations to justify its being held legally accountable for certain wrongful conduct of its franchisees. So, for instance, in an employee tort case, where a pizza franchisee negligently runs over a bystander during a delivery run in order to meet a guaranteed delivery time, the legal decision whether to hold the franchisor jointly liable with the franchisee for injuries to the bystander turns upon the level and quality of control that the franchisor exercised or could have exercised over the franchisee. A similar control analysis would govern the situation where an employee of the franchisee, rather than the franchisee, was driving.

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