FRANCHISE TRENDS

Franchisor Competency, Video 4

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RE/MAX FRANCHISEE OUT-MANEUVERS LEGAL CLUTCHES OF DEFECTIVE RESTRICTIVE COVENANTS NOT TO COMPETE

RE/MAX of New England, Inc., and RE/MAX, LLC, Plaintiffs v. Prestige Real Estate, Inc., d/b/a LAER Realty Partners, Stacey Alcorn, and Andrew F. Armata, Defendants, U.S. District Court, D. Massachusetts, July 7, 2014.

A real estate brokerage franchisor RE/MAX of New England, Inc. was denied a temporary restraining order or preliminary injunction after one of its franchisees terminated its relationship with RE/MAX and started to do business under a different name. According to the Court, in denying RE/MAX's motion for temporary restraining order and preliminary injunction, the real estate franchisor failed to demonstrate a likelihood of success on the merits of any of its claims. The franchisee, Prestige Real Estate, Inc. entered into 13 franchise agreements with RE/MAX, each for a different real estate office. Three of the agreements had expired prior to the dispute and had been continued on a month-to-month basis. The other ten agreements were active when, in April 2014, Prestige sent RE/MAX a demand letter terminating their relationship. The franchisee, Prestige, subsequently started doing business as LAER Realty Partners.

In rejecting the franchisor's request for preliminary injunction, the Court began its analysis by setting out the rule that "A covenant not to compete

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is enforceable if it (1) is necessary to protect a legitimate business interest; (2) is reasonably limited in time and space; and (3) is consonant with the public interest." The important twist in the case law in Massachusetts on this issue is that "Courts will not enforce non-compete provisions if their sole purpose is to limit ordinary competition."

The franchisor relied for its case on the violation of two different covenants not to compete: "in-term" covenants with respect to the ten franchises with unexpired agreements, and post-term covenants for the three offices operating month-to-month after the expiration of agreements. With regard to the in-term covenant, it obligated the franchisee to refrain from owning a non-RE/MAX real estate services business or affiliating with any other business that offers goods and services in competition with the plaintiffs. The franchisee argued that it was no bound under this provision because it had legitimately terminated all of the agreements as of April 14, 2014, when the franchisee sent the franchisor the Chapter 93A demand letter.

Alternately the franchisee argued that RE/MAX's unfair acts or practices and breach of the implied covenant of good faith and fair dealing created a constructive termination of the agreements. The franchisor rejected this argument and contended that the franchisee had no right to terminate any of the agreements and was still bound by them. On this issue, because the case was being heard at an early procedural stage, the Court held that "It is not possible to make a reliable assessment of either side's position on the current record."

However, the Court did flesh out this issue further when it stated that "Even if the agreements are still in force, the defendants persuasively argue that the non-compete provisions limit only ordinary competition and are, therefore, unenforceable as a matter of law. Certain interests, such as the need to protect confidential information, trade secrets, and good will, warrant the use of a covenant against competition." Unlike another case pointed to by RE/MAX, the Court held that this case did not involve the franchisee signing documents acknowledging the "proprietary and confidential nature of the information he was acquiring." Nor did the case involve the RE/MAX franchise have "access to operating manuals, recipes, marketing and promotion strategies, new product development, and the locations of sites for new stores."

Incredibly, on the slim record, the Court actually ruled that there were no trade secrets involved with the RE/MAX franchise relationship:

There are no trade secrets involved here. The plaintiffs' best argument is that the defendants have the benefit of knowing RE/MAX general business strategies. Given the nature of the real estate brokerage business, however, there is reason to wonder whether any good will generated by the various offices is due to RE/MAX branding and methods or the work and personal relationships of the agents. At the very least, the record does not convincingly support the former possibility.

Finally, regarding the in-term covenant, the Court held that RE/MAX has not "shown that the prospect of harm that is irreparable in the necessary sense. That is, they have not shown the inadequacy of a damages remedy."

With regard to the post-termination covenants, RE/MAX argued that the three offices where franchise agreements had expired are bound by post-

BIASED SALES PERFORMANCE STANDARDS IN FRANCHISE AGREEMENT COULD VIOLATE STATE CAR FRANCHISE STATUTE'S FAIRNESS PROVISIONS

CMS Volkswagen Holdings, LLC and Hudson Valley Volkswagen, LLC, Plaintiffs v. Volkswagen Group of America, Inc., and Lash Auto Group, LLC, Defendants, U.S. District Court, S.D. New York, June 26, 2014.

Volkswagen franchisees-dealers sued their franchisor Volkswagen Group of America, Inc. under the New York Franchised Motor Vehicle Dealer Act claiming that the franchisor had allegedly implemented unfair franchisee standards and benefit programs. Volkswagen's Dealer Agreement outlines how it evaluates each dealer's sales performance, called the Dealer Sales Index (DSI). The DSI is calculated by applying Volkswagen's regional segment-adjusted market share to a dealer's Primary Area of Influence, and it is used to set objectives for dealers (the Variable Bonus Program or VBP).

After the dealerships informed Volkswagen of changes to their ownership structure, Volkswagen requested additional documentation and demanded that the dealerships sign new agreements with additional unfair terms. The dealerships sought injunctions and declaratory relief under the Motor Vehicle Dealer Act.

Although the Court rejected the majority of claims brought by the franchisee-dealers, including discrimination claims, it did surprisingly uphold one of the causes of action, that the DSI violated section 463(2)(gg) of the Dealer Act, which makes it illegal for a franchisor "[t]o use an unreasonable, arbitrary or unfair sales or other performance standard in determining a franchised motor vehicle dealer's compliance with a franchise agreement."

The franchisees pointed to the fact that the DSI takes into account segments, or different categories of vehicles, in calculating the DSI, but not consumer preferences. For instance, since Volkswagen does not manufacture pick-up trucks, for example, the number of newly registered pick-up trucks is omitted when the DSI is calculated. Similarly, if small SUVs are less popular in a particular PAI, that is reflected in the DSI. Because the DSI adjusts for segments and not consumer preferences, the franchisees argued that "rigid adherence to regional market share, adjusted only for segment popularity and no other local consumer preferences, is the fundamental flaw with DSI and constitutes a violation of section 463(2)(gg) of the Dealer Act."

term non-compete covenants. Unlike almost all other franchise agreements, the RE/MAX agreements did not contain a post-term covenant. The plaintiffs, nevertheless, claimed that §2.E of the agreement, dealing with holdover franchisees, bound the franchisee to terms introduced in newer versions of the standard franchise agreement, as they might evolve. In this regard, Section 2.E of the relevant franchise agreement stated that, upon expiration, the franchise "will be deemed to be operating on a month-to-month basis under the terms and conditions of the franchise agreement and other agreements being used by us at the time of expiration of the Term, and from time-to-time thereafter ...."

After considering RE/MAX's argument, the Court stated that "If the plaintiffs are correct, then §14.1 of current agreements will apply to those three offices." Section 14.1 stated:

You agree that upon termination, expiration, or non-renewal of this Agreement, neither you nor your Owners ... will, for a period of one (1) year from the effective date of such termination, expiration, or non-renewal ... directly or indirectly operate, manage, own or have any ownership interest in any business that is a licensee or franchisee of any franchising organization or network that competes with [RE/MAX] ...

The Court then refused to find that the franchisee was currently operating in association with a competing franchise real estate network. "Though they may be part of the Prestige "network," the offices are apparently simply places where Prestige conducts business. They are not franchisees or licensees of Prestige, nor of any other organization." The Court bolstered its conclusion with an explanation of the purpose of the provision in the franchise agreement: "The provision is aimed at preventing former RE/MAX franchisees from becoming licensees or franchisees of a "franchising organization" or a "franchising network." LAER is not a licensee or franchisee of any franchising organization or network."

Last, the franchise agreement required the franchisee, upon termination, to assign all telephone numbers and domain names to the RE/MAX. The franchisee argued that RE/MAX never owned any of the telephone numbers because Prestige purchased them, and in any event, there is "no risk of consumer confusion." The Court agreed with the franchisee in that "success in the real estate industry is likely founded more on relationships between potential buyers and sellers, on the one hand, and individual agents and brokers, on the other." The Court continued that "It is also likely that personal references from friends and acquaintances are a major source of new business." At the end of the day, the Court refused to order a transfer of the phone number since the Court did not see any consumer confusion, and found that "the importance of telephone numbers in generating new business is less substantial than other factors."

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FRANCHISEE'S CLAIMS OF DISCRIMINATORY TREATMENT AVOID DISMISSAL AT EARLY STAGE OF PROCEEDINGS

Newpaper, LLC, Plaintiff v. Party City Corporation and Amscan Holdings, Inc., Defendants, U.S. District Court, D. Minnesota, July 1, 2014.

The plaintiff franchisee, Newpaper, alleged that instead of forming or continuing franchise agreements with the a group of competing franchisees (the "Excepted Stores"), the franchisor terminated the Excepted Stores' Party America franchises and then offered "supply agreements" by which the Excepted Stores gained the benefits of operating Party City stores without having to pay the related Ad Fund, advertising, or royalty fees - the very fees that the plaintiff franchisee was required to pay.

The franchisor conceded that it had terminated the Excepted Stores' franchise agreements and executed new supply agreements with the stores, which were former franchisees. As a result, the franchisor argued the Excepted Stores were no longer franchises, and did not fall under the strictures of the MFA. For one of its claims, Newpaper alleged that the franchisor violated the Minnesota Franchise Act by discriminating against Newpaper in favor of Excepted Stores.

According to the Court, since it was only examining the claims for proper pleading, and not for substantive merit, Newpaper had sufficiently alleged a violation of the MFA in connection with the Excepted Stores. "Regardless of its label, an agreement may establish a franchise relationship under the MFA, provided the relationship satisfies the statutory elements." In ruling that Newpaper had alleged a viable claim for discrimination under the MFA, the Court reasoned "Newpaper has plausibly alleged that the supply agreements have allowed the Excepted Stores to continue a franchise relationship with Defendants by another name. Taking those allegations as true, Newpaper has also plausibly alleged that the Excepted Stores receive more favorable treatment as compared to Newpaper."

The Court also in light of the procedural posture of the case stated that the defendants argument -- that even if the Excepted Stores constitute franchises, these stores belong to a different system altogether: the "Party America" system - was premature:

This argument may have merit, but is premature at this stage of litigation. The evidence may later demonstrate that the Excepted Stores do not have franchise relationships with Defendants, or that the Excepted Stores operate under a separate "Party

COURT RULES CAR DEALER'S FRAUDULENT SALES PRACTICES SUFFICIENT TO ALLOW AUTOMATIC AND IMMEDIATE TERMINATION WITHOUT OPPORTUNITY TO CURE UNDER FRANCHISE AGREEMENT

Giuffre Hyundai, Ltd., d/b/a Giuffre Hyundai Plaintiff-Appellant v. Hyundai Motor America, Defendant-Appellee, U.S. Court of Appeals, Second Circuit. No. 13-1886, June 25, 2014

The plaintiff, Giuffre Hyundai, Ltd. ("Giuffre"), the automobile franchisee, was an authorized dealer of Hyundai automobiles pursuant to a contract with Hyundai Motor America ("HMA"). HMA terminated its dealership agreement with Giuffre after a New York State court decided that the franchisee had engaged in fraudulent, illegal, and deceptive business practices, which allegedly breached the dealership agreement.

Giuffre responded by bringing suit in the United States District Court for the Eastern District of New York to enjoin the completion of the announced termination. Giuffre argued, in part, that section 463 of the New York Vehicle and Traffic Law, which provides protections to motor vehicle franchisees in their dealings with automobile manufacturers, required HMA to provide it with notice of and an opportunity to cure the breach triggered by the state court's fraud ruling. The district court rejected the franchisee's argument, and concluded that Giuffre's breach was incurable, which allowed HMA to terminate the contract immediately, notwithstanding the terms of the Vehicle and Traffic Law. The federal Court of Appeals agreed with the lower court, concluding that section 463 does not abrogate the common law with respect to incurable breaches of contract.

The provision in the underlying dealership agreement that the Court held had been violated was a stipulation that "HMA has selected Giuffre because of the reputation of its Owner(s) and the General Manager ... for integrity and their commitment to fair dealing." The dealership agreement further required Giuffre to refrain from "engag[ing] in any misrepresentation or unfair or deceptive trade practices." With regard to termination, the dealership agreement reserved the right to "terminate [the DSSA] immediately" if:

[Giuffre] or any Owner, officer, or General Manager of [Giuffre], is convicted of any felony or for any violation of law which in HMA's sole opinion tends to adversely affect the operation, management, reputation, business or interests of [Giuffre] or HMA, or to impair the good will associated with the Hyundai Marks. Such violations of law may include, without limitation, any finding or adjudication by any court of competent jurisdiction or government agency that [Giuffre] has engaged in any misrepresentation or unfair or deceptive trade practice[.]

In siding with the franchisor, the Court noted initially that under section 463, to support a termination, the franchisor must demonstration that it acted with "due cause." The Court then observed that due cause under the statute exists whenever there has been "a material breach by a new motor vehicle dealer of a reasonable and necessary provision of a franchise if the breach is not cured within a reasonable time after written notice of the breach."

This led the Court to the novel issue of whether the above language

America" franchise system. In either case, Newpaper's MFA discrimination claim would necessarily fail. At this stage, however, Newpaper plausibly alleges that despite the "Party America" name, Defendants have deliberately advertised the Excepted Stores using "Party City" trademarks.

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required that a franchisor must provide notice and an opportunity to cure for all terminations. The Court rejected this view, stating that "New York common law will not require strict compliance with a contractual notice-and-cure provision if providing an opportunity to cure would be useless, or if the breach undermines the entire contractual relationship such that it cannot be cured." In this case, explained the Court, "we conclude that the state court's judgment established as a matter of law an incurable, material breach of a reasonable and necessary provision of the DSSA. This provided HM A with due cause to terminate the Agreement without further delay."

The Court found that "the breach here was material and not susceptible of cure." The state court judgment established that Giuffre was "engaged in fraudulent and illegal business practices ... deceptive acts ... and false advertising" in violation of state and federal law." According to the Court, "That judgment is conclusive evidence of Giuffre's breach of the unambiguous terms of the DSSA, which provides that the Agreement may be terminated if Giuffre "or any Owner, officer, or General Manager of [Giuffre], is convicted of any felony or for any violation of law which in HMA's sole opinion tends to adversely affect the operation, management, reputation, business or interests of [Giuffre] or HMA, or to impair the good will associated with the Hyundai Marks." In rejecting the argument that the franchisee should have been provided with a cure period, the Court stated: "Moreover, because the Agreement speaks in terms of adjudicated misfeasance, rather than simple conduct, the breach is not one which subsequent good behavior could correct."

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