January 12, 2015 Franchise Law Committee

Franchise Law e-Bulletin

BUSINESS LAW SECTION STATE BAR OF CALIFORNIA

California State Bar Franchise Law Committee
February 2015

Recent Case Demonstrates Importance Behind Properly Educating Courts On California's Franchise Laws

Franchise and Distribution Law is one of a handful of legal specialties certified by the California State Bar. Franchising is recognized as a specialty largely in part to the complexities and nuances within state and federal franchise laws – most notably, California's Franchise Investment Law and Franchise Relations Act.

Notwithstanding this recognized area of legal specialization, lawyers less familiar with franchising are still retained to litigate disputes arising out of franchise or quasi-franchise relationships. Too often, this lack of familiarity results in misapplication of the law and unfavorable outcomes for their clients.

A recent California District Court decision in the case of *Estep v. Yung*, 2015 U.S. Dist. LEXIS 4475 (E.D. Cal. Jan. 14, 2015), illustrates the importance of qualified franchise counsel to the outcome of a case. As discussed below, the parties' failure to properly educate the *Estep* court on California's franchise laws resulted in a flawed application of the law and adverse outcome for the subfranchisor.

Estep v. Yung **– Factual Background**

The relevant factual background in this case is straightforward. Defendant HDYR, LLC ("HDYR") is a Texas-based franchisor of the fast-casual, custom sushi restaurant concept "How Do You Roll?" There are currently twelve How Do You Roll? locations spread across six states – none of which are located in Northern California.

In June 2012, HDYR registered to sell franchises in California. The following year, HDYR entered into an Area Representative Service Agreement (the "AR Agreement") with Mekadishkem-EBE, Corp. – a company owned and operated by Plaintiffs David and Deanna Estep. In exchange for a payment of $60,000, Plaintiffs' company was granted the exclusive right to solicit qualified prospective franchisees in a territory comprising much of Northern California, and to develop, support, and provide services to any franchisees in that territory.

In June 2014, Plaintiffs initiated a lawsuit against HDYR and its owner, Yuen Yung, in California Superior Court in Solano County. In their complaint, Plaintiffs assert claims against the Defendants for fraud and breach of contract arising out of HDYR's alleged (1) pre-sale misrepresentations concerning the activity and interest of California franchise prospects, and (2) breaches of the AR Agreement by failing to provide Plaintiffs' company with "marketing material, access to sales, advertising and promotional materials."

After being served with the lawsuit, Defendants timely removed the case to the District Court in the Eastern District of California on diversity grounds.

Forum Selection Clause Designates Out-Of-State Forum

Following removal, Defendants filed a motion to transfer the case to the Western District of Texas consistent with the AR Agreement's forum selection clause. Specifically, the forum

selection clause states that "the exclusive venue for disputes between [the parties] will be the state or federal district courts located in Austin, Texas, and each party waives any objection it might have to the personal jurisdiction of or venue in such courts."[1]

Plaintiffs opposed the motion to transfer on several grounds, most notably, on the ground that the out-of-state forum selection clause is void and against California's "broad" public policy codified in the California Franchise Relations Act ("CFRA") at Business and Professions Code § 20040.5 ("Section 20040.5"). [2]

Section 20040.5 provides that "[a] provision in a franchise agreement restricting venue to a forum outside this state is void with respect to any claim arising under or relating to a franchise agreement involving a franchise business operating within this state."

Relying upon this language, Plaintiffs argued that – although the AR Agreement is not a "franchise agreement" – the AR Agreement still falls within the protections set forth in Section 20040.5 because it *relates to franchise agreements*.

Defendants disagreed, arguing that Plaintiffs could not rely upon Section 20040.5 because the statute has limited applicability to "franchise agreements," and that the AR Agreement "is not a 'franchise agreement.'"[3]

The Courts Finds That Section 20040.5 Does Not Apply To AR Agreement

At the onset of its analysis, the court explained that under Ninth Circuit law, contractual forum selection clauses are "presumptively valid" unless: (1) the clause was the result of fraud, undue influence, or overweening bargaining power, (2) the selected forum is so gravely difficult and inconvenient that Plaintiffs would essentially be denied their day in court, or (3) enforcement of the clause would contravene a strong public policy of the forum in which the suit was brought.[4]

Then, turning its attention to the applicability of out-of-state venue prohibition in Section 20040.5, the court found that the AR Agreement "is *not* a franchise agreement; it is a contract between a small company and a sophisticated area representative who would oversee the solicitation of 30 franchisees." [5]

Based on this finding, the court granted Defendants' motion to transfer holding that "[t]he California Franchise Relations Act is not on point and it is not enough to outweigh California's stated policy of favoring contractual forum selection clauses."[6]

The AR Agreement Is A "Franchise Agreement" Under California Law

Any franchise lawyer presented with this fact pattern is likely to scrutinize the court for "getting it wrong." However, review of the parties' briefs suggest that the blame should not fall to the court, but instead, to the parties for failing to properly educate the court on California's franchise laws.

In particular, the parties failed to enlighten the court on the statutory definitions of "franchise" and "subfranchise" – two definitions that cover the AR Agreement and likely would have resulted in a dramatically different decision by the court.

The term "franchise" is defined by both the CFRA and CFIL as:

[A] contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

1. A franchisee is granted the right to engage in a business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and

2. The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and

3. The franchisee is required to pay, directly or indirectly, a franchise fee.[7]

Under this definition, the term “franchise” is synonymous with “franchise agreement.” This is important as Section 20040.5 contains only the term “franchise agreement,” and not “franchise.”

Without going into any significant detail, the terms of the AR Agreement appear to satisfy each of the three prongs defining a “franchise” – *i.e.*, Plaintiffs were granted the right to sell and provide support for How Do You Roll? franchise businesses under the direction of HDYR and in exchange for a fee of $60,000. Thus, the court should have found the AR Agreement to be a franchise under the franchise law.

Moreover, the CFIL and CFRA have expanded the definition of “franchise” to include “subfranchisor” – *i.e.*, “any contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right, for consideration given in whole or in part for such right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor.”[8] Because the AR Agreement is a contract granting the Plaintiffs’ business the right to sell franchises in Northern California, it falls within the definition of “subfranchisor.”

Under either definition – *i.e.*, “franchise” or “subfranchise” – the AR Agreement constitutes a franchise agreement under the franchise laws.

Instead of bringing these definitions to the court’s attention, Plaintiffs couched their argument entirely within the language of Section 20040.5, and Defendants’ papers did little more [9]. These obvious mistakes by counsel led to the court’s erroneous finding that the AR Agreement is not a franchise agreement and, therefore, not protected by Section 20040.5.

Outside Factors Potentially Influencing The Court’s Decision

To be fair, lack of education alone may not have been the only factor influencing the court’s flawed ruling. Rather, the court’s order suggests that it also may have been influenced by questionable conduct by Plaintiffs’ counsel.

For instance, the court pointed out that, “[c]onveniently, Plaintiffs left off the page of the [AR] Agreement containing [the forum selection clause] in the version of the [AR] Agreement they attached to their Complaint.”[10]

The Court also found Plaintiffs to have “inexplicably sued their own company” as part of what appears to be a failed attempt to defeat diversity jurisdiction.[11]

Finally, the Court was not pleased with Plaintiffs’ argument that the motion to transfer was untimely – noting that the Plaintiffs had “completely ignore[d]” the timing requirements of Federal Rule of Civ. Proc., Rule 81.

Notwithstanding the court’s evident frustration with Plaintiffs, the court would have been hard-pressed to grant the motion to transfer had the court been properly educated on the relvant franchise laws.

* * *

This case report was prepared by Kevin A. Adams (kadams@mulcahyllp.com), of the Irvine law firm of Mulcahy LLP. Mulcahy LLP is a boutique litigation firm that provides legal services to franchisors, manufacturers and other companies in the areas of antitrust, trademark, copyright, trade secret, unfair competition, franchise, and distribution laws.

1. Def.’s Mtn. to Transfer, Ex. A, ¶ 17.1 (October 21, 2014).
2. Pl.’s Oppo., p. 1:15-19 (November 20, 2014).
3. Def.’s Reply Brief, pp. 2:8-10, 5:1-3 (November 24, 2014) (emphasis added).
4. Estep, 2015 U.S. Dist. LEXIS 4475, *3 (citing R.A. Argueta v. Banco Mexicano, S.A., 87 F.3d 320, 325 (9th Cir. 1996), and Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 1284 (9th Cir. 2006) (“California favors contractual forum selection clauses so long as they are entered into freely and voluntarily, and enforcement would not be unreasonable.”).
5. Estep, 2015 U.S. Dist. LEXIS 4475, *3 (emphasis added).
6. *Id.* at *3-4.
7. Corp. Code § 31005(a); Bus. Prof. Code § 20001(a).
8. Corp. Code § 31008-31010; Bus. Prof. Code §§ 20004-20006.
9. Id., p. 4:16-19 (Defendants cited generally to the definitions of “franchisee” (“a person to whom a franchise is granted”), and “franchisor” (“a person who grants a franchise”) under Cal. Bus. & Prof. Code §§ 31006 and 31007 (erroneously referred to in the brief as § 31107)).

10. Estep, 2015 U.S. Dist. LEXIS 4475, *2, fn 2.
11. *Id.* at *2, fn 1.

Connect With Us

Join

For information about the Business Law Standing Committees, see Business Law Section Home Page and the standing committees web page.

You are receiving these periodic emails because you expressed interest in receiving updates from the Franchise Law Committee of the State Bar of California's Business Law Section ("BLS"). As a BLS member, you can sign up to receive e-bulletins from other standing committees by simply clicking HERE to update your e-bulletin subscriptions in My State Bar Profile. If you need assistance, please contact Elyse Jones. For up-to-date news, case and legislative updates, and information about events from the BLS and other Sections of the State Bar of California, as well as from the California Young Lawyers Association (CYLA), follow us on Facebook, LinkedIn or Twitter.

If you are not a member of the BLS, or know of colleagues who wish to join the Section to receive e-bulletins such as this, please click HERE.

The State Bar of California Office of Education is a State Bar of California-approved MCLE provider.