CLASS ACTIONS IN FRANCHISING CASES

By

Carmen D. Caruso[1]

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It's a strategy as old as the Roman Empire. The attackers seek strength in numbers. The defenders seek to divide and conquer. So too, franchisees with a significant grievance against the franchisor may strongly prefer to file a class action lawsuit for themselves and on behalf of all other franchisees who are "similarly situated." On the other hand, franchisors may seek to ward off the threat of future class actions by adding a clause in the franchise agreement that the franchisee promises in any future litigation or arbitration to litigate only their own claims and not those of any other party.

Class action suits almost always involve high stakes, in particular for the defendant that is threatened with the prospect of paying damages not just to one plaintiff but to an entire "class" of plaintiffs. Thus the prospect of filing a class action may, in the right circumstances, create tremendous leverage for an individual prospective plaintiff who is able to say *"Settle my case or I'll file a class action."*

Class actions in franchising have been a hot topic the past few years. On the surface, franchisees in large systems would appear to present very suitable classes of plaintiffs where they face "common questions" of law and fact, and courts have upheld the certification of franchisee classes where there were:

- System-wide policy issues. *See, Remus v. Amoco Oil*, where the issue was whether a system wide change by the franchisor in its policies was a breach of contact and/or a violation of a state dealership law.[2] The court of appeals in *Meineke* cited *Remus* with approval, as an example of when class actions are appropriate in franchising.

- Antitrust issues such as supplier restrictions and "tying claims": *See, Smith v. Little Caesar's Enterprises, Inc.*

Then came the decision in *Broussard v. Meineke Mufflers*, where the court of appeals not only rejected a class certification decision by the district court, but also reversed a $600 million verdict for the franchisees (after RICO trebling) that the "class" of muffler shop franchisees had obtained at trial.[3] *Meineke* teaches is that in class actions (or in any lawsuit) there is a danger of overreaching, and that the class actions must be properly *planned.* It is important for any prospective class plaintiff to work with lawyers who have experience in this field. It is certainly no place for novices. This article is intended to familiarize franchisees with the "nuts and bolts" of class action suits in general and class actions by *franchisees* in particular.

Some of the Basics

What is a class action lawsuit? A class action lawsuit is a procedural device that allows one or more persons to file suit on behalf of themselves and other persons who are "similarly situated" with respect to the subject of the case. The purpose of the suit may be to recover monetary damages to redress past wrongs. Or the class plaintiffs may seek "equitable relief" -- a court order for the franchisor to change its ways in or more important respects.

Who may file a class action suit? Anyone can file suit designating themselves as proposed class representatives -- and it is always up to the court to decide whether or not the proposed class representative is, in fact, qualified to be a class representative. But in the franchise area, it generally makes a lot more sense for franchisees to band together (through their association or otherwise) to intelligently plan the proposed class action.

How are the attorneys retained? As in any case, the class plaintiffs may choose to accept the case on a contingent fee basis, or they may negotiate an appropriate fee agreement with their clients. One obvious advantage of a class suit, where your association is behind it, is the option of association funding that my colleagues will discuss.

How is the class action suit filed? A complaint alleging a class action is filed like any other case, with a summons and complaint being filed in the appropriate courthouse. The proposed class plaintiffs alleges that they are suing for themselves and for all other persons in a certain class that are "similarly situated" to the plaintiff in regard to the subject of the suit.

What happens after the suit is filed? When a suit is filed as a proposed class action, the court must decide whether or not to allow it proceed it as a class action, before proceeding to the process of adjudicating the merits of the underlying case. The plaintiff will move for "class certification" -- although in some cases the plaintiff (or the defendant) may take limited discovery on the issue of whether class certification will be appropriate.

Federal Rule of Civil Procedure 23

Class actions may be filed in state or federal court depending on the grounds for federal jurisdiction and other factors (In other words, class actions are not automatically federal cases). In federal lawsuits, the franchisees or any other prospective class plaintiffs must meet the rules outlined in the Federal Rules of Civil Procedure, Rule 23. This rule states that a class must be "certified" before the class action is allowed to proceed. Most (if not all) of the fifty states have rules that are similar in substance to Federal Rule 23, but a survey of all fifty states would ruin your weekend at this beautiful resort.

Federal Rule 23 provides *four* threshold requirements to have any class action certified. The court must find that:

1. Numerosity: The proposed class of plaintiffs is so numerous that "joinder" of each member of the class as a named plaintiff would be impractical;

2. Commonality: There are questions of law and fact common to the class;

3. Typicality: The claims of the representative parties are typical of the claims or defenses of the class; and

4. Adequacy of Representation: The representative parties will fairly and adequately represent the class.

Each of these four elements must be proven to the court's satisfaction – and moreover, even if the court initially certifies a class at the beginning of a case, the court is always free to revisit these elements later in the case and to "decertify" the class at any time before the entry of a final judgment. In fact, it is a typical defense pre-trial strategy to raise issues on points 1-4 above and to file a last minute "motion to decertify" on the eve of trial or even on appeal! As discussed below, this is exactly what happened in *Meineke* – when the court of appeals decertified the class of franchisee plaintiffs.

In addition to these first four prequisites, each of which is highly contentious in itself, a federal class action must fit into one of three pigeonholes:[4]

A. That separate lawsuits by the class members would create risks of inconsistent results that might establish inconsistent standards for the party opposing the class (*this test is particularly appropriate for franchising cases where the franchisor's duties under the agreements are at issue*); or which might impair the ability of non-class members to protect their interests if the subject was to be decided and they were not parties.

B. The party opposing the class (the franchisor) has acted or refused to act on ground that are generally applicable to the class.

C. The court finds that common questions of law or fact predominate over individual questions and a class action is therefore superior to a series of individual suits. On this issue, the following factors are relevant:

(i) Whether individual class members have a strong interest in controlling their own cases.

(ii) Whether there are any cases already pending, filed by prospective class members.

(iii) The desirability or undesirability of concentrating the case in a particular forum.

(iv) The likely difficulties to be encountered in managing the class.

Notice to class members and right to "opt-out"

Experience teaches that most federal court class actions are certified under category C, that common questions of law or fact predominate over individual questions. However, for this type of class action, every proposed member of the class has the right to "opt out" by making an appropriate written declaration of that intent in the courthouse after notice of the class action is mailed to all class members.

There is no right to "opt out" under categories A and B above. From the point of view of the class representatives, therefore, A or B would usually be superior to C.

Sub-classes

In certifying a class of franchisees, it is possible to request that sub-classes be created. For example, making a distinction between present and former franchisees is an obvious sub-class distinction, but as with all aspects of this type of suit, careful planning is essential. *See, Doctor's Association, Inc. v. Hollingsworth.*[5]

An important limitation on sub-classes is that they may not be in conflict with each other. And, as a general rule, former franchisees can not represent present franchisees in class action suits. *Auto Ventures, Inc. v. Moran.*[6]

The *Meineke* Case – What Went Wrong?

The *Meineke* franchisees appeared to everything right. They banded together through their association to file a class action suit alleging serious wrongdoing in connection with the advertising fund. As the trial court found, the franchisor:

> created a wholly-owned subsidiary "New Horizons to perform [advertising related] tasks and took additional fees and commissions from the Weekly Advertising Account (WAC), negotiated volume discounts for advertising and took those discounts for itself, purchased superfluous advertising so fees could be charged against the fund, and used the WAC funds for other improper purposes such as settling a lawsuit, paying some of [the franchisor's] business expenses and using WAC funds to advertise to attract franchisees (as opposed to generating business for existing franchisees).[7]

On the class action questions, the issues related to the advertising fund seem ideal for class certification because:

- Every one of the franchisees had paid into the same advertising fund.
- Therefore, it certainly appeared that if the franchisor was liable to one, it was liable to all, in the exact same way.

The trial court thus certified a class of plaintiffs that was defined as:

> *"All persons or entities throughout the United States that were Meineke franchisees operating at any time after May of 1986 [the creation of New Horizons]."*

The *Meineke* franchisees proved their case in the trial court and all of the franchisees who were franchisees after New Horizons ransacked the advertising fund stood to share in a $600 million judgment.

What then, went wrong in the court of appeals? The Fourth Circuit found several errors in the way the franchisee class had been certified.

Conflicting Interests Among Sub-Classes

Specifically the court of appeals found that the class of all Meineke franchisees violated the "adequacy of representation" requirement because there were actually three sub-classes of Meineke franchisees that had been lumped together in the trial court:

- Former franchisees, who no longer had a stake in the future of this system.

- Current franchisees that had accepted the "EDP" (enhanced dealer program) offered by the franchisor – whereby the signing franchisees received some financial incentives such as reduced royalties, reduced commission rates etc., but in return, they were required to sign and did sign a *release* of any potential claims that they might have had against the franchisor. The EDP franchisees made up half the total class. \

- Current franchisees that had not signed the EDP and thus had not released the franchisor. *None of the named plaintiffs had accepted the EDP.*

The Court of Appeals held that these three sub-classes were in conflict with each other. In the opinion of the Fourth Circuit:

- The former franchisees had only a single interest, in maximizing the amount of damages that the franchisor would have to pay.

- However, the current EDP franchisees that had signed the releases were not able to collect damages because they had released their claims for past misconduct, and therefore they were only interested in prospective relief t correct the abuses going forward. Indeed, the court observed that one group of EDP franchisees attempted to intervene in the suit to argue that the large damages award threatened the viability of the system. They did not want damages paid to the plaintiffs. Rather, they wanted the franchisor to make "*restitution*" to the WAC account, for they would be able to share in the benefits of the reinvigorated WAC fund going forward along with the non-EDP franchisees (and future franchisees).

- The current non-EDP franchisees (who had not signed the releases) also had at least a theoretical interest in the continuing viability of their franchise system, the court found, and thus, the court reasoned, they were positioned somewhere in between the former franchisees and the current EDP franchisees.

The court of appeals opined that the non-EDP current franchisees had potential conflicting interests in obtaining damages and hurting the system, although as the court observed, *that* conflict did not come into existence. The damage award was so huge that that it appears that all the non-EDP franchisees were prepared to accept a weakened franchisor in exchange for their huge payday! The court found serious conflicts of interest between the parties that wanted damages and the EDP franchisees. Three times in the suit, the plaintiffs informed the district court that the purpose of the suit was to claim damages, not to provide restitution to

the WAC fund. The court of appeals stated that this election of remedies was contrary to the best interests of the EDP franchisees, and that therefore, the EDP franchisees were not "adequately represented" by the named plaintiffs who were non-EDP franchisees.

The franchisees were able to argue that the EDP franchisees that were opposed to the class were only a small minority of malcontents. But because the class was certified as a non-opt out class, even a small percentage of class members who were in actual conflict with the class representatives was fatal in the holding of the court of appeals. Therefore the class certification had been erroneous and the judgment had to be reversed.

The court found additional problems with the class certification

There were other problems with the class certification in *Meineke*, in the opinion of the Fourth Circuit, which stated that there were five "significant variations in the franchisees' 'factual and legal arguments' that defeated the attempt to establish "commonality" or "typicality" with respect to the plaintiffs claims. The court of appeals stated:

- Different franchisees signed different franchise agreements at different times; and the differences extended to the franchisors' duties with respect to the WAC fund.
- To a significant extent the case was built on misrepresentations that were made to individual franchisees in "final review sessions" that each franchisee participated in.
- The "reliance" element of the fraud and negligent misrepresentation claims were not readily susceptible to class-wide proof.
- The statute of limitations applied a little differently in each case.
- Each individual plaintiff had a different claim for lost profits.

The court of appeals concluded that these problems, individually or collectively, also required reversal of the franchisees' verdict.

Conclusions

Class actions remain viable in franchising, in particular where it is possible to identify system-wide issues where individual fact questions (conversations etc.) are of minimal importance.

In cases such as *Meineke* where it may be impossible to avoid some individual fact differences on issues such as reliance or damages, it may be useful to "bifurcate" the case into sections, to resolve class issues first, and reserve individual issues for litigation after the class issues are resolved. The author and his partners successfully employed this procedure in a state court class action for fraud in the sale of securities where the plaintiff class included shareholders in a bank, and where it was necessary to divide the totality of shareholders into appropriate sub-classes. By taking that precaution, the class plaintiffs were able to repel a motion to decertify the class that was filed a week before the trial was scheduled to commence. That unsuccessful

motion to decertify had made arguments similar to those arguments that persuaded the court of appeals to hold that the class of "all franchisees" in *Meineke* was overbroad.

In summary, class actions in franchising are not dead after *Meineke.* But the need for careful planning has never been more apparent. In planning, these questions must be asked:

- Are there any conceivable conflicts of interest among any class members or between any recognizable sub-classes?
- If so, can any of those conflicts be cured by:
    - Structuring the suit to allow opt-outs?
    - Creating sub-classes?
    - Cutting some sub-classes out of the suit entirely?
- Would these "cures" permit the excluded persons to litigate fairly in a separate suit; and would those persons who remain in the defined class be able to obtain complete relief in view of the absence of the other excluded persons?
- Is it possible to allege the claims in such a way that potential individual claims can be avoided entirely, or at least isolated in such a way as would permit the litigation of the class claims first?

These may be hard questions. It may take considerable fact and legal investigation at the start to yield the right answers – but the effort may be worth it

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ENDNOTES:

[1] Carmen D. Caruso is a principal in the law firm of Schwartz, Cooper, Greenberger & Krauss, Chtd. This article represents Mr. Caruso's opinions only and should not be considered legal advice.

[2] 794 F.2d 1238 (7th Cir. 1986).

[3] See, Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331 (4th Cir. 1998).

[4] See, Fed.R.Civ.P. 23(b). the requirements of this section are paraphrased in this text.

[5] 949 F.Supp. 77, 79 (1996).

[6] 1997 WL 306895 (S.D.Fla. 1997).

[7] See, 958 F.Supp. 1087, 1092 (W.D.N.C. 1997)