PUBLICATION

Franchisees Flatline in Case Against Doctors Express

May 5, 2015

On April 1, 2015, the U.S. Court of Appeals for the Third Circuit thoroughly shot down claims brought by franchisees of Doctors Express Franchising. Those claims asserted that Doctors Express misrepresented initial start-up costs and capital requirements in its Franchise Disclosure Document, made "deleterious system-wide changes" such as changes in required vendors and company leadership, and refused to provide a formal, audited accounting of its advertising and marketing fund.

The plaintiff franchisees, Laura Fabbro, Surendra Pai and their associated entities, alleged that these actions violated the Maryland Franchise Registration and Disclosure Law, the New Jersey Franchise Practices Act and state common law theories of breach of contract, breach of the implied covenant of good faith and fair dealing, fraud and negligent misrepresentation.

The Third Circuit began by affirming the district court's dismissal of the breach of contract claim for the most basic reason: the plaintiff franchisees did not point to a single provision of the Franchise Agreement that was breached. Rather, the provision challenged was merely an estimate of costs, from an affiliate in Maryland, that came with the caveat that "a franchisee's costs will depend on a number of factors including local economic and market conditions." The court found that the plaintiff franchisees did not plausibly articulate why understating initial start-up costs, capital investments or working capital constituted a breach of contract. Because the plaintiffs' breach of contract claim failed, so too did their claim for breach of the implied covenant of good faith and fair dealing.

Next, the court affirmed dismissal of the plaintiff franchisees' fraud and negligent misrepresentation claims primarily because they were based on predictions or promises regarding future events. Both Maryland and New Jersey law bar such claims in the absence of proof of intent to deceive on the part of the party making the predictions. The plaintiff franchisees did not plausibly allege any such intent on the part of Doctors Express, nor did they allege that Doctors Express knew the predictions were inaccurate at the time they were made. Thus, the court found that under both Maryland and New Jersey law, the plaintiffs failed to state a claim as a matter of law.

The plaintiff franchisee's most novel argument was that Doctors Express "constructively terminated" their franchise by making "material changes to their business model that have harmed, rather than helped, franchisees." They also alleged that Doctors Express's "incompetence, combined with stubborn management and strict requirements," rendered the plaintiffs' investment "inoperable." The Third Circuit soundly rejected these arguments, holding that because there was no breach of contract, no misrepresentations and no allegations evincing a "manifest intent of the defendant to cease doing business with plaintiffs," there could be no constructive termination. To the contrary, the plaintiff franchisees had demonstrated the implausibility of their argument by asserting they were still "in good standing" with Doctors Express – showing that nothing had actually been terminated.

Finally, the Third Circuit affirmed the dismissal of the plaintiff franchisee's remaining claims under the Maryland Franchise Registration and Disclosure Law, based on the statute of limitations, finding that, as evidenced on the face of the pleadings, the claims were not brought within the requisite three-year limitations period.

This case is a good example of a franchisor that appears to have done nothing wrong in making judgment calls on disclosure. Doctors Express, in providing cost and working capital information about a Maryland affiliate in its Franchise Disclosure Document, provided an adequate caveat warning prospective franchisees that costs depend on a multitude of factors. Doctors Express also steered clear of any breaches of its Franchise Agreement when making changes to the system, as evidenced by the fact that Fabbro and Pai were unable to point to any provision that was actually breached, despite being given multiple chances. This discussion supports the good faith, discretionary use of truthful data in FDDs, recognizing that franchisors need that latitude without "fly speck" second-guessing from franchisees. This court recognized that such discretion, in what is akin to a "business judgment" rule, should not be retracted by a court seeking perfect, customized disclosure and system management.