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News and Views for Your Hospitality and Franchise Business

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Summer 2015

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California Dreams Become Reality for Franchisees; Amended Franchise Relationship Law Passes

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The California State Assembly saw the seventh amended version of proposed changes to the California Franchise Relationship Act (CFRA)[1] introduced August 17, 2015, and a final version with additional amendments favorable to the industry passed both houses on August 24, 2015.

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Hospitality Industry Targeted in Proposed White Collar Overtime Regulations

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In a March 13, 2014 memorandum, President Barack Obama directed the Department of Labor (DOL) to "modify," "streamline" and "simplify" the federal regulations regarding exemptions to overtime under the Fair Labor Standards Act (FLSA). The goal? To increase the number of workers eligible for overtime. From the outset, both the President and the Secretary of the DOL declared that they believed many positions in the hospitality industry should qualify for overtime.

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Alabama Passes New (and More Restrictive) Non-Compete Statute

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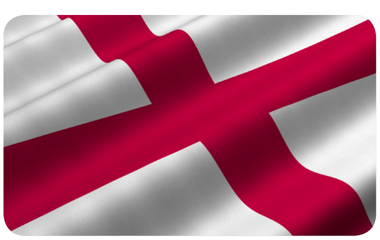

Effective January 1, 2016, Alabama has passed a new non-compete and non-solicitation statute, repealing Section 8-1-1 of the Alabama Code ("the New Act"). The New Act begins with the same general statement as the prior statute stating that any contract that restrains anyone from exercising a lawful profession, trade or business is void unless allowed by the New Act.

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[1] CA. Bus. Prof. Code Section 20020, et. seq.

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Greetings From Hospitalitas

Hospitalitas is the Baker Donelson newsletter for our clients and friends in the hospitality industry – hotels, restaurants and their suppliers. It is published several times a year when we believe we can deliver first-class, useful information for your business. Please send us your feedback and ideas for topics you would like to know more about. True to our Southern heritage of hospitality, we'll work hard to make each visit with us something special and worth repeating.

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This amendment is the product of industry negotiations that resulted from the realization that a bill was going to pass, whether or not franchisors agreed to the changes. Franchisors operating in California or considering operating in California after January 1, 2016 must prepare for the reality that the price of doing business in this consumer-rich market will be the limitations and costs imposed by the revised CFRA. Franchisees should likewise prepare for the reality that their costs of operating in California under the CFRA will rise, or that promising franchise concepts not currently operating in California will decide to operate in California through company stores, or not at all. The CFRA changes will apply to franchises entered into or renewed on or after January 1, 2016, and to franchises of an indefinite term that may be terminated without cause.

California Assembly Bill 525 ("the Bill") amends the substantive and procedural elements of the CFRA in an effort to reduce or eliminate the perceived arbitrariness of franchisor actions to enforce franchise agreements as written. As a result of the negotiations, there is better balance between protection of the brand and franchise system from poor performers at the expense of relatively long cure periods that will conceivably produce many unsatisfied customers in social-media-crazy California.

Termination Rights. The definition of good cause for termination or non-renewal remains very narrow. It is limited to failure of the franchisee to substantially comply with the franchise agreement, after notice and opportunity to cure. The opportunity for a good old-fashioned common law breach not enumerated in the franchise agreement as the basis for termination appears to be precluded. Although there is a market withdrawal concept included in the Bill (see below), the good cause provision and the market withdrawal provision are not well coordinated.

Under revised CFRA Section 20020, the franchisee will have at least 60 days and not more than 75 days to cure non-monetary defaults, and at least 10 days to cure regulatory violations, before a franchisor may terminate. The five-day monetary default cure period is retained. The bill preserves certain emergency termination rights, based on misconduct of the franchisee or external conditions such as foreclosure or eviction. The franchisor and franchisee may agree to terminate the franchise in writing, although it is unclear whether the practice of granting and reserving unilateral, mutual termination rights at specified intervals in the franchise agreement, which is common in the hotel industry, meets that standard. The franchisor can also terminate for repeated violations of the franchise agreement, whether or not a cure is effected, although the precise number of violations is not specified, and for a repeat violation of the same provision after the first violation is cured under the 60-75 day cure right.[2] Reading the two provisions together, a sensible interpretation would be three violations of the franchise agreement, which do not need to be the same violation. The Bill brings no clarity to these existing provisions.

[2] CA. Bus. Prof. Code Section 20021.

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However, the Bill brings new certainty to a long-standing practice in the hotel franchise industry, mutual termination rights. Under Section 20022 (f), the franchisees are free to agree in writing to terminate or not to renew the franchise. On its face, the plain language should allow franchise agreements to reserve termination rights without cause, and to agree in advance that the franchise is not renewable. Coupled with the exclusion from the buyback obligation that applies if the franchisee is allowed to retain the place of business, these common practices in the hotel industry should not be challenged under the new law. Likewise, a narrow non-competition covenant that allows the franchisee to continue in business in the same place, to the extent otherwise enforceable in California, should survive a challenge.

Another provision that is not addressed in the Bill is the protection of felonious franchise owners. Existing law prohibits the franchisor from terminating upon a felony conviction unless the crime relates to the operation of the franchise. Given California's concern for privacy and protecting people from identity theft, it is surprising that they did not take this opportunity to include among the litany of horrible deeds that overrides good cause a conviction of identity theft or credit card fraud, if the franchise involved the collection and retention of personally identifiable information and the processing of credit card payments, even if the crimes were not committed in the operation of the franchise or upon the franchise's customers. In other states, termination would not likely be challenged under similar facts.

Buyback Obligations. Under new CFRA Section 20022, at termination or nonrenewal at the discretion of the franchisor, the franchisor must repurchase from the franchisee at the franchisee's depreciated value the inventory, supplies, equipment, fixtures and furnishings that are paid for under the terms of the franchise agreement or a collateral agreement by the franchisee to the franchisor or its approved suppliers or sources that are used in the franchised business. The franchisee is free to sell or retain the equipment, and no obligation arises if the franchisee retains control of the principal place of business. The last round of amendments addressed the issue of requiring the franchisee to deliver clear title to the assets, free from adverse claims of creditors and secured parties. There is no provision for equipment lease resolution if the equipment is leased rather than financed, even with a capital lease.

There is also a market withdrawal option that eliminates the need to repurchase the assets if the franchisor announces a geographic market withdrawal affecting the area where the franchise is located. However, the relevant geographic market definition is borrowed from the gasoline dealer statute and includes an entire standard metropolitan statistical area.[3] Given the huge size of SMSAs in California, a franchisor cannot easily fine-tune its markets within the large metropolitan areas once it commences selling franchises. Offset rights for amounts owed to the franchisor may be exercised. This right to sell avoids the possibility that the franchisee will be stuck with large amounts of tangible assets that it cannot use or must sell for liquidation prices. Personalized goods for a particular franchise are excluded.

[3] Ca. Bus. Prof. Code Section 20999 (p).

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A more subtle element is the attack on the supposedly higher costs attributable to supplier rebates and payments arising from tangible goods purchased from the franchisor or approved suppliers. A franchisor can reduce exposure under this section if franchisees are free to purchase a specified item from any supplier so long as the item meets standards. Fueled by the perception that source-restricted programs increase costs for franchisees and expose them to higher post-termination losses in asset value, this will cause franchisors to examine carefully whether source restrictions in California are worth the risk of repurchasing tangible assets of terminated franchisees that may be below recoverable market value. The price is based on depreciated value (price minus accumulated depreciation), rather than the Generally Accepted Accounting Principles (GAAP) formula of the lower of depreciated cost or market value. The franchisee gets to sell the assets for the higher price – the fair market value or the depreciated value. GAAP franchisors will realize an immediate loss if cost exceeds market price, so the accountants will be considering whether reserves or contra-accounts that offset revenues from approved supplier and tangible asset sales to franchisees are needed for California franchisors. Whether or not franchisors will be able to lay off some risk of this economic loss to approved suppliers will no doubt be the subject of negotiation.

Transfers. Under new CFRA Section 20028, franchisors must permit franchisees to transfer ownership of the franchised business or any portion of the franchisee's equity to any person who is qualified under the franchisor's then-existing and reasonable standards, as consistently applied to similarly situated franchisees operating within the franchise brand, for the approval of new or renewing franchisees. The franchisee is likewise prohibited from engaging in the sale if the franchisor's consent is not obtained because the putative buyer does not meet the standards, or the franchisee and buyer do not meet the conditions of the franchise agreement for effecting a transfer. This provision allows the franchisor to exercise a right of first refusal at the same price as the bona fide offer, and applies to asset and equity transactions. Franchisors will need to articulate and publish procedures for transfer that meet objective reasonableness standards, and do not create an opaque, mystical or arbitrary process for transferring some franchises and not others.

Franchisors that have used undisclosed evaluation criteria for franchise applicants will be forced to articulate their standards or admit all franchise candidates. If the standards have not been published, the franchisor must communicate them to the selling franchisee within 15 days after receiving a request to transfer. There are no articulated guidelines for what is "reasonable" and a new franchisor will be forced to take some risks if it does not consent to a proposed transfer transaction, since it does not have an internal frame of reference for what is reasonable. As the law of unintended consequences will no doubt apply, franchisors will be forced to set high standards and then rigorously apply them without regard to special circumstances, or give people a chance to succeed when their paper credentials are weaker than the norm There is no protection for a franchisor that sets a bar for applicants as low as possible to comply with the statute and then experiences a high failure rate from unqualified or marginal candidates. The effect of this change may well lead to either high failure rates or foreclosed opportunities for entrepreneurs, with concomitant slower growth in jobs and business. There is no exception for

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California Dreams Become Reality for Franchisees; Amended Franchise Relationship Law Passes, *continued*

programs designed to offer opportunities for disadvantaged entrepreneurs or veterans, so these laudable efforts of the franchise community may well be curtailed or cease entirely in California.

Transfer Procedures. New CFRA Section 20029 lays out in surprising detail the notice and time periods required for transfers governed by CFRA Section 20028. In a classic example of statutory micromanagement of business functions, the statute goes into great specificity about the content of notices, the delivery of relevant documents for the transaction, and the time period during which the franchisor must make its decision, no more than 60 days after delivery of all relevant documents. Any disapproval must be stated with reasons, and is subject to challenge by the franchisee in court or in an arbitration proceeding. In what may be the most curious provision of the Bill, the disapproval of a transfer is presumed to be a question of fact to be determined by the trier of fact, but the provision goes on to state that the issue can be decided at summary judgment if the reasonableness can be decided as a matter of law. Judicial management of disapproval cases will bear close scrutiny, as these potentially inconsistent directions are interpreted.

Election of Remedies. New Section 20035 provides a simple remedy for a franchisee if a franchisor allegedly violates CFRA in termination or non-renewal of a franchise. The franchisor can be made to pay the fair market value of the franchise plus damages. The Section also authorizes injunctive relief if violations can be arrested or reversed. Mitigation is possible under new Section 20036 for amounts owed to the franchisor and any recovery under Section 20022 for amounts paid to the franchisee, although it is unclear if asset sale proceeds by the franchisee from sales to parties other than the franchisor will be applied under the statute as an offset. There is no guidance on how to determine fair market value of the franchise, and whether other common law theories of recovery are available or foreclosed. A battle of the valuation experts will ensue in all cases.

The remedial provision is curious insofar as it may apply most effectively to a predatory non-renewal or termination, where the franchisor or an affiliate swoops into a strong market in place of the franchisee and effectively usurps whatever market equity the franchisee might have built up from its success. In contrast, the failing or marginal franchise is not necessarily helped because its market value will be low. This provision is in essence a codification of common law damage theories for wrongful termination, so the last round of amendments made these changes more benign than earlier versions of the bill.

Bottom Line. Franchisors entering into or renewing franchise agreements with California franchisees after December 31, 2015, should think through how this legislation affects their options and obligations well before the law takes effect in franchise system management. Is this the end of franchising in California? The author believes that some franchisors will choose to take the risk given the riches offered by the robust market. Will more risk be priced into transactions through higher fees? Most likely. Will California consumers benefit from this legislation in the form of more choices, better meeting of their brand expectations and higher levels of consistent product and service quality? Not likely. Is this bill a trend that will influence state relationship law amendments under consideration in other states, a de facto norm of the industry? Stay tuned to these pages....

NEWS

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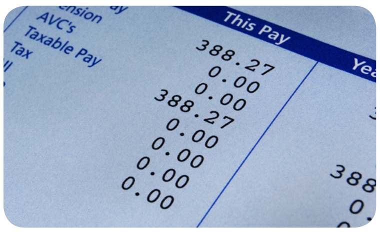

"The assistant manager at a fast food restaurant who puts in 60-70 hours a week for $455 and spends almost all of their time performing the same work as the employees they supervise and who does not get overtime is getting a raw deal," says Labor Secretary Tom Perez. "We are updating the rule to prevent this situation."

On June 30, 2015, the DOL announced the highly anticipated proposed changes to the overtime regulation. Although there was much speculation about the DOL attempting to simplify the job duties test for overtime exemption, they made no such changes. Instead, the department proposed an increase in the salary level required for exemption to overtime from $455/week ($23,660/year) to $970/week ($50,440/year) for 2016. The DOL also increased the salary level for highly compensated individuals from $100,000/year to $122,148/year. Additionally, the DOL indicated that they intend to include a mechanism to update automatically the salary level annually through a percentage tied to the Consumer Price Index. Although the DOL made no changes to the job duties test required for exemption, there is still a possibility that a future change could be proposed, since the department asked for comments on such changes.

The 295-page Notice of Proposed Rulemaking (NPRM) outlines the DOL's proposed changes and also includes extensive commentary on the rationale for the changes and the expectations regarding its applications. Throughout the NPRM, the department references positions in the hospitality industry as examples of where changes in classification need to occur. This industry has always been subjected to a disproportionate amount of interest from the DOL. The latest statistics from the department website show that 55 percent of the DOL audits in 2014 were of restaurants and hotels. The new proposed regulations will certainly create a new challenge for the hospitality industry. At a recent webinar conducted by Baker Donelson, there were a number of questions from attendees in this industry, seeking to understand how the proposed regulations may impact hospitality businesses.

Here are some of the more significant questions and our answers:

1. What is the difference between an "exempt" and "non-exempt" employee? Is this the same as salaried versus hourly?

Short Answer: An exempt employee is ineligible for overtime, while a non-exempt employee is eligible. This distinction is commonly called "classification." Exempt/non-exempt is not the same as salaried/hourly. The FLSA , the federal law governing wage and hour issues", has three basic requirements: payment of the federal minimum wage ($7.25/hour), overtime pay for time worked over 40 hours in a workweek and record keeping.

The FLSA, however, "exempts" certain employees from the minimum wage and overtime pay requirements. There is a common misperception that paying an employee a salary means they are "exempt" from overtime.

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Hospitality Industry Targeted in Proposed White Collar Overtime Regulations, *continued*

This is not true. Payment of a salary is only one of the requirements for exemption. To qualify for the exemption, employees must:

(1) Be paid on a salary basis (employers cannot reduce the salary because of quality/quantity of work or when employee works less than a full day);
(2) Be paid a certain salary level (currently $455/week or $23,660 annually); and,
(3) Meet a designated job duties test (that shows the employee primarily performs certain supervisory duties, compared with hourly workers performing "line" work).

These requirements are set forth in detail in the DOL overtime regulations. If all three of these requirements are not met, the employee is non-exempt. Job titles do not determine exempt status. Employers are required to pay non-exempt employees overtime and to maintain certain records of work hours for non-exempt employees.

2. Do I have to increase my affected managers' pay?

Short Answer: No. Although this is one of the myths that is being spread about the proposed regulation, there is no requirement to increase any individual's pay. Businesses have other options such as placing managers and other previously exempt employees on an hourly rate or classifying the employee as a salaried non-exempt employee where the employee is quoted a salary rate, with the realization there will be overtime owed for all hours over 40 per work week.

3. Can I just make sure my managers do not work more than 40 hours per week?

Short Answer: You can make it a policy that managers cannot work overtime but if they violate the policy, and they do not qualify for exemption, you must pay them overtime. Unless the manager meets all the tests for being exempt, including the new salary level requirement, the employer has an obligation to keep track of the employee's hours. Failure to do so can have two consequences. First, it is a violation of the record-keeping requirements and can subject an employer to a fine from the DOL, and we expect the DOL will be sending plenty of auditors out to hospitality industry businesses. Second, if the employee claims to have worked overtime hours for which he or she was not paid, and the company has not kept adequate records, the employer is at the mercy of whatever believable story the employee can produce as to how many hours he or she worked during the relevant period. An employer can have a policy in place that prohibits an employee from working overtime; however, if the employer "knew or should have known" that the employee worked in excess of 40 hours in a workweek, they will still be required to pay the overtime. However, the employee can be disciplined for violating the overtime policy.

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Hospitality Industry Targeted in Proposed White Collar Overtime Regulations, *continued*

4. Under the proposed new rule, which employees will be exempt from overtime?

Short Answer: Salaried employees who make at least $50,440 annually and perform primarily "white collar" or supervisory duties will be exempt. The new proposed DOL overtime regulations increase the salary level (test #2 above) from $455/week ($23,660 annually) to $970/week ($50,440 annually). These amounts will also be indexed for inflation, to combat the time lag these amounts experienced from their last adjustment many years ago. To maintain the exemption, the employees will still need to be paid on a salary basis and meet the job duties test (which, at this point, the DOL did not amend).

5. Will commissions or bonuses be counted as part of the $50,440/year salary level test?

Short Answer: Bonuses? Probably, but to a limited extent. Commissions? Doubtful. The DOL is "considering" whether to allow nondiscretionary bonuses that are tied to productivity, profitability and/or specified performance metrics to satisfy some portion of the salary level requirement. The department suggests limiting bonus payments to satisfy only 10 percent of the weekly salary level and that "employees would need to receive the bonus payments monthly or more frequently."

At this point, the DOL is rejecting the idea of counting commissions toward the salary level requirement. The department is seeking comments on the appropriateness of including commissions as part of the nondiscretionary bonus and other incentives that could partially satisfy the salary level test. It also appears that the DOL is not considering counting any other paid benefits toward satisfaction of the salary level test.

6. Can we limit the number of overtime hours these non-exempt employees work?

Short Answer: Definitely. No employer is required to guarantee overtime work or pay an employee more compensation as a non-exempt employee than what the employee was earning as an exempt employee. Employers should have an overtime policy stating when and if overtime is allowed (e.g., if an employee is required to get prior authorization of the overtime and from whom). If an employer knew or should have known an employee is working unauthorized overtime, however, the employer may discipline the employee in accordance with the overtime policy, but will still owe the employee the overtime pay.

7. What are the most important considerations for employers when analyzing these proposed changes?

Short Answer: Hidden overtime or time outside of the normal working hours that must now be tracked. Most exempt employees do not keep records of their hours. Therefore, many employers do not have adequate data on the number of hours their exempt employees are working. When these exempt employees are re-classified as non-exempt (because they no longer meet the salary level test), these hours will need to be tracked and any hours over 40 in a work week will be considered overtime. Many FLSA lawsuits allege employers failed to include time spent by non-exempt employees performing work activities outside of their normal shifts. Non-exempt employees may perform a variety of potentially

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compensable job-related activities during their "off-the-clock" time, such as taking work home, making/receiving job-related telephone calls and e-mails at home, working through lunch, working before or after regular shifts, taking care of work-related equipment or job-related "volunteer" work. This compensable time must be considered when re-classifying employees and working within the employer's payroll budget.

8. If this rule goes into effect, will we have to convert all of our salaried exempt employees making less than $50,440/year to hourly employees?

Short Answer: No, hourly is not the same as non-exempt. An employee can be non-exempt and still paid a salary. The FLSA does not require that non-exempt employees be paid hourly. When properly done, it is perfectly legal to have a salaried non-exempt employee. A non-exempt salaried arrangement is simply when an employer pays a non-exempt employee a fixed salary for the week instead of paying the employee by the hour. The employee receives overtime pay based on the salary for every hour worked over 40 during the week. The employer still has to track employees' work hours every week regardless of the method of payment.

9. When will this rule go into effect?

Short Answer: Although we cannot definitively predict when the DOL will publish its final rule, we believe it will happen in early 2016 and employers will have to be in compliance as of the effective date of the rule, which can range anywhere from 30 to 120 days after the final rule is published. The administration has been very vocal about its desire to see this change in the law implemented quickly, so we expect a short compliance period (i.e., less than 120 days). Some published speculation predicts the timing will precede the fall 2016 election by a sufficient period to allow political campaigns to take credit for increasing take-home pay in the election cycle. The possibility that the effect of the final rule will be to reduce hours worked, rates of pay, bonuses or employment is likely not part of the political calculus,

10. What should we do now?

Short Answer: Take advantage of the time before the final rule is issued to identify and correct any mistakes. Employers should identify the affected employees and possible issues relating to the re-classification of those employees, such as budgetary effects, workforce effects (job/compensation restructuring), employee morale, etc. Does your time-keeping mechanism work with the additional employees? Is it possible to get the same work hours under the employer's current payroll budget? How is the information going to be communicated to employees and what is the potential effect on morale and work performance? Right now is also an opportunity to analyze and to correct any misclassification. The changes in the law are being reported in mainstream news, so employees will be expecting changes of some type. Employers must weigh the increased costs of compensation and recordkeeping against the cost of simply moving managers above the new ceiling to eliminate the cost and risk of compliance. As many labor markets are tightening and pay is rising from market forces, this regulatory uncertainty is one more factor to consider in determining compensation and labor costs.

Alabama Passes New (and More Restrictive) Non-Compete Statute, *continued*

It also states that the provisions of the New Act express a fundamental public policy of the state of Alabama and any contrary foreign laws would not apply if they violate the New Act, thus prohibiting parties from attempting to avoid the New Act by choosing to apply another state's law.

The New Act attempts to codify principles the Alabama courts have previously addressed. It sets out explicitly the types of agreements allowed, including agreements (1) restricting parties to a contract from hiring an employee of the other party who holds a position "uniquely essential" to the business, (2) limiting commercial dealings to the parties to the contract, (3) preventing the seller of the good will of a business from opening a competing business or soliciting the buyer's customers within a specified geographic area, (4) preventing an employee from engaging in a similar business (i.e., a non-competition agreement), (5) preventing employees from soliciting current customers (i.e., a non-solicitation agreement), and (6) allowing owners in the event of dissolution of a business or contemplation of dissolution to agree not to carry on a similar commercial activity in the relevant geographic area. The New Act addresses what is a protectable interest that can support the agreements allowed, including trade secrets; certain confidential information (including pricing and customer lists); relationships with specific prospective or current customers, clients, patients or vendors; the good will associated with a business's customers, clients, patients or vendors; and specialized training that involves significant expense if that training is set forth in the agreement as the reason for the restraint.

The New Act continues the previous practice of allowing courts to modify agreements where they find either the duration or the geographic scope to be excessive. It requires both parties to sign any non-competition/non-solicitation agreement and requires the agreement to be supported by consideration, without stating whether continuing employment is sufficient consideration. The New Act also specifically continues any professional exemptions already recognized, although it also recognizes that a protectable interest can arise from "[c]ustomer, patient, vendor, or client good will associated with...an ongoing... professional practice," thus setting up what appears to be a conflict that the courts will have to resolve.

Most notably, the New Act sets time limits of what it presumes to be reasonable for certain restrictions, including the following:

(1) Two years is presumed to be reasonable for a non-competition agreement.

(2) Eighteen months is presumed to be reasonable for a non-solicitation agreement.

(3) One year or less is presumed to be reasonable for a non-compete or non-solicitation involving the sale of the good will of a business. The new provision regarding the sale of the good will of a business may be the most distressing, as some Alabama courts have upheld non-competition agreements with a term of five years that arise out of the sale of a business. The New Act's treatment

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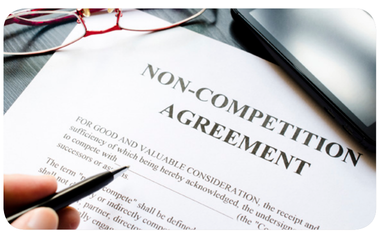
Alabama Passes New (and More Restrictive) Non-Compete Statute, *continued*

of non-solicitation agreements may also be a significant change in the law. Following the Alabama Supreme Court's 2006 decision that partial restraints of trade were not governed by Alabama's prior statute, some courts have held that non-solicitation agreements did not require a protectable interest and were only governed by a notion of reasonableness in scope and duration. The New Act now seems to require a protectable interest similar to that needed for a non-competition agreement and only allows non-solicitation of current customers and not prospective or past customers with whom an employer hopes to establish or re-establish a relationship. The New Act also limits agreements to commercial entities (instead of using the term "employer" as was originally suggested) raising some concerns about using these agreements with non-profit or religious entities. The New Act references franchises specifically, finding that a protectable interest includes customer, vendor and client good will in connection with an ongoing franchise or business, thus specifically allowing franchises to enter into protective agreements to protect these interests, but also subjecting those agreements to the time limits set forth in the New Act.



Finally, the New Act is silent on whether it applies to agreements entered into before the effective date, but Alabama statutes are generally not applied retroactively if they impact substantive rights as opposed to procedural or remedial rights The Alabama Supreme Court has stated on multiple occasions that a statute is not to have retroactive application unless the statute has an express provision of legislative intent that it applies retroactively. Thus, a strong presumption exists that a statute will apply only prospectively unless there is a clear and explicit intention otherwise. An exception exists for statutes that are merely remedial, which are those that impair no contracts or vested rights and do not disturb any past transactions. Although application of the New Act to reduce the time limits of agreements or to limit, for example, non-solicitation agreements to current customers would certainly impact substantive rights in contracts, it may set up an interesting argument with those who may argue that the New Act is merely an attempt to codify what the Alabama courts are already holding.

Business Succession Planning: The Time is Now

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Family-controlled businesses comprise between 80-90 percent of all business enterprises in North America.[4] And while it is estimated that nearly 40 percent of family businesses are passed successfully to a second generation, only a small fraction of them make it to the third generation or beyond.

[4] (Source: J.H. Astrachan and M.C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," *Family Business Review*, September 2003).

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Business Succession Planning: The Time is Now, *continued*

In fact, many business owners fail to give any meaningful consideration to what will happen if they die suddenly or otherwise become unable to continue managing their business, or they simply procrastinate in formalizing a succession plan. In situations where there are no family members possessing the expertise and know-how to manage effectively the family business after the owner's death or incapacity, the family may find itself in a position of having to dispose of the business to a third party for a price below what could be achieved in an unforced sale.

Regardless of whether an owner intends to pass the family business to the next generation or maximize its value through an orderly sale at the time of retirement or death, business succession planning is vitally important to ensuring a smooth transition. Fortunately, there are many options to consider when structuring a plan that is right for each business.

The first step in setting a business succession plan is choosing a successor. This can be a difficult task when there is no son, daughter or other family member who has demonstrated the requisite skills and interest necessary to maintain and grow the business. In some cases where there is not a readily available heir-apparent, an owner may consider taking on a new minority partner or hiring a new employee who can be groomed to take the reins. If you are in business with one or more co-owners, you should strongly consider a cross-purchase agreement, which requires each of the owners to purchase the interests of a deceased or incapacitated owner for a specified or determinable price, or an entity-purchase agreement, which requires the company itself to purchase the outgoing member's interest. These arrangements are often funded through life insurance policies taken out on the lives of the participant-owners.

Unless you intend to transfer your business through a bequest under your will, in which case you should consult an estate planner, the final steps to establishing a business succession plan include choosing an appropriate method for calculating the value of your business and selecting a mechanism to fund your successor's purchase. Some of the more popular methods for establishing the value of a business include: (1) engaging a qualified professional to conduct a business appraisal periodically or at the time of transition, (2) setting a fixed price that is agreed upon between the outgoing and incoming owners, which can be updated periodically to reflect changes in the finances and prospects of the business, and (3) preparing a formula based on objectively determinable metrics (e.g., net earnings) that is agreed upon by both parties.

Finally, the successor owner's purchase of the business is typically paid either in a lump sum funded by life insurance proceeds from a policy on the outgoing owner's life (usually only in the case of a minority partner/shareholder as successor) or a loan secured at the time of transition, or in installments that can be paid out of the business's profits.

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Business Succession Planning: The Time is Now, *continued*

A franchised business adds an extra layer of complexity to this process. First, a franchisee must understand the process for generational change that the franchise agreement sets in place. All of the planning must coordinate with the franchise agreement process. The process is described in summary form in Item 17 of the Franchise Disclosure Document, and in detail in the transfer sections of the Franchise Agreement. A franchisor will want assurances that the successor managers have the required training and experience, and the financial wherewithal, to carry on the business. This process should start before a life-changing event, because many franchise agreements have a short fuse for making decisions and transitioning to a new generation. Some franchises offer the opportunity for the franchisor or an affiliate, or an authorized franchisee, to step in and manage the business while the ownership status of the business is addressed. The franchisor or an affiliate may have a right to purchase the business, or its consent and payment of a transfer fee must be required. The critical focus for all parties is continuity of customer service and operations, so that the brand's standards of quality and service are met throughout the transition period, and the good will of the business is unaffected, to the extent possible, by the event and change of ownership.

A family-owned franchisor has a similar critical focus on maintaining good will and customer service to franchisees, with the added issues of updating disclosure documents and state registrations when Item 2 disclosures must change. The leadership change will have not only the company's suppliers and its employees as its constituencies, but the entire franchise community as well.

By taking the time to solidify a business succession plan now, business owners can ensure a smooth transition for their businesses while maximizing their value and avoiding unnecessary frustrations and potential discord among family members after they die.

For more information about business succession planning, contact the author of this article or another member of the Firm's Business Department.

Arkansas Loves Home Cookin'

By Kris Anderson

A federal judge in the Western District of Arkansas recently rejected a franchisor's attempt to invoke a forum selection clause, in *Rob & Bud's Pizza, LLC v. Papa Murphy's Int'l, Inc.*,[5] on public policy grounds rooted in a seemingly dormant statute, the Arkansas Procedural Fairness for Restaurant Franchisees Act (APFRFA), enacted in 1993.

The plaintiff in this case, Rob & Bud's Pizza (R&B) is a franchisee of Papa Murphy's Pizza. In 2014 R&B, along with numerous other Papa Murphy's franchisees, filed an action against Papa Murphy's in Washington state court claiming that Papa Murphy's had induced them to purchase franchises through various fraudulent and deceptive misrepresentations and omissions.

[5] No. 5:15-CV-5090, 2015 WL 3901611, at *2 (W.D. Ark. June 24, 2015).

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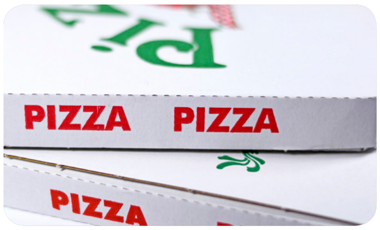
Arkansas Loves Home Cookin', *continued*



While the Washington litigation was ongoing, R&B initiated a second lawsuit in Arkansas state court, seeking injunctive relief while alleging that Papa Murphy's was unlawfully attempting to terminate R&B's franchise agreement in retaliation for failure to accede to settlement demands in the Washington litigation. Papa Murphy's then sought to transfer venue of the second case to Washington under the forum selection clause in R&B's franchise agreement.

In considering the motion to transfer, the court first noted that federal law would apply to the decision as a procedural issue, but also noted that "consideration of the public policy of the forum state must be part of the analysis." The court then found that the public policy of Arkansas "strongly weighs against enforcing the forum selection clause." The court cited the APFRFA, which states that "a party to a restaurant franchise may commence a civil action...in Arkansas if either party to the restaurant franchise is a resident of Arkansas," Ark.Code Ann. § 4–72–602, and states furthermore that "[n]either a franchisee nor a franchisor shall be deprived of the application and benefits of this subchapter by a provision of a franchise purporting to designate the law of another jurisdiction as governing or interpreting the franchise, or to designate a venue outside of Arkansas for the resolution of disputes." Ark.Code Ann. § 4–72–603(c).

Papa Murphy's made the common-sense argument that its franchise system does not fall within the definition of a "restaurant franchise" because its pizzas are specifically intended for customers to bake at home. The court found that argument unavailing because Papa Murphy's franchises also sell pre-made, ready-to-consume salads and soft drinks, neither of which require additional preparation at home. Therefore, under the court's rationale, any sale of pre-made, ready-to-eat food or drink in whatever setting, including gas stations, would place a franchise within the scope of the APFRFA.

This case is important for franchisors doing business in Arkansas for two primary reasons. First, the APFRFA is a seldom-invoked statute without a single other case citing it. The R&B case may give way to more Arkansas franchisees resisting enforcement of otherwise lawful forum selection clauses in franchise agreements with out of state franchisors. Second, the court's broad definition of what constitutes a "restaurant franchise" may serve as precedent for more types of franchise systems being called "restaurants" even if service is limited to soft drinks. Accordingly, a broad swath of franchise systems serving ready-to-consume food or drinks of any kind should consider the risk that the forum selection clauses in their franchise agreements may not be enforceable in Arkansas if other courts follow the R&B court's lead. Arkansas really loves home cookin'.

Look for Us at the ABA Forum on Franchising

Look for Baker Donelson attorneys Joel Buckberg, Sara Turner and Amy Andrews at the ABA Forum on Franchising Annual Meeting, "The Soul of Franchising," October 14 – 16 in New Orleans.

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