FRANCHISE

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LITIGATION TRANSACTIONS REGISTRATIONS

States Increasingly Seek New Revenue Streams through the Tax Code; Bad News from California

In recent months, the California Franchise Tax Board (FTB) has been contacting franchisors located outside of California in an attempt to collect taxes on payments made to the franchisor by California franchisees. The FTB is presenting franchisors with the option of either registering as a business user in California and paying franchise tax or having the FTB compel their California franchisees to withhold taxes from royalty payments made to the franchisor, at the rate of 7%.

The FTB is citing Regulation 18662-2 of California's Code of Regulations to justify its position that it can compel withholdings on royalty payments. That section provides in part that withholding is required "in the case of rentals or royalties for the use of, or for the privilege of using in [California], patents, copyrights, secret processes and formulas, good will, trademarks, brands, franchises, and other like property of such intangible property having a business or taxable situs" in California.

Although each franchisor must examine its own tax situation, we generally recommend that, given the choice, franchisors should register their business with California rather than subject their franchisees to the withholding process. By registering with the state, a non-resident franchisor can then determine whether it actually owes

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Arbitration Clauses – Who is Required to Arbitrate?

Many franchisors have made arbitration an integral part of their dispute resolution procedure in an effort to avoid the higher costs and delays of litigation. While some have questioned the efficiency, both in terms of time and expense, of arbitration over litigation during the past few years, a substantial number of franchisors still include an arbitration clause in their franchise agreements as the primary method of resolving claims arising out of the franchise relationship. By their very language, these arbitration provisions clearly bind the franchisor and franchisee to arbitration – it is important, however, to recognize and understand how the law in some states might bind third parties that are not signatories to the franchise (or other) agreement to arbitration as well.

Although the 2009 United States Supreme Court's ruling in *Arthur Anderson LLP v. Carlisle* provides that the ability of non-signatories to enforce arbitration provisions is governed by state law, the Supreme Court held that principles such as "assumption, piercing the corporate veil, alter ego, incorporation by reference, third-party beneficiary theories, waiver and estoppel" could all provide a basis for allowing an arbitration provision to be enforced against a non-signatory. In the franchise context, several recent state court decisions have shed light on certain situations where a third party can invoke the Federal Arbitration Act to stay or avoid litigation even though they were not a party to the franchise agreement containing the arbitration provision.

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States Increasingly Seek New Revenue Streams *(Continued)*

income taxes in California, during which time a franchisor, as opposed to the FTB, retains the amount that might be owed. If a franchisor does not have a nexus with California, it will not be subject to California income tax, even if it has already registered. Another advantage of registering with the state is that it may cost less to the franchisor. The withholding rate of a franchisee's royalty payment is 7%. This percentage is applied to the gross royalty amount and the franchisor is unable to take advantage of deductions. Alternatively, if a franchisor registers to do business in California, the effective tax rate may be less than 7%.

A franchisor owes income taxes in California if it has a "nexus" with California. While case law is still developing in this area and there is no clear standard as to determining nexus, generally, a franchisor will have a nexus with California if it has an office or inventory or regularly sends employees into California.

Franchisors can challenge the FTB's ability to require them to register with California or withhold taxes from royalty payments by arguing that there is no nexus. California has historically held that the situs of intangible property is determined by identifying the domicile or principal place of business of the franchisor. In *Rainier Brewing v. McColgan*, a California taxpayer sold out-of-state parties the right to use his trademark in consideration for royalties paid to him. The court held that the revenues derived from the transfer of the trademark had its situs in California. In *Rainier*, the place of business happened to be in California, but franchisors could argue that the same rationale applies no matter where the franchisor is located and that an out of state franchisor is not subject to tax.

However, more recently, in *Praxair Technology, Inc. v. Director, Division of Taxation*, the New Jersey Supreme Court held that a licensee deriving income from licensing intangibles in the state was subject to New Jersey tax. Moreover, in *The Classics Chicago Inc. et al. v. Comptroller of the Treasury*, the Maryland Court of Special Appeals held that an Illinois corporate subsidiary that conducts no business in Maryland but receives royalties from its parent company located in Maryland had a "substantial nexus" with Maryland that enabled the state to tax those payments. As states are increasingly looking for aggressive ways to increase tax revenues, we strongly recommend that you contact us to discuss your company's particular circumstances in order to develop an effective corporate and tax strategy.

Arbitration Clauses – Who is Required to Arbitrate? *(Continued)*

An Ohio Appellate Court in *Cleveland-Akron-Canton Advertising Cooperative v. Physician's Weight Loss Centers of America, Inc.* recently held that a franchisor could enforce an arbitration provision in its franchise agreement to stay litigation brought against it by one of the system's regional advertising cooperatives (the "Cooperative"), even though the Cooperative was not a party to the agreement, on estoppel grounds because the Cooperative's claims against the franchisor were based on the franchisor's obligation to collect advertising fees as set forth in the franchise agreement. The court held that estoppel could bind the Cooperative to arbitration in this case because "a party that knowingly accepts the benefits of [the franchise] agreement is estopped from denying a corresponding obligation to arbitrate." The court cautioned, however, that the Cooperative would not have been bound to the arbitration clause if it had brought claims that were independent of the franchise agreement which contained the arbitration clause. Indeed, in a separate opinion issued a few days later, the court determined that the franchisee members of the Cooperative could not enforce the arbitration provision against the Cooperative because the Cooperative's claims against the members were not based on the franchise agreement, but rather they were based on a separate cooperative agreement that did not contain an arbitration provision.

The Ohio court's decisions above demonstrate how closely courts will scrutinize the claims and facts surrounding a claim when determining whether to enforce an arbitration provision against a non-signatory. If you have an arbitration provision in your franchise agreement, chances are you want any claims brought by a franchisee against your officers, directors (and in some cases, suppliers) to also be subject to arbitration even though those parties are not signatories to the franchise agreement. To increase your chances of enforcing arbitration in these cases, we recommend, at a minimum, including a "Third Party Beneficiary" clause alongside the arbitration provision in your franchise agreement, which provides that your officers, directors, shareholders, agents and/or employees are third party beneficiaries of the provisions of the franchise agreement, including the arbitration provision.

Creating Value By Introducing New Revenue Streams

In these tough economic times, franchisors are striving to bring more value to their franchisees. One way many are doing so is by carefully reviewing the portfolio of products and services system franchisees are authorized to offer and sell to determine which lines are generating customers and driving profitability. Evaluating sources of revenue and costs is a key tool to maintaining the continued health of your franchise system.

Careful analysis may lead you to discontinue a line of products or services that is not generating revenue. More often than not, however, it may mean creating new revenue streams by broadening the types of products and services franchisees are authorized to offer and sell. This is especially true for franchise systems that service a particular "niche" within their industries.

Expanding outward into new lines of business can be exciting. However, the very thought of doing so invokes a variety of practical considerations. How do you convince existing franchisees to spend time and money: (a) learning new methods, (b) buying additional inventory and equipment, and (c) advertising the new line? Do you make the program mandatory or optional? Even if franchisees adopt a new line of products or services, how can you motivate them to develop the new line of business to its full potential? What if the business takes off and you later want the ability to spin it off into a separate franchise program?

With some careful planning up front, you can avoid any potential pitfalls. Perhaps do a test-run of the new line of business through company or affiliate operated locations. In the alternative, consider approaching your most motivated and successful franchisees first to test the program. That way, you can develop some reliable data to assist you in pitching the plan to the entire franchise system.

Consider offering the new line of business to existing and prospective franchisees through an optional program participation agreement. Doing so establishes from the beginning that the program is being offered as a courtesy to franchisees (i.e. they are not necessarily entitled to anything), while taking the pressure off of existing franchisees that may have their hands full. In addition, if the program is offered through a separate agreement, you can impose separate marketing and performance requirements to ensure the business is developed to its full potential. Finally, consider using a separate trademark. That way, the new line of business may be spun off into a separate franchise program at a later date if it proves to be successful, or terminated easily if it proves to be unsuccessful.

Use the information you have gathered about your franchise system in creative ways to ensure your continued growth and success. With careful planning, your franchise system can maintain its competitive edge and evolve with these changing times.

Expansion of the New Jersey Franchise Practices Act

The New Jersey Franchise Practices Act ("NJFPA") defines the relationship and obligations of franchisors and franchisees in the State of New Jersey. The NJFPA provides certain rights to New Jersey franchisees regarding the termination and sale of their franchises.

On January 16, 2010, New Jersey expanded the scope of the NJFPA by revising the concept of "place of business" within the statutory definition of "franchise." Specifically, the legislation broadened the previous definition of "place of business" to include an office or a warehouse from which franchisee personnel visit or call upon customers or from which the franchisor's goods are delivered to customers. The previous version defined "place of business" as "a fixed geographical location at which the franchisee displays for sale and sells the franchisor's goods or offers for sale and sells the franchisor's services" and did not mean an office, a warehouse, a place of storage, a residence or a vehicle.

By expanding the scope of the Act, the amendment will allow certain distributors to claim that they are protected "franchisees" and thus cannot be terminated, cancelled or not renewed without good cause.

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An Item 19 Financial Performance Representation Continues to Be an Effective Shield against Fraud Claims

Several cases in 2009 continue a long line of cases that support the argument that, rather than expose a franchisor to liability, a well crafted Item 19 is actually an effective shield. While each of these cases involve franchisees who received disclosure under the prior UFOC format, before the New FTC Rule on Franchising became effective, their reasoning should hold true under the new regulatory environment as well.

Federal courts in Colorado and Vermont found that franchisees could not maintain an action for fraud on allegations that they were provided with misleading earnings information by the franchisor because in each case the franchisor provided the franchisee with a UFOC containing an Item 19 earnings claim with express statements as to its limitations.

In *Rocky Mountain Chocolate Factory, Inc. v. Anderson*, involving a gross sales earnings claim, Item 19 provided that the earnings claim did not reflect the costs of sales or operating expenses, and that the franchisor does not make or authorize its sales personnel to provide such data. The court found that even if the franchisor had this information, and even if such information was unfavorable, the franchisee was on notice that it would not be provided and that the he should have conducted its own further investigation.

In *Sherman v. Ben & Jerry's Franchising, Inc.*, the court found against the franchisee when the Item 19 clearly stated that the franchisor was not representing that any franchisee or franchise could expect to obtain the reported results and that actual results would vary from unit to unit. The court found that it was incumbent on the prospective franchisee to conduct its own investigation and that the prospect could not sue on a claim of fraud because they relied on the representations.

While the New FTC Rule prohibits a franchisor from requiring a franchisee to disclaim reliance on the FDD, nothing prohibits a franchisor from properly stating what the Item 19 consists of, and what factors may impact a franchisee's performance. The New FTC Rule requires specific admonitions that a franchisee's individual financial results may differ from those stated in the Item 19. Moreover, in FAQ 27, the FTC provides language that a franchisor which makes an Item 19 financial performance representation may use to disclaim financial representations made outside of the Item 19.

Accordingly, the warnings and disclaimers that accompany an Item 19 will no doubt continue to have some benefit in subsequent litigation brought by a franchisee.

FisherZucker LLC is a full-service law firm with a national practice dedicated almost exclusively to franchise, distribution and licensing matters

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