



**May Dinner Meeting  
May 20, 2008**

**Legal and Legislative  
UPDATE**

# LEGISLATIVE

- **Massachusetts Attorney General Advisory on 2004 Independent Contractor Law**

- For a person to be an independent contractor (versus an employee) under Massachusetts law, that person must satisfy three requirements under Massachusetts law:
  1. Free from employer's direction and control in connection with the service provided (by agreement and in actuality),
  2. Service performed is outside the usual course of business of the employer, and
  3. Has an independently established trade or profession of the same type as the service performed
- The second requirement was added in 2004 and marks a major change in the law. The federal 20-factor test does not apply. It has been very hard to classify someone as a contractor under the second test.
- The recent AG's advisory interprets the second test. Under the recent guideline, the AG will interpret the "usual course" to mean only the services that are necessary and essential to the service recipient's business. Incidental services are not included.
- This interpretation narrows makes it easier to classify a person as an independent contractor by narrowing what constitutes service provided inside the usual course of business, which would lead to an employee classification.

- **North American Securities Administrators Association Proposes Adoption of FTC FDD Format**

- NASAA announced proposed rules would that allow states that register franchise offerings to accept, as of July 1, 2008, franchise disclosure documents prepared under the Federal Trade Commission's (FTC's)



amended Franchise Rule with certain additional requirements, including a state risk factor cover page.

- After July 1, 2008, filers will no longer be able to use the UFOC Guidelines to prepare franchise disclosure documents.

- **South Dakota's New Disclosure Law**

- South Dakota repealed its Franchise for Brand-Name Goods and Services Act, and in its place, enacted a new disclosure/registration law that provides requirements and procedures for notice filing prior to the sale of the franchise in the state.
- The new law requires a disclosure filing as set forth in the 2007 FTC franchise rule.
- Still in place from the repealed Act is an anti-waiver provision that voids certain provisions in the franchise agreement that may seek to waive the provisions of law, as well as the employment of any device, scheme or artifice to defraud in the offer or the sale of a franchise.

- **SBA – SOP 50 10 – Effective 15 June 2008**

- Wish list of items SBA lender “should consider”:
  - Access to Franchisor books and records relating to Franchisee/borrower billing, collections and receivables
  - Upon loan default, deferral of franchise fees and other fees until loan is brought current
  - Lender to get 30 days notice of intent to terminate franchise agreement “and/or”
  - Lender to get an opportunity to cure default
  - Franchisor consent to transfer not to be unreasonably withheld or delayed
- SBA will want language that says the Franchisor consent to transfer “must not be unreasonably withheld or delayed” or its equivalent

# COURT DECISIONS

- **Bernier v. Bernier (Massachusetts Supreme Judicial Court)**

- A couple going through a divorce faced major valuation dispute complications attempting to divide their assets. Each was a half owner in two S Corporations, OF which the husband was awarded ownership in the divorce. They could not resolve their disagreement over the valuation of the corporations.
- Using a consented-to income approach, the husband's expert valued the companies at less than half the value the wife's expert suggested. The husband's appraiser had discounted the value substantially by taking into consideration the husband as "key person," that the companies might not be marketable, and other similar factors. This disagreement over value led to a trial that lasted over a week.
- The disagreement was due primarily to how the experts handled taxation of the S-corporation income – the husband's appraiser (i) accounted for the fact that S-corporations are taxed like partnerships (single level of tax), (ii) applied a "key person" discount, and (iii) a lack of marketability discount. The wife's expert did not apply these factors, which led to a much higher valuation. The trial court adopted the husband's approach.
- The Supreme Court reversed the trial court, saying that the husband's approach undervalued the companies by ignoring the tax benefits of the S-corporations' structure. The court relied heavily on a recent Delaware case that was decided after the trial in the Bernier case but before the hearing in the Supreme Judicial Court. This approach attempts to capture the benefit of the S-corporation tax structure (cash distributions not subject to dividends tax).
- As to key person discount, that discount was found to apply when the key person was to stay on after the transaction.
- Lack of marketability was held to be immaterial.

- Significant impact: in a divorce case, the judge must approach the matter of dividing a company not as an arm's-length transaction, but as a transaction between fiduciaries entitled to an equitable distribution of marital assets. According to the court this means that key person and lack of marketability discounts should not apply.
- This upsets years of standard valuation practice that routinely looks at arm's length transactions as a proxy for fair market value.
- Owners can avoid these expensive and time-consuming disagreements over valuation by implementing shareholders agreements that contain set valuation guidelines. This will bring predictability to owners' financial planning decisions.
- **Batie v. Subway Real Estate Corp. (Texas Federal Court)**
  - Franchisee was deployed to Afghanistan, and as a result, did not make its lease payments on time. Franchisor's leasing entity sought and obtained evictions.
  - The Servicemembers Civil Relief Act (SCRA) is a federal statute passed by Congress to allow military members to suspend or postpone some civil obligations so that the military member can devote his or her full attention to military duties.
  - Franchisee successfully brought suit under the SCRA by arguing that the leasing entity violated the SCRA because it did not abide by the Act's procedural limits that would have prevented franchisee's eviction while franchisee was deployed.
- **Emerging Vision, Inc. v. Sundstrom (Wisconsin Federal Court)**
  - Within 1 year of filing for bankruptcy, Franchisee transferred her franchise assets to another entity she had created a year before filing for bankruptcy. Franchisor claimed that franchisee violated the Bankruptcy Code by purposefully hindering Franchisor.
  - The court found that franchisee didn't know she was in violation of the act, and therefore did not have the *intent* to hinder required by the Code.

- This impacts whether a debt can be discharged in a bankruptcy, as well as whether certain assets transferred within a period of time before bankruptcy can be pulled into the bankruptcy.
- **Minnesota Franchises Act and Attorney's Fees: Sellner v. Patterson (Kansas Federal Court)**
  - To obtain an award of attorney fees, a Franchisee is required to seek and recover relief under the Minnesota Franchises Act (MFA).
  - A Franchisee's request for attorney fees from the court under the MFA was denied after the jury found that the Franchisee had been terminated without good cause by a Manufacturer, but failed to award attorney fees under the MFA.
  - The jury awarded the Franchisee \$288,000 in compensatory damages for the manufacturer's breach of contract. However, the jury wrote "zero" in the space provided for the amount to compensate the Franchisee for violation of the MFA.
  - The Court held that the jury's findings of a breach of contract, but no statutory violation under MFA, were not conflicting results. Reasonably, the jury could have decided that all of the franchisee's damages were attributable to the breach of contract and not the statutory violation.
- **Award of Attorney Fees to Successful Parties: Best Western Int'l, Inc. v. Patel (Arizona Federal Court)**
  - Under an Arizona statute, courts have the authority to award the successful party reasonable attorney fees. The statute defines a party as successful if it obtains a judgment for an amount in excess of the setoff or counterclaim amount.
  - Franchisor brought suit against the Franchisee alleging that it breached the franchise agreement by failing to pay for goods and services and continuing to use the Franchisor's trademark after termination of the Franchisee.

- Franchisee responded with a counterclaim that Franchisor had breached the agreement and the duty of good faith and fair dealing that Franchisee's own actions were excused because of Franchisor's breach.
  - The jury returned a verdict of each party on their respective claims:
    - \$25,272 to the Franchisor for the Franchisee's breach;
    - \$34,646 to the Franchisee for Franchisor's breach;
  - An additional \$445,000 to Franchisee for Franchisor's breach of the duty of good faith and fair dealing.
  - Although both parties were successful on their claims, the Franchisee had a higher net judgment than the Franchisor and had obtained a judgment for an amount in excess of the setoff or counterclaim allowed, the requirement under the statute to award attorney fees to the successful party. Given these circumstances, the Franchisee was awarded attorney fees.
- **Starbucks Owes Baristas Over \$100 Million Dollars in Back Tips: Chou v. Starbucks Corp. (California)**
    - Starbucks baristas have just won a class action settlement for over 100 million dollars in back tips from Starbucks.
    - Baristas claimed that the Starbucks practice of allowing shift supervisors to share in the tips earned by the baristas was a violation of a state law that prohibits managers and supervisors from sharing in employee tips.
    - Attorneys for Starbucks are planning an immediate appeal calling the court's decision "unfair" and "beyond all common sense and reason."
  - **Jury Trial Waiver: AAMCO Transmissions, Inc. v. Baker (Pennsylvania Federal Court)**
    - A district court in Philadelphia granted a Franchisor's motion to strike the Franchisee's jury demand when it was clear that Franchisee had knowingly and voluntarily waived his right to a jury demand under a waiver clause in the franchise agreement.

- Although the court considered that the Franchisee might not have had equal bargaining power as compared to that of the Franchisor, the Court found no gross disparity of an imbalance of power.
- The court found that the Franchisee had a high level of sophistication, that he carefully investigated this business opportunity and still decided to waive his right to a jury trial in the agreement in order to pursue the opportunity.
- **Proper Notice of Arbitration: Choice Hotels Int'l. v. SM Property Management (Fourth Circuit Court of Appeals)**
  - A Franchisor terminated its Franchisees, a property management company and its two principals, and filed a demand for arbitration.
  - The Franchisor and the Arbitration Association sent copies of the demand and hearing notices to addresses the Franchisor kept on file. Franchisees maintain these addresses had been vacated at time these documents were sent, and that Franchisor and the Association failed to send the notices to the address of the Franchisee's Designated Representative, as contractually specified in the Agreement between the Parties with regard to arbitration.
  - An arbitration award was granted to the Franchisor, but a federal district court vacated the award on the grounds that the Arbitration Notice was not properly sent to the Franchisee's Designated Representative, even though the Termination Notice was properly sent to the address of the Representative, indicating that the proper address was known to the Franchisor. Franchisor was in violation of the arbitration notification clause in the Franchise Agreement.
- **The Requirement to Mediate: R&F, LLC v. Brooke Corp. (Kansas Federal Court)**
  - When Franchisor and Franchisee included a mandatory mediation provision in the franchise agreement, a Kansas court required the parties to undergo mediation prior to the filing of any litigation, even though the

Franchisee maintained that any mediation would constitute a “hollow exercise.”

- The argument that mediation is futile is of no consequence when a franchise agreement includes a mandatory mediation provision.
- **Tying Claims Against Franchisor: Schlotzsky’s v. Sterling Purchasing and National Distribution (Fifth Circuit Court of Appeals)**
  - The US Court of Appeals in New Orleans found that the owner of Schlotzsky’s deli restaurant system did not engage in the unlawful practice of tying by requiring its Franchisees to contract with one of two distributors for their branded, proprietary products as a condition for continuing to do business in the franchise system.
  - Under the Sherman Act, a tying arrangement is considered unreasonable when the party that imposed the tie has economic power over the tying product that would noticeably restrain free market competition for that product.
  - The Court held that Schlotzky’s conduct was not an exercise of market power, but contract power and that ultimately, Schlotzky’s actions were based on the good faith belief that use of these distributors would lead to economic prosperity for the Franchisees.
- **Nonpayment of Franchise Fees: Dunkin’ Donuts Franchised Restaurants LLC v. Cardillo Capital, Inc. (Florida Federal Court)**
  - When a donut shop Franchisee failed to make required payments under five franchise agreements, the Franchisor was entitled to summary judgment on the breach of contract claims after Franchisor presented evidence that breaches had occurred and Franchisee filed no response to Franchisor’s motion for summary judgment.
  - Franchisee claimed that Franchisor had waived its breach of contract claims by continuing to accept franchise and advertising fees pursuant to the agreements.
  - The amount of these fees accepted by the Franchisor fell far short of the type of conduct that was necessary to establish waiver by the Franchisor



of its rights to timely payments and non-use of trademarks after termination.

- Finally, the parties had agreed in their franchisee agreements that such conduct on the part of the Franchisor would not constitute waiver.
- **Fraud Evidence Disallowed: Cottman Transmission Systems, LLC v. Kershner ( Pennsylvania Federal Court)**
  - Franchisee claimed that franchisor made untrue representations in its UFOC regarding the past success of its franchises to persuade potential franchisees to pursue its franchise.
  - However franchisees were not allowed to use evidence of the misrepresentations because the franchise agreement stated that franchisees were not relying on any representations made outside of the agreement.
  - The court ruled that the parole evidence rule prevented introduction of extrinsic evidence of fraudulent inducement or misrepresentation. The claims of misrepresentations of past success of franchisees made in the UFOC were found barred because they alleged fraud in inducement, not fraud in the execution of the agreement. Fraud in the execution occurs when the person signing a document is deceived about what he is signing. Fraud in the inducement occurs when the person knows what he is signing but is deceived into signing by misrepresentations made by another as to relevant facts. Further, the franchisees could not show justifiable reliance on the statements because the merger clause in the franchise agreement said the franchisees were not relying on any representations outside the contract. This meant that any documents or statements existing before the franchise agreement was signed do not count, because the merger clause says you are relying only on what is in the franchise agreement itself.

- **Westerfield, et al. v. The Quizno's Franchise Company, LLC, et al. (Wisconsin Federal Court)**
  - A group of Franchise owners filed a class action asserting several claims. Franchisees first claimed fraud in the inducement, claiming that Franchisor purposefully misled them as to the likelihood of the success of the franchises. On November 5, 2007, the court dismissed the Franchisees' claims. The court noted that the agreement made express disclaimers stating that franchise salespersons were not authorized to provide information about potential success and that financial results would likely differ from figures presented. The agreement also contained an integration clause, stating that Franchisor would not be liable for any oral representations or commitments made before the agreement was signed. The agreement also contained acknowledgements by Franchisees that Franchisee should read the agreement carefully, that the business involved substantial risks, that no warranty as to the success of the business was given, and that no representations or communications outside of the document are binding. These acknowledgements were placed above the parties' signatures.
  - In April of 2008, the judge allowed the franchisees' motion to amend the complaint, now due in late May and reinstated their fraud claims. The franchisees will introduce new evidence to prove their claims. One such piece of evidence attempts to show that Franchisor had a written policy for its representatives instructing them that, on an acknowledgement form that asked what information Franchisees had received aside from the UFOC disclosures, they should tell Franchisees to write "none."
- **The Meaning of "Franchise" under the Minnesota Franchises Act: Dunn v. National Beverage Corp. (Minnesota)**
  - A federal bankruptcy court in Kansas ruled that a Purchaser of an automobile consulting business opportunity failed to prove that the opportunity was a "franchise" as defined by the Minnesota Franchises Act.

- While the Court found that the purchaser was granted the right to use the seller's name in the advertisement of his business, the first prong of what constitutes a franchise under the Act, the Purchaser was unable to convince the Court that the other two requirements, the "community of interest" and "franchise fee," were met.
  - Community of Interest:
    - The Purchaser contended that a community of interest was present because the Purchaser would have to pay the seller a fee each time he used its vehicle research and locator service. The Court held that such an arrangement did not necessarily establish the required level of community of interest.
    - Specifically, the contract didn't require Purchaser to use the locator service nor prohibit him from using another service.
    - The purchaser's obligation to use the service was not contingent on that locator service actually producing a sale for the Purchaser.
  - Franchise Fee:
    - Although Purchaser was required to pay seller an initial fee and a continuing annual fee to renew certain software and rebate schedules, the Court found that there was nothing about those payments that granted the Purchaser the right to enter into a business under their agreement, it only called for Seller to provide the Purchaser with certain materials and services.
    - The agreement didn't indicate that Purchaser was obligated to use Seller's services or that Seller had a right to control Purchaser's business.

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