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Franchise Relationships Beyond the Contract

By Kevin Adler

Adapted from a keynote presentation by Greg Nathan, managing director of the Franchise Relationships Institute (Brisbane, Australia), at the 32nd Annual American Bar Association Forum on Franchising in Toronto, Canada, on Oct. 14-16.

Franchising creates a relationship — a personal relationship — between a franchisor and a franchisee. This is an obvious statement, but it's easily forgotten or underestimated, especially during the daily challenges of managing a franchise system.

Attendees at the 32nd Annual ABA Forum on Franchising were given a timely reminder of the importance of relationships in franchising during a keynote presentation by Greg Nathan, managing director of the Franchise Relationships Institute (Brisbane, Australia). He presented strategies for improving the franchisor-franchisee relationship, gained from the Institute's more than 20 years of research and consulting in the field.

"While the global culture of franchising has been largely defined and shaped by legal frameworks, particularly in the U.S., the relationship between a franchisor and its franchisees is influenced by a range of factors which go beyond legal contracts.

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CA Tells Franchisees to Withhold 7% from Franchisor Royalties

By Dirk Giseburt, Rochelle Spandorf and Jaymee Castrillo

On the heels of the New York State Department of Taxation and Finance's recent move to require annual information returns from franchisors to help the state catch New York franchisees who underreport sales taxes, the California Franchise Tax Board (the "FTB") recently told California franchisees to begin withholding 7% of all lease and royalty payments to out-of-state franchisors ("Nonresident Franchisors") that exceed $1,500 per calendar year. In a Sept. 24, 2009 memorandum, the FTB explained franchisee withholding responsibilities and directed California franchisees to begin paying withheld amounts to the state if their Nonresident Franchisor is not qualified to do business in California.

The FTB's directive is straightforward, but there is more than meets the eye. California's apparent goal is to induce all Nonresident Franchisors to qualify to do business in California and begin filing state income tax returns. Nonresident Franchisors, forced to choose between qualifying to do business in California or accepting a 7% withholding of fees by their California franchisees, are scrambling to figure out which option leaves them better off. Not surprisingly, franchise organizations, like the International Franchise Association, are openly questioning the FTB's authority to impose the unorthodox withholding requirement.

Background/Legal Basis

The FTB's Sept. 24 memorandum tells franchisees: "If you pay California source income to nonresidents of California, the FTB wants to make you aware that unless certain exceptions apply, you must withhold and send to FTB seven percent of all payments that exceed $1,500 in a calendar year. (Revenue and Taxation Code Section 18662)"

The implementing FTB regulations require withholding "in the case of rentals or royalties for use of, or for the privilege of using in the State, patents, copyrights, secret processes and formulas, good will, trademarks, brands, franchises,

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and other like property of such intangible property having a *business or taxable situs*" in California. Cal. Code Regulations § 18:18662-2 (emphasis added). Section 18:17952(c) of the Regulations goes on to provide that intangible personal property (such as a franchise license) has a business or taxable situs in California if: 1) the intangible property is employed as capital in California, or 2) possession and control of the intangible property is "localized" in a business, trade, or profession in California based upon its substantial use in California.

There is no clear standard for when an intangible asset like a franchise license qualifies as being "employed as capital" in California or "localized" with a California business. Often cited as authority on this issue is *Rainer Brewing v. McCogan*, 94 Cal. App. 2d 118 (1949), which involved a California trademark licensor and a Washington licensee. *Ranier Brewing* held that the business situs of intangible property is the licensor's domicile or principal place of business and, on that basis, subjected the California licensor to state income tax on royalties paid by the Washington licensee. The recent FTB withholding directive involves the opposite facts (Nonresident Franchisor and California licensee) to those in *Rainier Brewing* (California licensor and Nonresident franchisee), which should mean, following *Rainier Brewing*'s logic, that the business situs of a Nonresident Franchisor's intangible property is outside of California and, therefore, not subject to California withholding.

Dirk Giseburt is a tax partner in the Seattle office of Davis Wright Tremaine LLP. **Rochelle Spandorf**, a member of this newsletter's Board of Editors, is a partner and **Jaymee Castrillo** is an associate in the firm's Los Angeles office, where they represent franchise parties in franchise regulatory and transactional matters.

The FTB's published guidance, FTB Publication 1017, offers no answers; it addresses the obligation for withholding only with respect to royalties paid for the use of natural resources located in California or personal services performed in California. In light of the new withholding instructions, Nonresident Franchisors and their California franchisees have, at best, confusing guidance from the FTB on how to determine if a franchise license has acquired a business situs in California requiring a California franchisee to withhold a portion of the fees payable to the Nonresident Franchisor.

Some commentators suggest that the FTB's recent withholding directive rests implicitly on the idea that a franchisor's intangible property exists in the locations where franchisees operate. In speaking with the FTB's legal staff in preparing this article, we were told that is not the FTB's perspective. (The FTB informed us that staff member Mike Bailey of the FTB's Withholding Services, 916-845-4806 will answer questions about California's new withholding instructions. We spoke with others at the FTB in preparing this article.) The FTB informally explained that the withholding requirement is not based on the situs of the intangible franchise license being in California, but on the more general premise that the franchisee's payments are California source income since the payments come from California franchisees. Taxing California source income is not a new concept. However, using withholding to collect the Nonresident Franchisor's California tax liability is novel in the franchise context and may be unprecedented among the states.

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Whether the FTB will be able to defend its authority to impose the withholding requirement in the franchise context, given the narrowly written regulations, remains an open question. Nonresident Franchisors may argue that the regulations control and that a "business situs" must exist in each taxpayer's individual case to justify withholding.

Should Franchisees Comply with Withholding Instructions?

With this uncertain background, Nonresident Franchisors might be tempted to tell their California franchisees not to comply with the FTB's directives and offer to indemnify the franchisees in any enforcement proceedings. On this point, FTB Publication 1017 states at Section 15: "If the withholding agent is certain that an intangible asset has acquired a California business situs, withholding is clear. If the status is not clear, the withholding agent is not required to withhold."

We do not know yet what enforcement efforts may be in the offing. The potential for penalties and the cost of legal proceedings are not trivial. Therefore, we do not recommend that Nonresident Franchisors encourage their California franchisees to disregard the FTB's memorandum.

Mismatch Between Withholding and Income Tax Liability?

Even if one assumes that a franchise license granted by a Nonresident Franchisor to a California franchisee has acquired a business situs in California, the 7% withholding rate may result in "over withholding." The business situs standard does not govern the amount of a taxpayer's income tax liability. Instead, via the Uniform Division of Income for Tax Purposes Act ("UDITPA"), California provides a formula apportionment method to determine the amount of a taxpayer's California tax liability. The net income allocated to California could be substantially less than the gross royalties received from California franchisees. Indeed, the formula could in some cases produce zero California taxable income. In these cases, submitting to California income tax filing requirements may be an attractive alternative to withholding.

Tax Implications of Qualifying as a Foreign Corporation in California

If a Nonresident Franchisor chooses to qualify to do business in California ("Qualified Franchisor"), the franchisor is subject to California's minimum tax of $800 and must file a California income tax return. Withholding by franchisees is not required when a franchisor qualifies to do business in California. California's current UDITPA formula looks at sales, property (excluding the value of the intangible franchise), and payroll, with double weight being applied to the sales factor, to compute the California income of taxpayers subject to tax in multiple states. (In 2011, the state will begin permitting taxpayers to elect to use a single-factor sales formula.)

At the moment, the middle course may be the best option available to Nonresident Franchisors.

For sales-factor purposes, California treats royalties paid by California franchisees as part of the franchisor's California sales factor only if the franchisor is "taxable" in California. Cal. Code Regulations § 13:25137-3(b)(2)(B).

The sales factor rule raises the question of whether a Qualified Franchisor with no physical presence in California must pay California income tax. California courts and the U.S. Supreme Court have not taken a clear position on whether there is a physical presence standard for state income tax nexus purposes. *See Quill v. North Dakota*, 504 U.S. 298 (1992) (physical presence required for imposing sales tax collection duty on remote sellers). In fact, the FTB's current audit manual states, "the case law is still developing in this area." The FTB may be getting ready to litigate the claim that a Nonresident Franchisor creates a "substantial nexus" with California by granting a franchise right to a California franchisee. Given California's economic problems, it should surprise no one if the FTB takes a more aggressive approach to income tax nexus.

Even if nexus is conceded and a Nonresident Franchisor's royalties paid by California franchisees are allocated to California, the net income tax at California's top corporate tax rate (8.84%) may be significantly less costly than the withholding against gross franchise royalties and rentals at 7%.

Conclusion

Nonresident Franchisors should review their own tax situations carefully before making any decision regarding the FTB's withholding directive. Most Nonresident Franchisors will find that allowing withholding will cost them more than qualifying to do business as a foreign corporation. Fighting withholding based on the FTB's lack of regulatory authority is best approached through an organized, collective effort. A middle course, registering as a foreign corporation to do business in California, buys Nonresident Franchisors time to develop a tax strategy that takes into account nexus and apportionment considerations and allows for measured responses to new developments in the FTB's enforcement position. At the moment, the middle course may be the best option available to Nonresident Franchisors.

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Relationships

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A contract may signify the presence of a relationship, but the contract is not the relationship," said Nathan. "The franchise relationship actually exists independently of the legal contract in another form, a type of 'psychological contract,' defined in this context as: 'A set of beliefs or expectations around the reciprocal obligations of franchisees and franchisors.'

"Relationships also have the power to create or destroy — in business and in life. The quickest and surest way to wreck a marriage or make a sports team, business partnership, or organization vulnerable to failure is to create an environment of poor communication, conflict, and mistrust."

Attorneys are expert at putting everything that could affect the franchisor-franchisee relationship in writing. Legal documents protect the rights of franchisors or franchisees and ensure that decisions do not expose the parties to unnecessary risk, said Nathan.

Yet, although legal documents are crucial in franchising, they do not capture everything that is at stake. "It is in not writing down or discussing our most important mutual obligations that make them so important and powerful as agents of influence," said Nathan. "'They should have known better!' we say when someone breaks their part of a psychological contract. This, often unfounded, assumption that people understand what they expect from each other in their relationships, is the cause of much confusion, disappointment, and conflict in relationships, including the franchise relationship. In other words, the franchise relationship includes franchisors and franchisees meeting a set of implied or implicit obligations that are not written into the franchise agreement."

The Institute's research shows that franchisee satisfaction and business performance in franchise networks are influenced as much by elements of the psychological contract as by legal contracts or commercial factors. Franchisees look for franchisors who "have integrity, are concerned for their success, and are competent to run things," said Nathan.

Solutions to Conflict

Unfortunately, when a franchisee and franchisor reach a disagreement, each side has a tendency to contact attorneys. The attorneys focus on the written agreement and relevant law to protect the rights of their client — quite sensible actions, but not necessarily the best way to arrive at a solution. "An inherent dilemma here is that lawyers traditionally encourage their clients to take a defensive stance and prove their position is right, which, of course, makes the other party wrong," said Nathan. "This 'rights-based paradigm' can exacerbate an already strained franchise relationship, even if this is not the intention."

To avoid having difficult situations get out-of-hand, Nathan suggested a series of steps that franchisors can take to improve communications, demonstrate leadership, strengthen the culture of the system, and select good franchisees. Among the highlights:

- Reduce stress. In one in-depth survey of 890 franchisees, the Institute found that the largest number of them said that they bought a franchise in order to improve their work-life balance (31%) and many said that their motivation was having greater control of their work environment (15%); by comparison, building wealth was the primary motivator for

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Kevin Adler is the associate editor of *LJN's Franchising Business & Law Alert*.

Of Course, It's Personal

Greg Nathan shared this anecdote during his keynote presentation at the 32nd Annual American Bar Association Forum on Franchising:

"Early in my consulting career, I was approached by the franchisor president (we will call him George) for advice about a franchisee who was threatening to sue his company for misrepresentation. The franchisee's business had never reached break even, and after two years of trading losses and royalty payments not being made, the franchisor decided to terminate the franchise agreement. George told me his company had done everything they could for the franchisee, and he could not understand why this person was threatening to sue.

"I phoned the franchisee, explained that George had told me about his predicament and that I was interested to know what had gone wrong and how he was coping. Toward the end of the conversation he said to me, 'You know Greg, I really appreciate you calling and talking with me about this. The thing that has really upset me and my family about this whole situation is that George has not even called or spoken to us to say he is sorry about us losing the business.'

"I recounted these comments to George. His response surprised me. He said, 'It's not as if it's personal.'

"A principle in franchising is that to a franchisee who invests his money, his personal pride, and his sense of purpose into a franchise, it is extremely personal. B[ecause] the franchisor [was] not showing empathy for his loss, this franchisee felt the franchisor had violated the psychological contract (though he would not have expressed it in this way). The legal posturing was primarily a way to bring this sense of personal injustice to the attention of the franchisor."

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COURT WATCH

By Alexander Tuneski

Insurance Agencies Closer To Qualifying As Franchises In Michigan

In *Bucciarelli v. Nationwide Mutual Ins. Co.*, 2 Bus. Franch. Guide (CCH) ¶14, 200 (E.D. Mich. 2009), the Eastern District of Michigan declined to rule as a matter of law that the Michigan Franchise Investment Law (the "MFIL") did not apply to insurance agency contracts, deviating from precedents set by courts in other jurisdictions and setting the framework for future decisions that could have a lasting impact on the insurance industry in the state. The plaintiff, Rick Bucciarelli, was the sole owner of an insurance agency, Rick Bucciarelli and Associates. Bucciarelli signed an Independent Contractor's Agent Agreement with Nationwide Insurance in which he was entitled to sell insurance and financial products offered by Nationwide and its affiliates.

Several years after entering the agreement, Nationwide offered loans to its insurance agents through one of its banking affiliates in an effort to encourage them to open additional offices and expand their businesses. Bucciarelli alleged that he was pressured to take advantage of these loans, which Nationwide represented would be waived if his agency reached certain performance targets set forth in a pro forma. After failing to meet the targets, Bucciarelli claimed that Nationwide had committed fraud by misrepresenting that the performance goals were reasonable and achievable, as the company had never performed near those rates. Moreover, he alleged that Nationwide hindered the efforts of agencies to achieve the goals by requiring agents to follow unreasonable and unwise marketing programs and by constantly changing the performance targets. In addition, without informing the agencies, Nationwide began selling policies directly to consumers, without using agents, which further reduced the agencies' sales and inhibited their ability to make educated business decisions. As a result, he alleged that his agency had been unable to reach the targets necessary to activate the waiver and had been unable to pay off its loans, resulting in him making interest payments to Nationwide's affiliated bank.

Because the plaintiff had failed to present evidence of who had pressured him to take the loans and to open an additional office, the court granted judgment on the pleadings to the extent that the plaintiff's fraud claim was based upon allegations that the plaintiff was fraudulently induced to do so. However, the court refused to grant judgment on the fraud claims to the extent that the claims were related to the representations made in the pro forma statement, because the court could not determine whether the representations in the pro forma were related to future promises, which may have not been fraudulent, or were representations made about existing, verifiable facts.

In addition to the common law fraud claims, Bucciarelli asserted that Nationwide's actions constituted deceptive practices under the MFIL. Nationwide argued that as a matter of law, the MFIL never covers insurance agency agreements — and that even if it did, it would not cover the agreement in this case. Nationwide noted that decisions in Florida, Illinois, Missouri, New Jersey, New York, and Virginia have held that franchise laws in those states are inapplicable to the insurance industry.

Because no Michigan cases directly addressed the question and the MFIL did not provide a categorical exception for insurance contracts, the court refused to conclude as a matter of law that the MFIL did not apply to insurance contracts. Instead, the court went through each of the three elements of the definition of a "franchise" under the MFIL to determine whether the statute applied to the insurance agreement at issue.

The first element of a franchise under the MFIL is that the franchisee is "granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor" (MCL 445.1502). Adopting an argument that had been successful in Illinois cases, Nationwide argued that the plaintiff could not meet this element of the definition because previous Michigan cases had established that insurance agents are mere order takers, while the insurer actually owns and sells the policies. Because the legal definition of the word "offer" would require a contract to be consummated if the offer was accepted, Nationwide argued that insurance agents could not be considered as offering insurance policies, because a contract would not be formed if an offer was accepted.

The court rejected this argument and criticized the Illinois decisions for ignoring part of the language of Illinois' own statute. The court noted that if the legal interpretation of the word "offering" was used, the word "selling" would then be duplicative. The court concluded that the words were not intended to be redundant, and it chose a broader and less technical interpretation of the word "offer": to "refer to making goods or services available in a practical rather than a legal sense." As a result, the court concluded that insurance agents soliciting orders for insurance coverage were offering goods and services, satisfying the first element of the definition of franchise.

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The second element of a franchise under the MFIL is that the "franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate." Nationwide did not argue that the plaintiff failed to meet this element of the definition.

The final element of a franchise under the MFIL is that the franchisee "is required to pay, directly, or indirectly, a franchise fee." Under the statute, a franchise fee is defined to include a fee or charge that a franchisee must pay "for the right to enter into a business under a franchise agreement, including but not limited to payments for goods or services" (MCL 445.1503(1)). Payments for goods, equipment, or fixtures at a bona fide wholesale price are excluded from the definition. The court noted that the Independent Contractor's Agreement did not require the plaintiff to pay money or interest for the right to enter the business. The plaintiff, however, claimed that before entering into the agreement, he was required to pay a franchise fee of $12,900 for four-year-old office furniture and $3,000 for four-year-old computer equipment as a condition of having policies assigned to his agency. Though the court doubted that the plaintiff would be able to offer evidence to support this claim, the court refused to grant judgment on the pleadings on the issue, preferring to see whether the facts supported that he had been required to purchase excessively priced furniture and equipment. Accordingly, the court denied Nationwide's motion to dismiss the MIFL claim.

The decision by the court to conclude that an insurance agent's offer of insurance policies could qualify as a franchise under MFIL is a significant departure from the conclusions reached by other courts facing similar facts. Though it is not clear whether a franchise fee was actually assessed, the decision suggests that it is possible that insurance agencies, under certain conditions, could fall within the purview of Michigan's franchise laws.

Employee Statements Viewed As Franchisor Representations

In *Kiddie Academy Domestic Franchising LLC v. Faith Enterprises DC, LLC, et al.*, 2 Bus. Franch. Guide (CCH) ¶14, 185 (N.D. Md. 2009), a federal district court considered whether the comments by a franchisor's employee concerning a pro forma created by a former franchisee fraudulently induced a franchisee to purchase a franchise. Kiddie Academy, the plaintiff, sued a franchisee and its affiliates for breach of contract after the defendants had failed to pay royalties on two franchises that they had purchased from an existing Kiddie Academy franchisee. The defendants counterclaimed that Kiddie Academy fraudulently induced them to enter into franchise agreements and made negligent misrepresentations.

When the defendants were investigating whether to purchase two existing franchises, they were provided a pro forma statement from the transferring franchisee, which they believed represented the current financial condition of the franchise. The defendants forwarded the pro formas to Kiddie Academy's chief development officer and asked whether the figures were accurate. The Kiddie Academy employee responded that "they look okay to me"; and in a later conversation, the employee informed the purchasers that the profitability of the centers was "in the mid to high teens." The defendants asserted in their counterclaim that these representations fraudulently induced them to purchase the franchise.

To succeed on a fraudulent inducement claim, the defendants were required to show that Kiddie Academy made a representation, which it knew was false or made with reckless indifference to the truth, and which it made with the intent to defraud the defendants. In addition, the defendants needed to prove that they justifiably relied on the misrepresentation and had suffered compensable injury as a result.

Considering the first elements, the court held that a reasonable jury could conclude that Kiddie Academy had made a false representation, because Kiddie Academy adopted the documents when its employee reviewed them and represented that they looked acceptable. Kiddie Academy claimed that because its employee had no knowledge of the financial health of the two franchises and was not responsible for reviewing their financial statements, he could not have knowingly made false statements regarding the pro forma statements. The court rejected this position because the chief development officer had knowledge of Kiddie Academy franchises, Kiddie Academy had financial statements from the former franchisees that contradicted the information in the pro formas, and there had been time for the employee to check the accuracy of the pro formas. As a result, the court held that a reasonable jury could find that the employee had knowingly or recklessly and indifferently made a false statement, and such statement was attributed to Kiddie Academy.

Turning to the defendants' reliance on Kiddie Academy's statements, the court focused on the fact that the defendants had been given by the transferring franchisee other profit-and-loss statements and income tax returns that contradicted the pro formas. The court concluded that despite Kiddie Academy's statements approving the pro formas, the conflicting documents put the defendants on notice of possible deception. Consequently, the defendants could not have justifiably relied on Kiddie Academy's statements, and

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NEWS BRIEFS

FTC Issues New Rules On Endorsements and Testimonials

On Oct. 5, the Federal Trade Commission approved final revisions to the guidance it gives to advertisers on how to keep their endorsements and testimonials in line with the FTC Act. The notice represents the first major update since 1980 to the FTC's Guides Concerning the Use of Endorsements and Testimonials in Advertising. The Guides address testimonials and endorsements by consumers, experts, organizations, and celebrities, including endorsements through blogs, social networks, and other online media.

Most prominently, the revised Guides remove the safe-harbor provision that had allowed advertisers to use consumer testimonials to make extreme performance claims, but then to state that the "results are not typical." Now, advertisers will be required to clearly disclose the results that consumers can generally expect.

Also, the revised Guides more specifically define when and how "material connections" between advertisers and endorsers must be disclosed. "While decisions will be reached on a case-by-case basis, the post of a blogger who receives cash or in-kind payment to review a product is considered an endorsement," the FTC stated. "Thus, bloggers who make an endorsement must disclose the material connections they share with the seller of the product or service."

The new guidelines have been published in the Federal Register, and they will take effect on Dec. 1. They can be found at www.ftc.gov/os/2009/10/091005endorsementguidesfnnotice.pdf.

"These new FTC Guides constitute a sea change for certain marketing practices that are widespread and effective in all industry sectors," said Anthony DiResta, attorney with Manatt, Phelps & Phillips, LLP, and general counsel to the Word of Mouth Marketing Association. "Transparency and honesty are essential in communications by consumers or experts in all media formats."

Many franchisors are using social media for branding and marketing purposes, as well as working with celebrity spokespeople. The new rules affect how franchisors and their franchisees can conduct those campaigns, leading one franchise marketer to say that franchises "had better make sure they know what their franchisees are doing online."

In a conference call to discuss the new Guides, DiResta said that marketers should check their marketing immediately to make sure that they are complying with the new rules. "As a practical matter, we're on notice now," he said. "Campaigns started even before the Dec. 1 deadline are a risk-management issue for advertisers … It would be prudent to go back and re-evaluate past campaigns." However, online campaigns that have ended will not be subject to FTC review, he said.

DiResta added that he does believe the new rules will be followed with more aggressive enforcement activity, but "the FTC staff will not be online most of the day [seeking violations of the rules]. The FTC really does listen to consumer complaints or complaints by consumer groups … And the groups concerned about abuses of social media are not shy."

McDonald's Franchisees in NJ, PA Sued By EEOC

The Equal Employment Opportunity Commission ("EEOC") filed lawsuits in September against a New Jersey McDonald's franchisee for allowing male employees to be the victims of sexual harassment by a female supervisor and against a Philadelphia-area franchisee for allowing harassment of an employee with an intellectual disability. The New Jersey lawsuit, *Equal Employment Opportunity Commission v. McDonald's USA*, Civil Action No. 09-5028, was filed on Sept. 30 in U.S. District Court, District of New Jersey (Newark). A teenager who worked in a McDonald's claimed that he was harassed by a female manager when he was 16 and 17 years old.

The Philadelphia lawsuit, *Equal Employment Opportunity Commission v. McDonald's USA*, Civil Action No. 09-4347, was filed on Sept. 24 in the U.S. District Court for the Eastern District of Pennsylvania against Alstrun LLP, which operates five McDonald's franchises in Pennsylvania. It was filed on behalf of Timothy Artis, who claimed that he was repeatedly called degrading names and subjected to physical threats. Artis alleged that he was physically grabbed and shoved, and that he was forced to perform hazardous duties outside of his job description, such as removing a raccoon from a trash can. The restaurant failed to stop the harassment despite repeated complaints from Artis' mother, according to EEOC.

During FY 2008, disability discrimination charges filed with the EEOC rose to 19,453, an increase of 10% from the prior fiscal year and the highest number of disability charges filed in 14 years.

Roark Capital Makes First Franchise Purchase Since June 2008

Venture capital firm Roark Capital added its 15th franchise system by purchasing Pet Valu in September for about $131 million. The deal represents Roark's first franchise purchase since the acquisition of Primrose Schools in June 2008. Pet Valu is described as "Canada's leading small-format specialty retailer and wholesale distributor of pet food and supplies." The company generates C$230 million in system sales across 356 franchised and corporate stores in Canada (295 stores in Ontario and Manitoba) and the United States (61 stores in Pennsylvania, New Jersey, Maryland, and Virginia).

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Movers & Shakers

Matthew J. Kreutzer joined **Armstrong Teasdale LLP** as a partner in its Las Vegas office, effective Sept. 28. He was formerly with Holland & Hart LLP and, prior to that, with Hale Lane. Kreutzer has contributed numerous articles to the "Communique" newsletter, an official publication of the Clark County (NV) Bar Association. "Nevada is a priority for Armstrong Teasdale's continued growth and success," said Byron E. Francis, managing attorney of Armstrong Teasdale's Las Vegas and Reno offices.

Shane D. Gosdis has opened his own firm in Phoenix, specializing in franchise litigation. He has launched a blog, www.fanchiselawblog.net. He was formerly with DLA Piper, where he was a senior litigation associate.

Jeffery S. Haff will be rejoining **Dady & Garner, P.A.**, in Minneapolis, effective Jan. 1, 2010. He was an associate at Dady & Garner until starting his own firm seven years ago. At Dady & Garner, Haff will represent franchisees, dealers, and distributors.

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Court Watch

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their fraudulent inducement claim could not succeed.

Similarly, the conflicting tax returns undermined the defendants' negligent misrepresentation counterclaim, which also required the defendants to have justifiably acted in reliance on the plaintiff's misrepresentations. The result was a summary judgment in favor of Kiddie Academy for its breach of contract claim.

Though ultimately, the defendants' counterclaim was unsuccessful, the case is a significant example of how an employee's statements can be construed as a representation by the franchisor. Had the defendants not been provided with contradictory information in their investigation, their reliance on the pro formas that had been tacitly approved by Kiddie Academy could have resulted in a successful counterclaim and a successful affirmative defense against the breach of contract claim.

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Relationships

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only 22%. "This goes against the accepted wisdom that franchisees are only interested in making money," he observed. "It is also a reminder for franchisors not to underplay the realities of long hours and hard work when building a business as this may lead to later disappointment and resentment, factors that can only demoralize a franchisee and undermine their performance." The solution, Nathan suggested, is to monitor the stress that franchisees are facing and to make sure that the franchisor's staff is available to help franchisees achieve work-life balance, even in the context of working hard.

- Manage change. Change is inevitable in the business world, but franchisors and franchisees often see a system change very differently, said Nathan. A franchisor is choosing to make the change, whereas the franchisee is being told to change. Therefore, to get franchisees to react positively to change, franchisors need to communicate in advance about the need for the change and the benefits that it will bring. They must respond to franchisees' questions about the change, not brush them off as irrelevant. They should conduct pilot programs and tests so that they can ensure a smooth rollout. And they should not assume that silence on the part of franchisees is acquiescence to or agreement with the change.
- Monitor profitability. It's been long assumed that profitable franchises are happy franchises. The Institute's data bear this out — to some degree. But the inflection point where a franchisee's satisfaction is significant seems to be in the upper 40% of revenue for the system, which means that mid-range performers are not much more satisfied than low performers. Nathan recommended starting by benchmarking franchise performance and sharing that information throughout the network (backed by coaching and support), so that moderate and low performers can improve.

"Healthy franchise relationships and franchisee satisfaction [are] linked to financial performance," Nathan concluded. "The data also show that franchisee satisfaction is influenced by a range of other factors, especially confidence in leadership, optimism for the future, and a sense of natural justice."

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