LJN's
Franchising Business & Law Alert®

LJN Law Journal Newsletters

An ALM Publication

Volume 19, Number 4 • January 2013

Impact of Private Equity on Franchising

Observations from Industry Leaders

As 2013 begins, franchising is being transformed by major investments in franchise systems by private equity funds. *FBLA* asked leading franchise attorneys how they see private equity affecting the industry, and their responses reflect widespread optimism that these investors are bringing much more than (the widely appreciated) funding that can fuel franchise expansion. With their focus on investor returns, private equity investors can help franchises to define their strategies more carefully and to be relentless in seeking to improve profitability. However, these benefits come at the price of a loss of independence that can be especially hard for founders of franchise systems who have accepted private equity ownership.

Most Influential Force in Franchising Today

David Koch, Plave Koch PLC

In 2012 alone, our firm has worked on eight private equity deals, mostly on the buyer side, and we sponsored two private equity conferences in New York. The most interesting thing we've seen is how private equity has learned to zero-in on the real value factors in franchise systems — unit-level economics and the quality of the franchise relationships. One deal blew up because the fund could not get comfortable with the brand's largest franchisee. Has it affected franchising? I would venture to say that it's the most influential force in franchising today.

Benefits Include Greater Experimentation

Craig Tractenberg, Nixon Peabody LLP

I believe that investments which keep franchise companies private benefit the companies and their consumers. Public companies are compelled to meet earnings calendar earnings targets to satisfy their many investors. Public companies will play to the analysts to meet those targets and engineer their balance sheets. Private companies need only satisfy a smaller number of investors, allowing more daring and diverse strategies executed in the privacy. Mistakes are allowed and are not magnified in the media with private companies — which allows for greater experimentation.

continued on page 2

Supreme Court Upholds Mandatory Arbitration in Employment Contract

By Kevin Adler

Proponents of mandatory arbitration clauses were given a victory in November when the U.S. Supreme Court vacated a decision by the Oklahoma Supreme Court in which the Oklahoma court had ruled that an employment non-compete agreement could be reviewed by a state court, despite an arbitration requirement in an employment contract. In *Nitro-Lift Technologies, L.L.C. v. Howard*, No. 11-1377, the Court issued a *per curiam* opinion on Nov. 26, 2012 and remanded the case back to Oklahoma.

"State courts rather than federal courts are most frequently called on to apply the Federal Arbitration Act ("FAA"), 9 U.S.C. 1 *et seq.*, including the Act's national policy favoring arbitration. It is a matter of great importance, therefore, that state supreme courts adhere to a correct interpretation of the legislation," wrote the Court. "Here, the Oklahoma Supreme Court failed to do so. By declaring the non-competition agreements in two employment contracts null and void, rather than leaving that determination to the arbitrator in the first instance, the state court ignored a basic tenet of the act's substantive arbitration law. The decision must be vacated."

continued on page 6

In This Issue

PERIODICALS

Private Equity

continued from page 1

Equity Firms Possibly Become Franchisors

Gregg Rubenstein, Nixon Peabody LLP

I think this trend reflects the maturing of franchising as a business model. While there are still plenty of examples of someone creating a business and then deciding to grow that business through franchising, I believe it will become less common going forward. Instead, we will see venture capital funds actively looking for new business concepts that they buy and then use their expertise to franchise. The switch from business concept to franchisor has traditionally been difficult, but this should make the failure rate go down as "professional" franchisors become more common. The downside is that it will also make it more difficult for small-business concepts to franchise, as the professionally driven companies will likely present a more compelling picture to prospective franchisees than the smaller mom-and-pop systems.

More Capital and Sophistication

Peter Silverman, Shumaker, Loop & Kendrick, LLP

There's a fear that equity players will seek to buy-and-flip franchises by taking short-term steps to improve net and gross numbers in ways that hurt franchisees (*e.g.*, higher fees, higher rebates, lower service, lower direct advertising, aggressive remodel requirements) or the system (*e.g.*, lower standards for bringing in new franchisees). I've seen some of this, but my guess is that it will soon be the exception rather than the rule. A short-term focus in franchising is destructive; firms that try it will soon figure out that they're just digging a hole that will take a lot of time, capital and vision from which to dig out. The only buyers they'll be able to flip to will be turn-around buyers looking to buy at a steep discount.

If equity buyers do become longer-term players, I think the development will be very healthy for franchising. It offers capital and sophistication to franchisors and multi-unit franchisee owners looking for partners or to exit.

Another consideration is that franchising as a business model is young. The entrepreneur who builds the system doesn't necessarily have the skills to maintain it or take it to the next level. Over time, a strong successor-ownership model will evolve, and I'd expect that equity investors would play a dominant role in that model.

Tougher Scrutiny from Demanding Investors

Joel R. Buckberg, Baker, Donelson, Bearman, Caldwell & Berkowitz, PC

Private equity funds and other institutional investors have been investing in franchisors since franchising's early days. They have always recognized and rewarded the predictable cash flow, scalable growth models, and high margins. What's different is the growth path. Private equity used to be a waypoint on the road to public-company status. Today, as fewer franchisors decide to go public, private equity ownership has supplanted public company financial models. Public franchisors were and are largely owned by institutions. The same institutions now invest through private equity vehicles, but the private equity fund managers are tougher on franchisor management than the public investor oversight world. They have less flexibility and more aggressive growth targets that push the limits of how far and how fast a brand can grow. That's where the difference lies.

Pros and Cons

Leonard Vines, Greensfelder, Hemker, & Gale, P.C.

The increasing control of franchise systems by investment groups has affected franchising both positively and negatively. On the positive side, since these groups provide owners a vehicle for succession and exit planning, franchising as a business model may become more desirable as investors can see a way to cash out. Conceivably, some of those who sell will devote funds to develop new, innovative concepts.

In addition to providing necessary funds for expansion, private equity groups can bring skilled expertise

continued on page 3

Franchising
Business & Law Alert®

LJN'S Franchising Business & Law Alert® (ISSN 1079-6339)
is published by Law Journal Newsletters, a division of ALM.

Telephone: (877) 256-2472
Editorial e-mail: jgromer@alm.com
Circulation e-mail: customercare@alm.com
Reprints: www.almreprints.com

LJN's Franchising Business & Law Alert 023145
Periodicals Postage Paid at Philadelphia, PA
POSTMASTER: Send address changes to:
ALM
120 Broadway, New York, NY 10271

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, Pa 19103
www.ljnonline.com

ALM
An Integrated Media Company

Private Equity

continued from page 2

and a high level of sophistication. Cost-cutting measures and improved efficiencies, along with the opportunity to forge new relationships, can enhance the value of the system. The franchise can become more competitive and profitable and thereby focus on growth and innovation without the looming cloud of financial pressures. Opportunities to expand both nationally and internationally also can help the overall economy and create more jobs.

On the negative side, however, there is a risk that the culture of the franchise will change for the worse. Franchisees who once felt they were part of a benevolent "family" may feel like employees or "just a number" with little control over their destiny. If the culture changes too dramatically, many franchisees could become unhappy, which is bad not only for the system, but for franchising in general. Finally, some franchisors simply are not prepared to give up control and are not willing to accept the inevitable changes that will be made to their system.

Managing Competing Priorities

Rupert Barkoff, Kilpatrick Townsend & Stockton LLP

Private equity and venture capital funds can create interesting situations when they purchase interests in franchise system. There are at least two reasons why I say this:

First, their economic interests may be focused differently than those of the franchisees. Franchisees are in for the long haul. Investors in the franchisor typically have a shorter focus. They are more interested in what return they can earn for their investors in the short haul — perhaps three to seven years. Historical loyalty of the employees becomes less important as the new owners ask, "What have you done lately?" Culture is not as important as cash.

And that brings me to my second point. Those who purchase franchise systems do not often fully appreciate the role that franchisor-franchisee relationships play. While the franchise agreement will almost always give the thumb on the scale to the franchisor, the power that the franchisor can exercise over the franchisees is not unlimited. Franchisors typically want existing franchisees to buy more units; happy franchisees help sell franchises to outsiders. Bad-mouthing can severely damage franchise sales.

System change is not all bad. When it clearly adds to the franchisees' bottom line, it will be better received. But life seems to favor inertia rather than change. And change can often lead to the departure of long-time friends from management. A franchisor should never underestimate how important the goodwill of the franchisees can be in contributing to success.

Growth Is the Game

Jeff Baker, Burr & Forman LLP

Most franchise systems were originally built around the concept of personal investment by individual entrepreneurs who would run the franchised business as an owner/operator. Access to capital and other factors tended to keep growth rates moderate. Once franchisees started becoming large enough to attract investment by private equity funds and similar investors, we began to see a shift in the power dynamic between franchisee and franchisor. Private equity funds have the ability to put together complex capital structures that enable rapid growth, and growth is their game. In response to the potential economic threat posed by a system of very large franchisees run by investors rather than owner/operators, some franchisors have started to implement size limits on their franchisees.

Private equity funds generally prefer not to hold real estate in their portfolio companies because fee-owned real estate presents risk and valuation issues that can be difficult to quantify when calculating the fund's projected return on investment. As a result, many franchisees have found themselves in the position of pushing their operating properties into the sale-leaseback market in order to posture the business for sale. Careful attention must be paid to the assignment and change-of-control provisions embedded in such leases in order to make certain that the sale-leaseback landlord does not obtain unreasonable control rights that could limit the franchisee's ability to sell to a private equity fund or, more importantly, limit the private equity fund's exit strategy on the next turn of the company.

New Sources of Capital and Expertise

Frank Zaid, Osler, Hoskin & Harcourt LLP

The acquisition of control of franchise systems by private equity funds, venture capital funds and other types of investment groups ("investment funds") has clearly affected franchising.

First, as a result of the continuing recession, franchisors have been denied access to traditional sources of capital for system development and operations growth. Similarly, traditional lenders have withdrawn franchisee financing programs. The net result is that more franchisors lack capital resources to grow their systems, and fewer franchisee candidates can access funds to purchase franchises. Investment funds can bypass these problems by injecting funds into the franchise system and by creating more flexible franchisee financing programs.

Second, many franchise systems have reached maximum management expertise and require new investment and strategic direction for the next stage of development. In some cases, the owners are ready for succession or retirement, but do not have qualified successors. An investment fund can structure an exit strategy but also retain the owners as employees or consultants for a period of time. Franchisees will appreciate the continuity and gradual transition.

Third, investment funds often introduce new management systems, controls and reporting standards that reduce costs, improve efficiencies and enhance franchise value. While more stringent controls over franchisees may lead to some unrest, compliant franchisees usually benefit from a more tightly controlled operation.

continued on page 4

Private Equity

continued from page 3

In an era of negative growth for many franchise systems, acquisitions by investment funds have provided exits for struggling owners and relief for floundering franchisees. As in so many other business situations, timing is everything.

Change Coming for Franchisees

Gaylen Knack, Gray Plant Mooty

The invasion of private equity and other investment funds into the world of franchising has had a significant impact. While the impact has been widespread, private equity (and similar funding) mechanisms have altered the franchising landscape in three significant ways. First, it has provided a possible exit strategy for family or closely owned franchisors and some multi-unit franchisees, many of whom spent years building their businesses. Without private equity, these owners would struggle to find a successor inside or outside the family. Second, healthy prices currently being offered for franchise systems have increased pressure on buyers to improve efficiencies and drive revenue. Private equity funds with seasoned management are adept at handling these pressures while maintaining good rapport with the system's franchisees. Private equity groups new to franchising, however, may not grasp the sometimes fickle relationship with franchisees and make short-sighted decisions that alienate franchisees. Finally, as private equity and other investment funds become more active in franchising, franchisees more likely will be confronted with change. Their reaction to this environment of change likely will lead to closer scrutiny of franchisor initiatives as well as provisions in the franchise agreement that grant the franchisor discretion to implement these initiatives.

Loyalty to Fund Investors Is Third Dimension

Rochelle "Shelley" Spandorf, Davis Wright Tremaine LLP

As private equity investors pour billions of dollars into franchise companies, the overall news is good for franchising. Of course, nothing is absolute. Not all franchisees see their outcomes improve after a PE fund acquires their franchisor, not all funds do their homework and properly size up the franchise system's culture or competitive challenges before investing, and not all fund managers appreciate the difficulty of leading a collective of independent owners. But, on balance, PE funds offer system members opportunities they would otherwise never enjoy. They bring credibility to a franchise system by publicly expressing faith in the brand and capital to fund system expansion. While funds may be less tolerant of underperforming franchisees and focused on cost-savings, these measures help build brand value, attract sophisticated franchisee candidates and improve the resale market for franchise units.

No doubt, having a PE fund steward the brand adds a third dimension to the franchise paradigm: loyalty to fund investors. But professional fund managers are smart and, as they become more experienced operating franchise companies, they better appreciate the interdependence between their own and their franchisees' profitability. Funds today also invest heavily in multi-unit franchisees and understand franchising from both sides of the aisle.

What PE fund ownership may signal is that there is no longer room for "moms and pops" within the system's rank and file. System growth through "corporate" multi-unit franchisees may mean a seismic cultural shift for some franchise systems. PE funds that are insensitive to this cultural dynamic may be unprepared for managing the human element of franchising.

Franchisors Should Move Cautiously

Earsa R. Jackson, Strasburger & Price, LLP

The increasing presence of private equity funds in the franchise arena has its benefits as well as challenges. Private equity can be a godsend for a company ripe for expansion that does not have the capital to expand. Because private equity funds are so geared toward business and the bottom line, they can be useful in helping franchise systems trim down where necessary and cleaning up any loose ends on operations.

Depending on the degree to which the private equity fund involves itself in the operation of the core business, a franchise system may find that its corporate culture changes. I have heard franchise executives talk about difficulties with maintaining their own corporate identity once private equity comes to the table. Like every deal, the devil is in the details. Not all deals are created equal, just like not all private equity funds are created equal. A franchisor should take its time during the "courtship" phase to get to know the private fund before it jumps into bed with a stranger who might ultimately be calling the shots.

Positive Impact

Matthew Kreutzer, Armstrong Teasdale LLP

I think the influx of private money has affected franchising in a positive way. The private equity funds I have encountered have largely taken a "hands off" approach to management, being content to leave in place the leadership structure that has brought the franchisor to their attention. That said, the fund managers are not disinterested. Wanting to protect their investment, they closely monitor the franchisor. The franchisor's executives (many who owned their companies outright prior to the third-party investment) are faced with having to answer to a third party for their decisions, which generally results in increased efficiency and reduced expenses across the board. At the same time, these outside investors are important to the acquired franchisor, as they provide access to much-needed capital. The influx of money carries with it a number of benefits, allowing the franchisor to improve its infrastructure and to grow its system. As the system grows, franchisee businesses also tend to grow and improve with it.

Bottom-Line Perspective Extends to Litigation

Jeffrey Fillerup, McKenna Long & Aldridge, LLP

Private equity has generally had a favorable view of expected litigation/dispute resolution costs and

continued on page 8

COURT WATCH

By Darryl A. Hart

Claims to Prevent Enforcement of Arbitration Clauses

Two recent U.S. district court cases considered claims by franchisees seeking to prevent the enforcement of arbitration clauses in their contracts. *Ace Hardware Corporation v. Advanced Caregivers, LLC d/b/a/ Hialeah Ace Hardware, et al.*, Bus. Franchise Guide (CCH) ¶14,935 (USDC, N.D. Illinois, Oct. 18, 2012) was an action by Ace to compel arbitration of fraud claims brought in state court by the respondents. The respondents, apparently an entity and its owner, had signed various agreements in connection with the entity becoming an Ace Hardware store owner. At the time of their signing, the agreements used by Ace did not contain an arbitration provision. Several months after the agreements were signed by the parties, Ace notified the respondents that there was an error in the agreements concerning the address of the respondents' Ace store. Ace forwarded revised agreements to the respondents. Between the time the original agreements were signed and when the revised agreements were provided, the standard-form agreements used by Ace were modified to require arbitration of disputes between the parties to the contracts. In the cover letter to the respondents, Ace did not point out the arbitration provisions, only that the agreements now contained the correct store address. The respondents signed and returned the revised agreements to Ace.

Several years after the agreements were signed, the respondents brought an action against Ace in state court for fraud and sought class action status. Ace went to federal court and sought to compel arbitration of the claims.

Darryl A. Hart is an attorney with Bartko, Zankel, Tarrant & Miller in San Francisco. He can be reached at 415-956-1900 or at dhart@bztm.com.

The respondents attempted to prevent arbitration of their claims by alleging that the arbitration provisions in the revised contracts should not be enforced because they were unaware that they were agreeing to arbitration when they signed the modified contracts. The respondents argued that since they did not know the agreements contained an arbitration clause, there was no meeting of the minds or mutual assent to those provisions and that their inclusion resulted from mutual mistakes — Ace's mistake was sending the altered agreements, and the respondents' mistake was signing them. The respondents also attacked the arbitration provisions on the basis that they were not notified by Ace that the contract provisions were changed, that the change was the result of procedural unconscionability, and that their consent to the altered agreements was procured by fraud.

In determining whether there was a mutual mistake, the court determined that it could look only to the written agreement, not to the subjective intent of the parties; it noted that mutual mistakes are rarely found in commercial transactions between sophisticated parties. Looking at the four corners of the agreement, the court pointed out that it is basic contract law that a person who signs an agreement is presumed to know its terms and, by signing, agrees to be bound by those terms. As such, there was no mistake, either by Ace, which sent the agreements with the disputed terms, or by the respondents, whom the law presumes to have read and agreed to the contracts.

The absence of notice by Ace that the terms had been changed was of no consequence to the court since there was no duty by Ace to notify the respondents that the terms had changed. One party does not have a duty to the other party to inform that party as to what the contract says.

The court made quick work of the claim that the new contracts were not enforceable because of procedural unconscionability — where the terms of a contract are hidden in a lengthy document, hard to find, hard to read, difficult to understand, etc. The arbitration clauses in the contracts were headlined in bold print; the word "arbitrate" appeared in the relatively short agreements over a dozen times; and the provisions appeared immediately above the signature lines in the revised contracts.

While the absence of a reference to the arbitration provisions in the cover letter transmitting the new agreements to the respondents could arouse suspicion, the fact was that the respondents could have easily found the new clauses by looking over the contracts. Having the opportunity to read the contracts, which opportunity the respondents claim they did not take, defeated the fraud claim.

While never a defense, an "I should not be bound by the contract since I did not read it" claim can be somewhat appealing in a case like this. However, courts will expect the parties to an agreement, even a revision of a previously agreed to agreement, to review a contract prior to signing. Anyone who has been burned by slipped-in provisions need not be reminded of the risk of not reviewing a revised agreement prior to signing. The respondents in this matter are now members of that club.

In *Ironson v. Ameriprise Financial Services, Inc.*, Bus. Franchise Guide (CCH) ¶14,891 (USDC, D. Connecticut, Sept. 10, 2012), the plaintiff, the proprietor of a financial planning business previously affiliated with the defendant, was put to a choice: Either become an employee of Ameriprise, an alternative financially unattractive to the plaintiff, or become an Ameriprise franchisee. The plaintiff chose the latter. The franchise agreement signed by the parties contained an arbitration clause. The franchise agreement had been in effect for more than 10 years when Ameriprise sought to terminate the franchise because of the plaintiff's failure to comply

continued on page 6

Court Watch

continued from page 5

with certain account requirements. The plaintiff filed suit against Ameriprise, alleging violations of the Connecticut Franchise Act and the Connecticut Unfair Trade Practices Act. Ameriprise moved to compel arbitration. The plaintiff argued that the franchise agreement was unenforceable because it was signed under economic duress; this contractual defense, while not recognized in all states, is available in Connecticut.

Under Connecticut law, to prove economic duress, one must establish a wrongful act or threat that left the complaining party no reasonable alternative but to agree to the concerned transaction and, as a result, the victim consented to the proposed agreement, resulting in the party becoming the victim of an unfair transaction. Ameriprise had threatened to significantly change the plaintiff's current earning ability if he elected to become a direct employee, although that alternative still could have been elected.

The plaintiff claimed that the franchise agreement was a non-negotiable contract that he had to sign if he wanted to keep his clients and save what he had built in 15 years as proprietor of his business. Direct employment was less attractive and promised a lowered income. However, Ameriprise had the right to pressure the plaintiff to accept its relationship preference. The court pointed out that economic necessity or pressure is not the same as economic duress. There was no wrongful act or threat, only business alternatives which the plaintiff, a sophisticated businessman, had adequate opportunity to consider. Just as conditioning employment on an agreement to settle disputes by arbitration does not amount to economic duress, neither does requiring the signing of a franchise agreement containing such a clause by a person who had previously enjoyed a different relationship with a franchisor.

—❖—

Arbitration

continued from page 1

"The ruling affirms other rulings pertaining to the FAA," said Cullen Seltzer, partner, Sands Anderson. "It affirms that the FAA applies nationally, even though some people think that it is limited to cases in federal court or affecting interstate commerce. The FAA favors enforcement of arbitration agreements when they are [required] in contracts; if the contract is enforceable, then the arbitration clause is enforceable."

The dispute arose when two former employees of Nitro-Lift, which serves operators of oil and gas wells, left the company and began to work for competitors. The employees had signed confidentiality and noncompetition agreements with Nitro-Lift that contained the following arbitration clause: "Any dispute, difference or unresolved question between Nitro-Lift and the Employee (collectively the 'Disputing Parties') shall be settled by arbitration by a single arbitrator mutually agreeable to the Disputing Parties in an arbitration proceeding conducted in Houston, Texas in accordance with the rules existing at the date hereof of the American Arbitration Association."

Claiming that respondents had breached their noncompetition agreements, Nitro-Lift served them with a demand for arbitration. The former employees then filed suit in Oklahoma district court, which found the arbitration clauses to be invalid under state employment contract laws. Nitro-Lift appealed to the Oklahoma Supreme Court, and the company argued that any dispute about the contracts' enforceability was a question for the arbitrator, referencing *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 446 (2006) and other decisions. The Oklahoma Supreme Court upheld the district court's ruling and stated that "the existence of an arbitration agreement in an employment contract does not prohibit judicial review of the underlying agreement." Then the state supreme court found the noncompetition agreements in the Nitro-Lift contract were "against Oklahoma's public policy," and declared them to be "void and unenforceable."

In rejecting that analysis, the U.S. Supreme Court referenced *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984), which found that the FAA "declares a national policy favoring arbitration."

In other words, said Seltzer, the U.S. Supreme Court stated that Oklahoma cannot carve out a state exemption from the FAA. "The Court made clear that an arbitration provision, enforceable by federal law, will be given effect even in cases where that means a dispute concerning a non-compete provision disfavored by state law will be kept out of the state courts," he said.

The Court added further weight to its decision by rejecting a particular statutory-construction argument advanced by the Oklahoma Supreme Court opinion, Seltzer added. "The Oklahoma court had reasoned that because Oklahoma had a specific state-law provision concerning non-compete agreements, that specific provision ought to trump the general provisions of the Federal Arbitration Act, which apply to arbitration clauses generally," he said. "The Supreme Court agreed that specific statutes generally do trump general ones, but that principle only applies only to conflicts of 'laws of equivalent dignity.' Oklahoma's state law, disfavoring non-compete provisions, is an inferior law to Congress's supreme law of the land favoring the enforcement of arbitration clauses."

—❖—

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

NEWS BRIEFS

Virginia Proposes Changes To Franchise Rule

In order to harmonize Virginia's franchise disclosure regulations with those of other states, the Virginia Division of Securities and Retail Franchising has published recommended revisions to the Virginia Retail Franchising Act rules. The proposed changes would match Virginia's rules to the guidelines adopted by the North American Securities Administrators Association ("NASAA"). The changes are scheduled to come into effect on March 1, 2013, but a public comment period will be open through Jan. 15, 2013.

The proposals would require franchisors operating in Virginia to:

- Use NASAA's Guarantee of Performance form;
- File the Franchise Disclosure Document in CD-ROM format;
- Provide franchisees with copies of each "materially different" FDD used in the last three years; and
- File amendments to a franchise registration with the securities division when a material change is made (file within 30 days of the change).

Also, franchisors could not use the "seasoned franchisee" exemption if their audit report contains a "going concern" comment.

The proposed rules changes can be found at www.scc.virginia.gov/srf/s_12_40.pdf, and the rules for submitting a comment can be found at www.scc.virginia.gov/case.

Hotel Franchisee Sues for Lack of Support

A Crowne Plaza Hotel franchisee in Lenexa, KS, is suing franchisor InterContinental Hotels Group PLC ("IHG") for breach of contract in the U.S. District Court for the District of Kansas. The lawsuit, *Lenexa Hotel, LP v. Holiday Hospitality Franchising, Inc., Intercontinental Hotels Group PLC, and Six Continents Hotels, Inc.*, claims lack of promised marketing support and botched online and phone referrals after an existing hotel was converted from a Radisson to the Crowne Plaza brand in 2009.

Franchisee Stephen Craig claims in the lawsuit that he spent more than $7 million on hotel upgrades and met his contractual obligations for the rebranding. He is seeking reimbursement of his expenditures, as well as damages, attorneys' fees and interest. IHG has informed Craig that he has not met his obligations under the franchisor's Property Improvement Plan.

The complaint, provided to *FBLA* by one of Craig's attorneys, Tyler Hudson, a partner with Wagstaff & Cartmell, LLP in Kansas City, KS, states that Craig signed a 10-year franchise agreement in May 2008 after receiving assurances "through emails and in-person communications," that IHG would "market the Hotel, which is located in suburban Lenexa, Kansas, to business travelers and other potential customers as an upscale Kansas City metropolitan hotel." Lenexa is a suburb south of Kansas City.

In a statement provided to *FBLA*, IHG noted that it "is aware of the lawsuit filed in Kansas City district court by Lenexa Hotel Group and Mr. Stephen Craig. We have no further response regarding this pending litigation."

Craig alleges that IHG has favored another Crowne Plaza hotel, located in downtown Kansas City, in descriptors used for online searches and in referrals made by phone reservation agents. For example, he alleges that online listings by IHG referenced the hotel as a Radisson more than a year after it had been rebranded to Crowne Plaza. Although Craig, an experienced owner-operator of hotels, made his complaints known to franchisor executives beginning in 2009 and received assurances that changes would be made, the complaint alleges that IHG continued to promote Craig's Crowne Plaza as a Lenexa, KS, facility, rather than his preferred designation as a hotel for business and upscale travelers who are visiting Kansas City and Overland Park. As a result, Craig's Crowne Plaza is severely underperforming expectations.

According to the complaint, the UFOC signed by Craig in 2008 included performance representations. These stated that the average occupancy rate of 53 "mature Crowne Plazas in suburban markets in 2007" was 63.5% and yielded $70.43 in revenue per available room ("RevPar"), a standard industry metric. In contrast, Craig's hotel had a 28.07% occupancy rate and RevPar of $20.42 in 2009. The numbers inched up in 2010, and by 2011 they had reached 41.6% occupancy and $32.75 RevPar. Not only are those figures well below the national averages cited in the UFOC, but they are also below the performance of the hotel when it was a Radisson brand, Craig maintains.

Craig also alleges that he realized in 2009 that IHG's national reservation line was not referring guests to his hotel. He hired researchers to call the reservation system. "In many of these calls, IHG's call center representatives did not identify the Hotel at all. Instead, they identified only the downtown Crowne Plaza. In fact, the agents often suggested a Holiday Inn, a midscale IHG brand, even though the customer called the specific Crowne Plaza phone number and asked specifically for a Crowne Plaza hotel in Kansas City," according to the complaint. After Craig provided records of the calls, a year of back-and-forth discussions with IHG executives did not resolve the problem, according to Craig.

Franchisor Execs Charged With Fraud

The SEC's settlement in May 2011 of fraud charges against five executives of the now-defunct Brooke Corp. has not ended government lawsuits filed against the former insurance agency franchisor. In November 2012, a federal grand jury in Kansas indicted two of the former executives, Robert D. Orr and Leland G. Orr, with one count each of conspiracy to defraud the Securities and Exchange Commission and three counts of making false statements in filings to the SEC. Robert Orr also was charged with two additional counts of making false statements in SEC filings and one count of bankruptcy fraud.

Brooke Corp., formerly based in Overland Park, KS, was a fast-growing franchisor of insurance agencies

continued on page 8

Movers & Shakers

Steven K. Fedder and **Julie C. Janofsky** have opened a new firm, **Fedder & Janofsky LLC**, in Baltimore, MD. Fedder's 30 years as a trial lawyer include franchise litigation involving intellectual property, business fraud, professional liability, contract, and employment disputes. Janofsky has focused on employment lawsuits in her 25 years as an attorney, and she has been an AAA arbitrator for more than 10 years.

The **New England Franchise Association** announced its new Board of Directors: **Suzanne Cummings**, Cummings Franchise Law, P.C.; **Donato Dandreo**, Compete Now; **Steve Dubin**, PR Works (and president of NEFA); **Kevin Dubois**, Lapels Dry Cleaning; **Evan Hackel**, Ingage Consulting; **Chuck Lynch**, MaidPro; **Murray Vetstein**, Source4; **Gina Weinstock**, G. T. Reilly & Company; **Bruce Wildes**, Acadia Business Advisors, LLC; and **Kim Woods**, Franchise Solutions.

Charles Cannon, a former member of the **Governing Committee of the ABA Forum on Franchising**, died in December. Cannon was a former partner at both **Jenkens & Gilchrist** and **Haynes and Boone**, firms where he helped to establish their substantial franchising practices. He was best known for his work on using alternative dispute resolution to settle franchising disputes, and he was the founder of **Bold Journeys Conflict Resolution Services**.

—❖—

News Briefs

continued from page 7

in Kansas and many other states. When the company ramped-up its expansion strategy after becoming a public company in 2003, it reached nearly 850 franchisees, according to media reports. Brooke's strategy was to offer franchises to existing insurance agencies. Franchisees would sell insurance policies, and the premiums were paid to Brooke, which would then send commissions back to the franchisees. In return, franchisees were told they would receive the marketing benefits of what was becoming a national brand, extensive software and bookkeeping support, and could borrow money through a Brooke-affiliated company, Aleritas Capital Corporation. Brooke would then repackage and resell those loans to outside investors.

However, those lending practices were apparently at the core of the company's demise and a major source of legal trouble. Brooke's business began to unravel in 2007 and 2008, and it declared Chapter 11 bankruptcy in October 2008. In 2011, five executives settled SEC charges that included alleged violations of the RICO Act, double-pledging loans as collateral, and misrepresenting to outside investors the financial health of the loans to franchisees that Brooke was repackaging and reselling. They paid fines and penalties, and they agreed to permanent officer and director bars, according to the SEC.

Insurance industry publications and regional business newspapers reported that several hundred franchisees failed in the wake of the bankruptcy, and also that several regional banks failed because they had extended large loans to Aleritas.

—❖—

Private Equity

continued from page 4

problems in franchising, and this has made the investment in franchise businesses more attractive. From the perspective of potential investors, franchise businesses tend to have a favorable litigation track record, a positive franchisor-franchisee relationship history, and a relatively nominal amount of litigation and disputes relative to the revenues generated. On the downside, equity investors are not as enthusiastic about some of the litigation-related features of franchise businesses, such as franchisors' inability to have complete decision-making control over the entire system, which can sometimes lead to franchisor-franchisee conflicts.

When private equity has invested in a franchise businesses, on the franchisor or franchisee side, it has had a net positive impact on franchising. Private equity tends to have sophisticated and experienced management in all aspects of business, including litigation and dispute resolution, leading to common-practice litigation management. Litigation directed by private equity tends to be bottom-line driven, which is typical of litigation in other businesses, and there tends to be a broader perspective in connection with resolution of disputes and settlement of litigation. However, there are aspects of franchising that private equity has been less able to calculate in the dispute-resolution equation. Private equity [management] typically will not have experience with contentious franchisees and franchisee associations, whom they are forced to deal with because they cannot simply terminate problem groups or individuals as they can in other businesses. Private equity also has difficulty with some of franchising's unique issues, such as franchisees' exclusive territories, and finding a clear path to both overall system growth while avoiding franchisee encroachment complaints.

—❖—