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LJN's
# Franchising Business & Law Alert®
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## Iowa Decision Upholds Tax Assessment Against Out-of-State Franchisor

**By Adam B. Thimmesch**

The Iowa Supreme Court recently issued a decision holding that the state of Iowa has the authority to impose its income tax on out-of-state franchisors based solely on the use of their intangible property by franchisees located in the state. The court's decision in *KFC Corporation v. Iowa Department of Revenue* (No. 09-1032, 2010 WL 5393506 (Iowa Dec. 30, 2010)) is expected to lead to increased enforcement efforts in Iowa, and perhaps other states. Franchisors should therefore be aware of this case and the impact that it could have on them in Iowa and in other states across the nation.

The *KFC* case involved an assertion by the Iowa Department of Revenue that KFC was responsible for paying corporate income tax in the state based solely on its receipt of royalties from franchisees in the state. In June 2009, an Iowa District Court upheld the state's imposition of tax, and KFC appealed the decision to the Iowa Supreme Court. The Iowa Supreme Court heard oral arguments in May 2010 and issued its determination on Dec. 30, 2010.

The principal issue in *KFC* was whether the state of Iowa could impose its corporate income tax

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## Key Trends in Franchise Law in 2011

FBLA *asked leading franchise attorneys and other experts about key trends in franchise law in 2011. Here are their outlooks and their advice about how to prepare for new developments in franchise law and business.*

**Craig Tractenberg, Partner, Nixon Peabody**

*Social Media and False Advertising Risks.* Review your social media policy, educate your constituencies, and coordinate the policy with the franchise agreement, the operations manual, and best practices. Suppose a negative review appears and a franchisee requests that a customer respond with positive reports and affirmations on LinkedIn, Myspace, and Facebook affinity sites and on blogs. But the customer is also an employee of the franchisee, which is not disclosed on the sites but is later exposed. A competitor then brings a false advertising claim. Better make sure that you know about the risks of such claims and educate your colleagues about using best practices on social media.

*Non-renewal and Transfer Issues.* Review the qualifications for new franchisees. As the economy changes, franchisees will seize the opportunity to exit, and some franchisors will see the opportunity to obtain stronger operators. Make sure your criteria for new franchisees is defensible. For sellers, ensure yourself that you are reaching a qualified buyer pool. Franchisors will be looking to raise performance and deny renewal. They know the demand for franchises only needs financing to catch up with the supply.

**David L. Cahn, Whiteford, Taylor, Preston**

One recent trend that I expect to continue has been successful claims against food franchisors for extracting compensation from approved suppliers of products. In a case involving Wendy's, the franchise agreement was ambiguous concerning the franchisor's ability to designate a mandatory single supplier, as opposed to allowing the franchisee to obtain approval of alternative suppliers. As a result, a court held that Wendy's did not have the right to compel purchase from a sole supplier of buns that would pay Wendy's a percentage of its revenues from those sales.

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PERIODICALS

## *Key Trends*

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Meanwhile, a class action brought by Quizno's franchisees was settled after the presiding court denied motions for dismissal prior to trial. While the ability of Quizno's to obtain rebates was stated in the FDD and franchise agreement, Quizno's also promised to establish purchasing relationships "for the benefit of the franchise system." It is likely that the franchisees had evidence that the prices that they were being required to pay were higher than they would have paid as non-franchised sandwich shops.

So, franchisors' attorneys must make sure that the franchisor's rights to designate sole suppliers, limit the number of approved suppliers, and obtain compensation from suppliers are clearly disclosed. If franchisors promote that the size of the franchise system will enable franchisees to obtain volume discounts on supplies, they need to be able to prove that such a benefit actually exists.

**DAVE HOOD, PRESIDENT, THE iFRANCHISE GROUP**

With more than half of the U.S. state governments operating at a deficit and many facing the possibility of bankruptcy during 2011, it is not surprising that state governments are doing everything they can to increase revenues. For many years, experts have foreshadowed the likelihood that states would assess taxes on royalties paid to out-of-state franchisors who had no "assets" in the state other than their independently owned franchisees. California, Colorado, New York, Ohio, Oklahoma, and Washington, among others, have adopted standards preparing them for taxation based on a taxpayer's economic nexus in their state. Over the past few years, several states have sent nexus questionnaires to franchisors operating in their state — laying the groundwork for future taxation.

In December 2010, the Iowa Supreme Court issued a decision upholding the state's right to tax franchisors based in other states based on their having only an "economic nexus" in Iowa. (See review of this decision on p. 1 of this issue.) This decision will likely encourage other states to become even more aggressive in taxing the revenues of out-of-state franchisors in 2011 and beyond. Franchisors should comply with any changes in the state tax requirements, while consulting with tax and legal counsel on how to best plan for these more aggressive tax measures.

**BRUCE SCHAEFFER, PRINCIPAL, FRANCHISE VALUATIONS, LTD.**

*Tax Nexus.* I expect the states to intensify efforts to collect taxes — income taxes and, probably, sales taxes as well — from franchisors. Franchisors that cling to the argument that physical presence is a requirement for tax nexus will not prevail and will suffer threefold liabilities.

*Liability.* As suggested in the Federal Judicial Center *Manual for Complex Litigation, 4th edition*, litigation counsel will finally realize that "the attention given to liability issues … may lead to neglect of injury and damages issues" and that "[e]arly scrutiny of the claimed damages can facilitate settlement, either because of the magnitude of the potential exposure or because provable damages are too small to justify the cost of pursuing the litigation"; and litigation counsel will see the wisdom of retaining damages experts at the beginning of a case rather than at the end.

*Internet Security.* I think that a prominent franchisor will be the victim of an Internet security attack, and millions of consumers will be subject to identity theft. The franchisor will face a huge financial burden to recover from the breach, and its reputation will suffer. As a result, members of the franchise community will finally wake up and realize they could be next.

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## *Key Trends*

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### Justin Klein, Partner, Marks & Klein

Franchising continues to grow and thrive as a driving force of the American economy, and 2011 should be no different. I believe in 2011 (and beyond) the industry will see a more experienced and more sophisticated franchisee entering the marketplace and fewer unqualified, inexperienced franchisors emerging. I believe the tightening of the credit markets has made it tougher for individuals to invest in many franchises, but that this has led to financially stronger franchisees, as well as franchisees with more business experience. Because unemployment rates remain high, otherwise qualified employees are turning to business opportunities such as franchises as an alternative to remaining unemployed. I am also optimistic that more experienced and sophisticated franchisees will lead to better relations between franchisee and franchisor. Franchisees will be better equipped to understand the nature of the relationship, and it will therefore be difficult for franchisors to engage in overly one-sided conduct.

### Jay W. Schlosser, Partner, Briggs and Morgan

One item of interest in 2011 is the antitrust claim at issue in *Burda v. Wendy's International, Inc., et al.* (S.D. Ohio). In *Burda*, the franchisee asserted that after he had entered into his franchise agreement, Wendy's changed its policy and forced him to purchase supplies from Wendy's affiliates. The federal court in Ohio has allowed the franchisee to proceed with his illegal tying claim, under a *Kodak* locked-in theory, finding that the language in the franchise agreement was not specific enough to put the franchisee on notice of the potential imposition of exclusive purchasing restrictions. Franchisors should carefully review the language in their agreements to ensure that it permits the franchisor to designate an exclusive supplier for products.

A second area that appears ripe for 2011 is the issue of vicarious liability of franchisors. Two recent decisions, *Soto v. Superior Telecom, Inc.* 2010 WL 2232145 (S.D. Ca., June 2, 2010) and *Bauer v. Douglas Aquatics, Inc.*, Bus. Franchise Guide (CCH 14,459) (Sept. 7, 2010), suggest that courts, focusing on implied/apparent agency theories, will be carefully reviewing the franchise relationship before summarily dismissing claims against franchisors. Franchisors will need to closely examine their "control" over the day-to-day activities of franchisees.

### David Koch, Plave Koch PLC

*Franchise Sales on the Rise.* The pent-up demand to sell franchise brands, which cracked open in 2010, will be fully released in 2011. Many brands are held by private equity firms that are well past their normal exit horizon. They've kept their holdings longer because of market conditions in the last two- to three-years. Franchise counsel should polish-up their due diligence checklists and prepare for battle over representations and warranties. The same goes for existing franchises: More owners will look to sell because, with employment prospects improving, they will have less fear of making a move, and buyers will have a better shot at financing. Franchisors ought to consider developing a set of transfer guidelines that walk existing franchisees through the franchisor's transfer process.

*Supply Chains.* The backlash against franchisor supply chain restrictions might grow as franchise owners gain confidence in business conditions. Franchisors and their counsel should confirm that supply chain practices align with existing contract terms.

*New Concepts.* I think we'll see more "surrogate parenting" in franchising. By this, I mean situations where external investors (the "surrogates") negotiate for the right to franchise a concept whose owners don't wish to franchise it themselves.

### Sarah J. Yatchak, Special Counsel, Faegre & Benson

Good or bad, change will be the key theme for franchising in 2011. With every sign of life that surfaces in the economy this year, franchisors will confront the reality that they must adapt to shifting consumer demand or be left out of the game. The ability to adapt or change is only possible if franchisors first listen to consumers and then work through myriad business and legal issues associated with implementing various system refinements and improvements, all with any eye toward helping the system (and their franchisees) stay relevant.

International franchising also will continue to be a hot trend in 2011, especially in countries such as India and China, both of which are experiencing periods of record economic growth. In addition, Australia, Brazil, and South Africa recently have attracted more attention from U.S.-based franchisors given their relative economic stability and consumer demand for foreign products and services. Smart franchisors that wish to expand internationally not only will work diligently to determine the regulatory framework within which they will be expected to operate and secure the necessary trademarks in the country of choice, but also they will engage their advisers in early, frequent, and robust discussions about how best to strategically enter a particular market from both a business and legal perspective.

Finally, as more franchisees take stock of their own interests in 2011, franchisors may be faced with an increasing number of transfer requests brought about by franchisee estate planning. These types of transfers (*i.e.*, transfers to trusts) bring with them a host of unique legal issues — from personal guarantees to releases to basic control — that need to be addressed before an estate plan is put into place. Franchisors should develop protocol specific to handling transfers to trusts for estate planning purposes. Franchisees will

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## *Key Trends*

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appreciate the franchisor's forward-thinking approach to this issue.

**KATHERINE WALLMAN, ASSOCIATE, GRAY PLANT MOOTY**

In most states, courts evaluate the reasonableness of the scope, time, and geographic reach of a post termination non-compete covenant in a franchise agreement to decide whether it is enforceable. Courts are only beginning to deal with post-term covenants that prevent franchisees from selling products and services over the Internet. Because an Internet sales ban could be regarded as a global ban, whether or how such restrictions will be enforced is an unresolved question. Last September a Maryland state court, in *In Wild Bird Centers of America, Inc. v. Duer*, CCH Business Franchise Guide ¶ 14,490 (Sept. 2, 2010), interpreted a post-term non-compete covenant to preclude Internet sales into territories specified in a franchise agreement, but not in others. Although the franchise agreement did not expressly address Internet sales, the franchisor sought to shut down a terminated franchisee's Web site from which he was selling the same products that were sold through the franchise. The court concluded that the covenant should be enforced within 20 miles of Duer's franchise territory and within 20 miles of the territory of any other WBCA franchisee (as the franchise agreement provided). The terminated franchisee was free to sell to customers outside the territory, even though the former franchisee operated his Web site from within the former franchised territory. In light of this decision, franchisors should continue to evaluate the types of language they need to protect their e-commerce Web sites from both in-term and post-term competition by franchisees, and they should carefully consider the reasonableness of any contractual remedies that they may draft in their franchise agreements.

**CARL ZWISLER, PRINCIPAL, GRAY PLANT MOOTY**

The enforceability of pre-dispute arbitration agreements will continue to be much debated in 2011. The U.S. Supreme Court recently ruled that certain challenges to arbitration agreements must be decided by arbitrators, and not judges. *Rent-a-Center Inc. v. Jackson*, No. 09-497, __ U.S. __, slip op. (June 21, 2010) involved an employee, Jackson, who filed a racial-discrimination claim against Rent-A-Center in federal court. Rent-A-Center moved to have the complaint dismissed because Jackson had agreed in his employment contract to submit such disputes to arbitration. The contract also provided that any question of whether the arbitration was enforceable would be decided by an arbitrator, not a judge. Jackson claimed that the arbitration agreement as a whole was unconscionable. The Supreme Court concluded that because Jackson consented to have disputes settled by arbitration, it made "no difference" that the dispute at issue was about the enforceability of the arbitration agreement itself. Franchisors should determine if they want questions of arbitrability to be decided by an arbitrator and draft their franchise agreements accordingly. Franchisees' lawyers wishing to challenge arbitration clauses that do not expressly reserve the right to determine arbitrability to the arbitrator should be prepared to distinguish the *Rent-A-Center* case.

**LEONARD VINES AND BEATA KRAKUS, GREENSFELDER, HEMKER & GALE**

Financial difficulties facing state governments are forcing many states to find new sources of revenue. Activities of franchisors and franchisees are among the targets. In December 2010, the Iowa Supreme Court, in *KFC Corporation v. Iowa Department of Revenue*, found that the state could impose a corporate income tax on revenue earned by an out-of-state franchisor that did not have physical presence in Iowa, solely because the franchisor's intangible property was used by franchisees located in the state. Observers will closely watch this case to see if KFC appeals to the U.S. Supreme Court. (See review of this decision on p. 1 of this issue.)

Other examples include reporting requirements by franchisors. In New York, they are required to submit annual transaction information about their franchisees to the Department of Taxation and Finance. The California Franchise Tax Board has advised some franchisors that they must withhold 7% of royalty payments if they have not registered as a resident corporation. South Dakota has been asking out-of-state franchisors to pay sales and use tax on initial franchise fees and royalty income. This year, several states have introduced tax legislation that would affect franchisors.

Yet another potential revenue source is gift cards. New Jersey is attempting to raise millions of dollars by seizing unredeemed gift cards. Constitutional objections have been raised, and the state intends to appeal a decision that enjoined enforcement of the law. (See *American Express Travel Related Services Company, Inc. v. Sidamon-Eristoff,* Civil No. 10-4890, 2010 WL 4722209 (D.N.J. Nov. 13, 2010).)

And let us not forget *Pius Awuah et al. v. Coverall North America Inc.*, Civil No. 07-10287-WGY, 2010 WL 1257980 (D. Mass. Mar. 23, 2010), where a Massachusetts federal district court classified franchisees as employees of the franchisor. Although this case is fact-specific and based on Massachusetts law, it would not be surprising if some other states followed suit. If so, some franchisors could be required not only to pay more taxes, but also to provide other benefits available to employees but not to independent contractors. The case is on appeal on the certified question of damages available under the Massachusetts Wage Act.

**JENNIFER DOLMAN AND ANDRAYA FRITH, PARTNERS, OSLER, HOSKIN & HARCOURT**

*Trends in Ontario, Canada.* In the past five years, there have been many

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# COURT WATCH

By Rupert Barkoff

## Escaping the Long Arms of Government and Individuals

If this were a science fiction novel, the opening line might read, "We are not alone in this world." The same principle seems to be oozing its way into American jurisprudence, both with respect to how government relates to its constituents and how individuals and businesses cross paths with others.

From the government-constituent perspective, in the franchise arena, there seems to be no area of higher profile than the taxation of out-of-state franchisors where only the ghost of the franchisor crosses into the boundaries of another state's jurisdiction — *i.e.*, a jurisdiction where the franchisor's presence is almost invisible, but that franchisor's system does affect the economy of the foreign state.

In *KFC Corporation v. Iowa Department of Revenue* (No. 09-1032, 2010 WL 5393506 (Iowa Dec. 30, 2010)), which is further analyzed on p. 1 of this issue, the Iowa Supreme Court presented a well-stated history of state government attempts to tax out-of-state entities that have minimal financial relationships with those jurisdictions and no physical presence. Historically, these attempts focused on imposing sales and use taxes on entities that shipped products from other jurisdictions into the state that was trying to impose and collect the tax, but where the entity's connections with that state were minimal. As the Iowa Supreme Court eloquently demonstrated in *KFC*, the courts traditionally looked for some sort of "presence" to justify the long-arm of the state's taxing authority. In recent times, dating back to the decision from the South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Commission,* 313 S.C. 15, 437 S.E.2d 13 (S.C. Jul. 6, 1993), *cert. denied*, 510 U.S. 992 (1993)), the taxpayers have frequently been losing these battles. In *Geoffrey*, the court held that income of Toys "R" Us that derived from activities in that state could be subject to that state's income tax. According to the court, the taxpayer's intangible property (*i.e.*, licensing arrangements) acquired a "business situs" in South Carolina, the state whose taxing authority brought the action. *KFC* is, in essence, a confirmation of the ruling in *Geoffrey*, demonstrating that the long-arm of state taxation is in fact very long. The concept of physical presence as being a prerequisite for taxation is virtually dead.

The consequences of these decisions is that franchisors should be prepared to file income tax returns in most, if not all, states where they have franchisees, and to pay some taxes to those states. Since income tax credits don't always fully compensate an out-of-state taxpayer, as contrasted to having to pay income taxes only to one jurisdiction, this could mean more cost to a franchisor that expands its franchise systems into numerous jurisdictions.

The long arm of the law, however, has not been reserved to our government. As demonstrated by *Bauer v. Douglas Aquatics, Inc.,* 698 S.E. 2d 757 (N.C. Ct. App. 2010), individuals as well as governments can use intellectual property licensing as the basis for asserting claims against out-of-state franchisors. In *Bauer*, the franchisor, a Virginia entity whose franchise system was engaged in the construction of swimming pools, licensed various entities to be its franchisees in North Carolina. While the franchisor had no physical presence in that state, the language on its Web site suggested that the franchisees in North Carolina were the franchisor's agents. On a motion by the franchisor to dismiss the proceeding because of lack of jurisdiction, the court first ruled that the franchisee was not the agent of the franchisor. There were insufficient indicia of actual control by the franchisor over the franchisees to make the plaintiff franchisee the franchisor's actual agent, and there was no actual privity of contract between the franchisor and the franchisee's dissatisfied customer. Moreover, the franchise agreement, as is almost always the case, provided that the franchisee was an independent contractor, and not the franchisor's agent.

However, the court found that the franchisee was the apparent agent of the franchisor. The wording on the franchisor's Web site suggested that the North Carolina locations were its locations. In addition, the franchisee's manager, in speaking with the aggrieved customer who brought suit, had represented to the customer that the company had been in business for more than 30 years. Thus, the court concluded that the customer was entitled to rely upon these representations as the basis for thinking that it was dealing with an agent of the Virginia-based franchisor itself, and that the case, as pleaded, was sufficient for the court to assert personal jurisdiction over the franchisor.

The court's decision suggests that in these circumstances, a tweaking of the Web site's language, as well as guidance on the sales presentations made to prospective customers, could have resulted in the opposite conclusion by the court, one favorable to the franchisor. Consequently, *Bauer* does not stand for the proposition that an out-of-state franchisor can always be successfully dragged

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## *Court Watch*

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into litigation by a franchisee's customers in each jurisdiction where its franchisees are doing business, but it does serve as a clear indication that full caution in the methods of promoting the business is essential in order to avoid this result. Again, we find that the numerous benefits of the Internet often carry baggage with them for a franchisor.

### Battle over Enforcement of Collection of Lost Future Royalties Continues

Prior to the California Appellate Court's decision in *Postal Instant Press, Inc. v. Sealy,* 43 Cal. App. 4th 1704, 51 Cal. Rptr.2d 365 (1996)), Las Vegas would probably have given favorable odds that a franchisor would be able to recover lost future profits or royalties from any franchisee that failed to keep royalty payments current, if the franchisor decided to terminate the franchise agreement as a result of the franchisee's payment breach. *Sealy*, however, started a trend in the other direction. In *Sealy*, the court held that the franchisor could not recover lost future royalties when the franchisor elected to terminate the agreement because the franchisor's decision to terminate was the proximate cause of the franchisor's inability to collect such royalty payments. The court also held that allowing the franchisor to recover those sums would be unconscionable.

Putting aside the unconscionability issue, over the 14 years following the decision, several courts have, in essence, followed the *Sealy* thinking, Florida and Michigan being two jurisdictions where comparable judicial decisions were rendered. In the last couple of years, Colorado has joined the unenforceability camp, and in North Carolina, the issue is in the midst of battle. In *Meineke Car Care Centers, Inc. v. RLB Holdings* (No. 3:08cv240-RJC, 2009 WL 2461953 (W.D.N.C. Aug. 10, 2009)), the trial court ruled in favor of the franchisee, but the case is currently on appeal to the Fourth Circuit. As for neighboring Georgia, in *Progressive Child Care System, Inc. v. Kids R' Kids International, Inc.*, (No. 2-07-127-CV, 2008 WL 4831339 (Tex. App. Nov. 6, 2008)), a Texas appellate court, interpreting Georgia law, upheld the franchisor's right to recover lost future profits as damages. Otherwise, the court noted, the franchisor would not obtain the benefit of its bargain from the franchisee.

As a result of the recent decision in *Moran Industries, Inc. v. Mr. Transmission of Chattanooga, Inc.* (Bus. Franchise Guide (CC) ¶ 14,428 (E.D. Tenn. Aug. 4, 2010)) from the U.S. District Court for the Eastern District of Tennessee, the law in Tennessee now follows the traditional line of thinking espoused by Georgia. In *Moran*, after noting the split of authorities that had evolved among the states, the court found the franchise agreement in question to be ambiguous, and thus denied the franchisee's motion to dismiss, ignoring the franchisee's clever but somewhat convoluted argument that the language of the contract limited the possibility of the franchisor's recovering lost future royalties to the initial five years of the contract, a period which had already expired. The court then focused on the damages claimed by the franchisor, noting that, given the 27-year relationship between the parties, a damage claim for lost future royalties would be anything but speculative. The court also noted in passing that even *Sealy* did not prohibit a franchisor from recovering lost future royalties when the franchisee abandoned the franchise, as was the case in *Moran*. (The *Moran* court gives an excellent summary of the development of the law related to collection of lost future royalties; *see also Moran, infra,* at 6-8.)

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## *Key Trends*

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successful class action certification motions against franchisors alleging breaches of the Ontario franchise legislation. This trend is likely to continue in 2011 and beyond, particularly in light of recent statements by the Ontario Court of Appeal in *Quizno's* that "a dispute between a franchisor and several hundred franchisees is exactly the kind of case for a class proceeding" (*Quizno's Canada Restaurant Corporation v. 2038724 Ontario Ltd.*, 2010 ONCA 466 at para. 62). While a common agreement shared by numerous franchisees may work to a franchisor's detriment in resisting class action certification, franchisors faced with defending a certification motion should consider seeking summary judgment which, if successful, will stop a class action in its tracks at an early stage.

We also anticipate continued reliance by Ontario franchisee counsel on not just the statutory duty of fair dealing under section 3 of the Arthur Wishart Act, but also the franchisee's right of association under section 4. In *Midas*, the Ontario Court of Appeal affirmed that this right includes the right to participate in a class action and that releases obtained from individual franchisees on renewal or transfer to prevent class actions are not enforceable (*405341 Ontario Limited v. Midas Canada Inc.*, 2010 ONCA 478). In *Sobeys Capital*, a franchisor's restriction of a franchisee's access to funds to pay legal fees was found on the hearing of an injunction to constitute a serious issue to be tried as to whether the franchisor had interfered with the franchisees' ability to pursue collective action (*1318214 Ontario Ltd. v. Sobeys Capital Inc.*, 2010 ONSC 4141). Since there is a right of damages for any breach of section 4, franchisors must tread cautiously in their day-to-day dealings with franchisees.

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# NEWS BRIEFS

## Franchise Compensation Survey 2011 Released

FRANData's "Franchise Compensation Report 2011," released late last year, found that general counsel to franchise firms earned a median salary of $180,000, in-house attorneys earned a median salary of $101,000, and paralegals earned a median salary of $45,000.

Due to minimal overlap in franchise companies that responded to both the 2009 and 2010 surveys, FRANData aggregated the responses from those two years and it did not issue comparative figures that would show compensation trends. Given the weak economy, FRANData assumed that salaries did not increase from 2009 to 2010.

For purposes of comparison, in-house attorneys were grouped in a job function category with management-level employees of franchises, including human resources, compliance, field operations, marketing, and site selection. Attorneys' median salaries were about 30% above managers in each of those categories, though their full compensation was much closer to the average because other positions typically received larger bonuses and other forms of compensation.

The survey also revealed that in-house attorneys said they spend 78% of their time on legal matters and 22% of their time on compliance.

To purchase the full survey, go to www.frandata.com.

## Noble Roman's Wins Lawsuit Against Franchisees

On Dec. 23, 2010, the Superior Court in Hamilton County, IN, granted summary judgment in favor of franchisor Noble Roman's, Inc. against numerous groups of franchisees that sued it in 2008 (*Kari Heyser, Fred Eric Heyser and Meck Enterprises, LLC, et al. v. Noble Roman's, Inc. et al.*). Noble Roman's is the franchisor of Noble Roman's Pizza and Tuscano's Italian Style Subs, and it is traded over-the-counter under the symbol NROM.

Originally, 13 franchisees groups filed lawsuits against the franchisor and institutional lenders that provided funds to franchisees. The former franchisees alleged that Noble Roman's fraudulently induced them to purchase franchises for traditional locations through misrepresentations and omissions of material facts regarding the franchises. They sought compensatory damages of $5.1 million, as well as punitive damages. During the litigation, one group of franchisees voluntarily dismissed its claims, and the court held another group of franchisees in contempt and dismissed its claims with prejudice. Also, the court had previously dismissed the claims against the institutional lenders.

After winning summary judgment, Noble Roman's Chairman Paul Mobley issued a media statement indicating that Noble Roman's will continue with its counterclaims against the former franchisees for breach of contract. Those claims are for approximately $3.6 million, plus attorneys' fees, costs of collection, and punitive damages (in some cases).

## Wyndham, Choice Hotel Franchisees File Two Class Actions

In December 2010, franchisees of Wyndham Worldwide, Inc. and Choice Hotels International filed class action lawsuits seeking an excess of $260 million in damages and $240 million in damages, respectively, against the hotel chains for violating franchise agreements and using unfair and deceptive practices. Specifically, the franchisees allege that the franchisors are charging an extra royalty fee of up to 5% of the room rate by tying guests' visits to the franchisors' guest-rewards programs, but neither the fee nor the details about which visits would qualify for the fee were sufficiently disclosed in franchise agreements. The lawsuits, *Amar Shakti Enterprises, LLC, et al. v. Wyndham Worldwide, Inc., et al.* and *Jade Hospitality, LLC, et al. v. Choice Hotels International, Inc., et al.*, were filed in the U.S. District Court, Middle District of Florida.

Franchise contracts typically obligate franchisees to pay a "royalty" fee and a "reservation" or "system" fee. "However, on top of these fees, the hotel chains have charged and required plaintiffs and all other similarly situated franchisees to pay an additional fee of up to 5% of gross room sales generated from hotel stays by members of Wyndham Rewards [former Trip Rewards] and Choice Privileges," said David Wood, shareholder, Ruden McClosky (Orlando, FL), which is representing the franchisees.

Franchisees are challenging the legitimacy of those loyalty club fees on several grounds, though the details vary depending on when a particular franchise contract was signed and with which hotel brand. According to the complaints, some franchise agreements "make no reference to qualifying stays by loyalty rewards members." Other agreements allow the franchisors to increase the basic reservation fee for additional services, but do not "otherwise delineate what the services may be."

In addition to challenging the validity of the fees, franchisees allege that franchisors inflated the number of guests whose visits qualify as loyalty club stays. Franchisor-required reservation software at every hotel "proactively matches" a guest with the rewards program even when the guest has not asked to accrue loyalty points. "Not only has a customer not affirmatively presented his loyalty program information, but he might not even know that he is a member," said Wood, referencing another of the franchisees' complaints — namely that many customers have been added to the loyalty programs without their knowledge because they were automatically enrolled when they made an online reservation. To not enroll would have required removing a check mark in a box at the bottom of the reservation — that is, an opt-out from the program, rather than an opt-in. On that last point, Wood added that Wyndham and

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## News Briefs

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Choice might have recently changed the automatic opt-in system, after receiving franchisees' complaints.

Wyndham Worldwide currently franchises 13 brands, including Days Inn, Super 8, and Ramada, which comprise more than 7,090 hotels in the United States and nearly 70 countries and territories. A Wyndham representative said that the company does not comment about pending litigation.

Choice Hotels franchises more than 6,000 hotels in the United States and more than 35 countries worldwide, under brands such as Clarion Inn, Comfort Inn, and Quality Inn. The company did not respond to a request for comment.

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## Tax Assessment

*continued from page 1*

on KFC — a company with no employees or business locations in the state — based solely on KFC's receipt of royalties from franchisees located in Iowa. KFC argued that it was not subject to that tax because it did not have the necessary "nexus" with the state that was required under the Commerce Clause of the U.S. Constitution. KFC based its argument upon Supreme Court precedent holding that the Commerce Clause required that an out-of-state party have a physical presence in a state for that party to be subject to that state's tax.

The department argued that KFC was subject to income tax in Iowa because it derived income from franchisees in the state. It further argued that the state could impose its income tax on KFC regardless of KFC's lack of physical presence in the state, noting that the Supreme Court decisions cited by KFC involved sales and use taxes and thus should not apply to the state's income tax. The department also relied upon case law from other states that supported its position that "economic nexus" was sufficient under the Commerce Clause when evaluating the imposition of a state income tax.

The court's decision contained a thorough and careful analysis of the U.S. Supreme Court's jurisprudence regarding the limits on state taxation imposed by the Commerce Clause. Based upon that analysis, the court issued two holdings with respect to the Commerce Clause issues raised by the parties. First, in an unexpected and unique ruling, the court held that KFC's licensing of its trademarks to its Iowa franchisees was the "functional equivalent" of a physical presence in the state. Therefore, according to the court, KFC would have been subject to income tax in the state regardless of whether a physical presence was required. Second, notwithstanding its first ruling, the court held that the physical-presence test did not even apply. The court held that "by licensing franchises within Iowa, KFC has received the benefit of an orderly society within the state and, as a result, is subject to the payment of income taxes that otherwise meet the requirements of the dormant Commerce Clause."

### Analysis and Impact

The *KFC* court's rejection of the physical-presence test for purposes of the state's income tax was consistent with actions taken by other state courts in recent years and was not unexpected. Since 2005, a growing number of state courts have held that the Commerce Clause of the U.S. Constitution does not require a person or entity to have a physical presence in a state before that state can impose its income tax on that person or entity. Further, the Supreme Court has declined to review any of those cases.

One aspect of the decision that was unexpected, however, was its holding that the physical-presence test was met by KFC despite its lack of a true physical presence in the state. As noted above, the court held that KFC's licensing of its intangible property to Iowa franchisees gave it the functional equivalent of physical presence in the state. This functional equivalency test goes beyond case law from the Supreme Court or other states and is of questionable basis.

*KFC*'s rejection of a physical-presence standard for purposes of state income taxation is consistent with state-court decisions in cases across the nation. Although those cases have not involved franchise relationships, they have established a body of law upon which states can rely upon in seeking to enforce their income taxes against out-of-state franchisors. Thus, in addition to expecting enforcement actions against franchisors by the Iowa Department of Revenue, franchisors should expect that other states' revenue authorities will begin to take action as well. Franchisors should be aware of this trend and determine a strategy for analyzing and responding to this development.

KFC has 90 days to appeal the Iowa Supreme Court's decision to the U.S. Supreme Court. Unfortunately, the U.S. Supreme Court has declined the opportunity to review several similar cases in recent years, and thus it appears unlikely that it will review this case even if KFC does appeal. If KFC does not appeal, or if KFC's appeal is not accepted by the Supreme Court, the Iowa Supreme Court's decision will stand. The Iowa Department of Revenue would thus be able to proceed in assessing the state's income tax against out-of-state franchisors with franchisees in the state.

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