

# PUBLICATION

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## KFC Franchise Guarantors Not Subject to Mint Julep Jurisdiction

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Franchise agreements are often signed by single purpose entities that are not income-tax-paying entities and that own only the franchised business for a particular location. The franchisee's equity owners are often asked to guaranty the franchisee's obligations under the franchise agreement, as these flow-through entities employed to eliminate double taxation of income rarely accumulate capital and net worth to make creditors more secure. The written guaranty usually repeats or incorporates the personal jurisdiction and venue selection provisions of the franchise agreement so any action against the franchisee for money owed can include claims against the guarantors as well. But what happens if some of the guarantors are not subject to the personal jurisdiction of the court selected in the franchise agreement?

The franchisee and the guarantors had signed franchise agreements and related agreements for two KFC restaurants in the Dallas, Texas area. KFC became aware of certain breaches, gave notice to cure, and then terminated when the breaches continued without cure. The franchisee continued to operate both stores, allegedly violating the Lanham Act and the express terms of the franchise agreements. KFC brought an action to enforce post-termination remedies and for damages against the franchisee and its guarantors in its local federal district court, although the opinion reports that the franchise agreement and the related guaranty agreement contained no forum selection clause.

The U.S. District Court for the Western District of Kentucky<sup>1</sup> decided that a case by KFC Corporation against a terminated, holdover Texas franchisee and its guarantors must be transferred to a Dallas court, instead of continuing in the Louisville federal court designated in the KFC franchise agreement. Although the franchisee corporate entity and the principal shareholder-operator were subject to the Kentucky Long Arm Statute, in the court's view, the other shareholder-guarantor, who worked in the business on an active basis, and the wives of the investors who were also guarantors but did not work in the business, were not subject to the court's personal jurisdiction. The court recognized the inefficiency of splitting the case and elected to grant KFC's alternative motion to transfer, rather than dismissing the case.

Procedural issues aside, the decision presents a curious analysis by the court of what is a common commercial context in franchising. The franchise agreement and the guaranty recited that payment and performance of the franchise agreement's obligations to be guaranteed by the guarantors was due in part in Kentucky, where the franchisor's headquarters were located. The franchise agreement was signed and made binding in Kentucky, which satisfied the primary test of the Long Arm Statute, namely, the last act necessary to form the contract occurred in Kentucky. The guaranty recites that the franchisor was relying on the undertaking of the guarantors to assure performance of the franchisee's obligations in Kentucky to enter into the franchise agreement with the franchisee.

The court has no trouble with finding jurisdiction over the franchisee under the standards of the U.S. 6th Circuit Court of Appeals<sup>2</sup>, and the Supreme Court in *Burger King v. Rudzewicz*<sup>3</sup>. However, the court relied on the analysis of a similar question in a *Long John Silvers* case<sup>4</sup> to find that the connection between Kentucky and the guarantors was too infrequent and attenuated to support jurisdiction. Because the contracts contemplated that the guarantors' contacts with Kentucky would arise only if the franchisee defaulted, the contacts were not sufficiently frequent or regular to satisfy the court's notion of due process. The court found that the signing of

the guaranty, the submission of information as part of the franchise application by the guarantors and the reliance of the franchisor on the guaranty were insufficient to meet the requirements for personal jurisdiction.

As Kentucky is home to some substantial franchise organizations, this case now confirms the earlier decision as a non-anomaly with some punch. Franchisors relying on Kentucky law will need more specifics and continuous interaction with guarantors to be assured of local jurisdiction. Indeed, the paradox of this decision is to deprive Kentucky franchisors of the opportunity to protect their interests in Kentucky courts if the franchisee to which they have granted a franchise defaults so that enforcement of a contract entered into in Kentucky becomes necessary against the out-of-state owners of the franchisee. The case also reminds us that alleged violations of the Lanham Act perpetuated by a holdover franchisee create a federal question that federal courts should decide, but don't subject the franchisee and any contributory parties to jurisdiction where the franchisor is located. The franchisor must still satisfy the elements of its home state long arm personal jurisdiction statute to haul the franchisee and related parties into its local courts.

In this case, one speculates on the outcome if the guarantors signed initially as a general partnership and then assigned the franchise agreement to their controlled corporation. The franchisor could condition consent to the assignment on the continuation of primary liability for the assignors. What would happen if the history of the relationship included several instances where the franchisee had failed to pay, the guarantors were then called upon to pay and then did so by making direct payments to the franchisor, instead of contributing the funds necessary to the franchisee and directing that such entity make the payments? At a minimum, franchisors should pay attention to and document interaction with the guarantors of a franchisee with a view toward evidence needed for their home state long arm statute.

<sup>1</sup> KFC Corporation, v. Texas Petroplex, Inc., Et Al., Civil Action NO. 3:11-CV-00479, United States District Court For The Western District Of Kentucky, 2012 U.S. Dist. LEXIS 144342, October 4, 2012, Decided, October 5, 2012, Filed.

<sup>2</sup> Bird v. Parsons, 289 F.3d 865, 874 (6th Cir. 2002) (quoting S. Mach. Co. v. Mohasco Indus., Inc., 401 F.2d 374, 381 (6th Cir. 1968))

<sup>3</sup> Burger King Corp. v. Rudzewicz, 471 U.S. 462, 475-476, 105 S. Ct. 2174, 85 L. Ed. 2d 528 (1985).

<sup>4</sup> Long John Silver's, Inc. v. DIWA III, Inc., 650 F. Supp. 2d 612 (E.D.Ky. 2009).