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Hospitalitas

2011 Issue 2

News and Views for Your Hospitality and Franchise Business

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Baker Donelson will host Fran-Guard,™ a franchise sales management and compliance training course, in our Nashville office on Tuesday, April 26, 2011. The program, which runs from 9:00 a.m. to 5:00 p.m. (Central Daylight Time), will cover both the legal and business aspects of compliance with a series of modules designed for CEOs and senior executives, franchise development professionals, in-house counsel and franchise attorneys, paralegals and compliance managers. Deadline for registration is April 19, 2011. For more information, click here or contact Laura Ellis at lellis@bakerdonelson.com.

KFC Rules the Roost but Franchisees Govern the Coop

Jillian M. Suwanski, 615.726.5558, jsuwanski@bakerdonelson.com

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In the traditional franchisor's point of view, brand ownership means control over all brand components, with input and advice from franchisees at the franchisor's discretion. This point of view held little sway with the Delaware Chancery Court, which recently ruled that the KFC National Council and Advertising Cooperative (NCAC) has the power to propose and approve the advertising plan for the KFC brand, while franchisor KFC Corporation (KFCC) has the power to hire, fire and direct the brand's national advertising agency and public relations firm.[1] The court acknowledged that business realities may make it

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Getting Maximum Value for Franchisee and Franchisor During Condemnation Proceedings

Ivy N. Cadle, 404.589.0009, icadle@bakerdonelson.com

A recent Georgia trial illustrates certain challenges for franchisees and franchisors forced to close a location because of a transportation project. One of the most important and challenging damages to recover is the lost value of the business. While the standard of "just and adequate compensation" applies almost universally to real property damages, most jurisdictions do not allow recovery for the destruction of business value. Georgia is a minority jurisdiction because it clearly recognizes that permanent

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Greetings from *Hospitalitas*

Hospitalitas is the Baker Donelson newsletter for our clients and friends in the hospitality industry – hotels, restaurants and their suppliers. It is published several times a year when we believe we can deliver first class, useful information for your business. Please send us your feedback and ideas for topics you would like to know more about. True to our Southern heritage of hospitality, we'll work hard to make each visit with us something special and worth repeating.

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impossible for the parties to continue operating in the manner the Certificate of Incorporation (the Certificate) requires, but the court strictly construed the language of the NCAC's heavily negotiated Certificate in a manner favorable to the franchisees based on principles of contract interpretation.

This case is instructive for franchisors that have or are considering sponsoring or creating an advertising cooperative or sharing control over brand advertising with a franchisee-dominated organization. Clarity in organic documents is crucial to avoiding a litigation-defined relationship.

In August 2009, the KFC brand was on the verge of "going dark" with no on-air national television advertising for a month-long period because the Committee governing the NCAC (the Committee) would not approve the KFCC-proposed commercial. The commercial focused on KFC's relatively new grilled chicken product, while the Committee (13 out of 17 of whom are franchisee representatives) wanted the focus to remain squarely on fried chicken. Three days before the September advertising window was set to begin, the NCAC, through the Committee's action, agreed to the commercial, avoiding a potential loss of millions of dollars in already-committed media purchases.

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Shortly thereafter, a similar dispute arose when KFCC proposed the brand's advertising and marketing plan for 2010. The Committee wanted to amend the KFCC proposal and recommend a different plan over KFCC's objection. KFCC argued that it was the only party that could plan and propose advertising for the brand and that the NCAC's role was to approve KFCC's proposed plan or request a modified plan from KFCC, not to propose its own plan. This time, the parties could not agree, and the NCAC, through the Committee's action, filed *KFC National Council and Advertising Cooperative, Inc. v. KFC Corporation* in the Delaware Chancery Court on January 7, 2010.

The NCAC was organized in 1964 to maintain and utilize the advertising fees paid by each KFC franchisee. In 1997, KFCC and its franchisees concluded an eight-year class action lawsuit, part of the settlement of which was re-negotiating the NCAC Certificate. The parties later came to dispute what powers and duties each agreed to in the Certificate and their respective roles in the approval of the advertising plans and strategies.

The negotiated and revised Certificate limited the Committee's powers from what they were prior to 1997. It gave KFCC representation on the Committee, which KFCC previously did not have, but it allowed the franchisees to maintain a super-majority of Committee members. The Certificate enumerated the following powers and duties of KFCC: (1) the sole authority to hire and fire the national advertising agency and public relations firm and direct their work; (2) development of national advertising, public relations and media plans and strategies and submission of such plans for approval by the Committee; (3) recommendation of any changes in the advertising calendars and budgets, which changes can only be implemented by the approval of the Committee; (4) approval of the Committee; (4) development of all creative and production of all commercials; and (5) management of the purchase of media.

The Certificate also set forth the roles and duties of the Committee: (1) evaluation and approval of all advertising, publicity and promotional programs and establishment of related fiscal policies; (2) planning and approval of yearly advertising program, within the limits of an estimated budget developed by KFCC; and (3) review of performance of advertising agencies and PR firms; approval of strategic direction, calendars and budgets; approval of campaign strategy; approval of national advertising prior to airing; and approval of price points and promotions featured in national advertising.

The revised Certificate was not a model of clarity. Thus, the court's task was to parse the language and interpret the Certificate. The court determined that the Certificate was ambiguous, with the parties urging widely divergent interpretations. KFCC interpreted the Certificate to allow KFCC the sole authority to hire and fire the national advertising agency and to propose the advertising plan and strategy, while giving the Committee only an "up or down" vote on the proposed plan. NCAC argued that because the Certificate was silent as to whether the Committee could make proposals of its own, it had the power to do so. The court believed that both parties' interpretations were reasonable but decided that "if I were to have to decide this case by only referring to the

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KFC Rules the Roost but Franchisees Govern the Coop, *continued*

language of the Certificate, I would rule for the franchisees."[2] However, because of the ambiguity, the court was forced to consider additional facts and law by admitting parol evidence.

The court next examined the typical rules of interpretation of corporate instruments and determined that those rules would not apply because the Certificate was the product of bi-lateral negotiation, unlike most corporate instruments where the stockholders have no role in negotiating the terms. The court dispensed with the Committee's argument that the Certificate should be construed in favor of the "equity holders," in this case the franchisees. However, the court noted that if the language and the parol evidence are ambiguous, then the burden "should be borne by the party seeking to have the corporation act in a manner contrary to majority rule."[3]

The court then turned to an examination of the extrinsic evidence, including the facts surrounding the negotiation of the Certificate and the course of dealing of the parties. The court considered the testimony of individuals involved in the settlement of the class action litigation, including then-KFCC President David Novak, who testified that KFCC wanted to create a win/win situation for franchisees and KFCC. He said that restructuring the NCAC was one of the goals of the settlement. The Committee had originally played the leading role in national advertising for the brand, and KFCC wanted to obtain more rights while not taking all power away from the Committee.

Evidence showed that KFCC offered to grant franchisees a 1.5-mile exclusive territory in exchange for obtaining the right to hire, fire and direct the national advertising agency. The related testimony and documents convinced the court that KFCC did not attempt to obtain the sole authority to make advertising plan proposals. Instead, the approval process would remain the same, and KFCC's only new right was to hire, fire and direct the national advertising agency.

According to the court, the history of the NCAC also weighed in the Committee's favor. Franchisee members of the Committee had previously submitted advertising proposals that the Committee voted on without KFCC's objection, and other advertising had been approved over the objection of the KFCC representatives on the Committee.

The court construed the Certificate to mean that "KFCC has primary responsibility to make recommendations to the NCAC for the Committee's approval but that the NCAC retains the authority to make recommendations of its own or modify KFCC's recommendations and then vote on those recommendations by majority rule."[4]

The court acknowledged, however, that this reading of the Certificate may not be the most practical or "sensible" solution because KFCC has more resources and capability to plan the advertising for the brand.[5] Splitting the functions of directing the national advertising agency apart from approving the advertising plan has not functioned smoothly in the past and may not prove sustainable without continued disputes. However, strict adherence to rules of contract interpretation won the day, with the court stating that because "KFCC does not like the reality that it has long lived with is no excuse for a court to change it."[6] Thus, if the ruling stands, the only method for improving the structure will be to renegotiate the Certificate.[7]

KFCC's consolation is that it still maintains control over what products are sold and, obviously, owns the brand itself and the associated trademarks to which the NCAC has a license. The NCAC is obligated to use the marks "in good taste and consistent with the then current Bylaws of the NCAC."[8] As the court noted, if the Committee decided to air a campaign called "All Fat, All Fried, All the Time," KFCC could prevent the national advertising agency from airing such a campaign.[9]

Both sides claimed victory in the case, with the Committee's Vice Chair John R. Neal stating that "this ruling reaffirms KFC franchisees' rights to develop and approve advertising, publicity and promotion programs for the KFC system in the United States"[10] and with KFCC's President Roger Eaton stating that "this lawsuit was always about retaining rights, not gaining rights, and we are pleased the court has affirmed that the franchisees do not have authority to run ads which KFC Corp. deems to be inconsistent with its brand image."[11]

Certainly, the franchisees have every incentive to help the brand succeed, but the parties may have divergent visions of how to achieve that success, which makes this case and the power it allows the franchisees problematic for franchisors. This franchisor's introduction of grilled chicken onto its menu in response to perceived demand for healthier dining options ran

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KFC Rules the Roost but Franchisees Govern the Coop, *continued*

into the franchisees' resistance to changing the successful fried chicken KFC brand identity. After all, fried is the brand's middle name. Because the franchisees have the power to approve or reject advertising plans, the franchisees may be able to make their differing vision manifest by refusing to approve or changing a grilled-chicken-focused advertising campaign. Because the franchisor still directs the advertising agency, though, it remains to be seen how this structure will play out absent cooperation between the parties.

Ms. Suwanski is an attorney in our Nashville office.

1. *KFC Nat'l Council and Advertising Co-op, Inc. v. KFC Corp.*, 2011 WL 350415 (Del. Ch. January 31, 2011).
2. *Id.* at *12.
3. *Id.* at *15.
4. *Id.* at *28.
5. *Id.*
6. *Id.* at *29.
7. The court stated that "[U]ltimately, of course, if KFCC does not like its relationship with the franchisees it can reopen contract negotiations. However painful this is, it might be that current business realities make it impossible to continue applying band-aids to the Colonel's outdated business model." *Id.*
8. *Id.* at *28, citing the Agreement between KFCC and NCAC dated November 1, 2004.
9. *Id.* at *29.
10. NCAC Press Release, "KFC National Council and Advertising Cooperative Announcement: Court Rules for Franchisees in Dispute with KFC Corporation" at http://www.restaurantnewsresource.com/article52004.html, February 3, 2011.
11. KFCC Press Release, "KFC Retains Right to Control Brand Image and Advertising" at http://www.restaurantnewsresource.com/article51912.html, February 1, 2011.

Getting Maximum Value for Franchisee and Franchisor During Condemnation Proceedings, *continued*

destruction of business value is a separate compensable interest. Businesses with operations in multiple states should check with counsel to determine whether their jurisdiction allows recovery of lost profits if a location is destroyed or damaged due to condemnation.

A loss of a franchised unit location damages both the franchisee and the franchisor. Though the damages may be reflected in a loss of brand strength, market penetration and customer base, legal damages are measured by lost business value. For franchisors and franchisees, the damages are two-fold. The franchisors lose the value of the franchise fee income stream and the franchisees lose the value of the business primarily created by net income. The nature of the relationship between the franchisor and franchisee creates a series of challenges in recovering such lost value.

Baker Donelson attorneys recently tried a case to a jury where the Georgia Department of Transportation condemned the leasehold interest of a nationally franchised restaurant and forced the closure and demolition of the franchised unit at that location. After the condemnation, the franchisor assigned its rights to any recovery to the franchisee-condemnee. The landlord settled the real estate value claim with the DOT and the only issue at trial concerned lost value of the business. To recover lost business value, Georgia requires that any party meet three criteria. First, did each entity operate a business at the location? Second, could the location be replaced in the immediate vicinity? Third, was the evidence sufficiently grounded in fact so as not to be remote and speculative?

The nature of the relationship between the franchisor and franchisee creates a series of challenges in recovering lost value.

Franchisors are often challenged regarding the "operates a business" test. Even though the business interests of the franchisor and franchisee are directly related with regards to gross revenues, service and product quality, and public perception of the brand as offered by the franchisee at the franchised unit, the franchisor does not operate the business literally. This hurdle is especially challenging because franchisors draft their franchise agreements, operating manuals and internal publications with a view toward avoiding the imposition of tort liability for acts and omissions of the franchisee. Fortunately, the degree of control needed for eminent domain purposes is a limited and less stringent notion than the literal meaning. A court may interpret the test to impose a degree of control significantly less extensive than what is thought to be necessary for a franchisor to be held liable for torts committed by the franchisee.

However, these competing policy goals allow condemning authorities to attack the "operates a business" assertion with any language from franchise agreements, manuals, handbooks and internal publications that may give the franchisee "wink and nod" flexibility to ignore instructions of the franchisor. Because

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Getting Maximum Value for Franchisee and Franchisor during Condemnation Proceedings, *continued*

the success of any single location is so intertwined for the franchisee and the franchisor, all internal guidance by the franchisor for the benefit of the franchisee is most helpful in the condemnation realm if it is drafted to reflect the actual degree of control the franchisor intends to assert over the operations of the franchised unit. Clear and mandatory guidance from a franchisor setting forth the revocation of a franchise for failure of a franchisee to comply with the franchisor's directives makes it difficult for a condemnor to argue that the franchisor does not "operate a business" on the site for condemnation purposes. Such clear and plain documentation effectively communicates to the court that the franchisor's system, products and trademarks are equally necessary for the affected business to operate and that the financial performance of the location is the result of the efforts of both franchisor and franchisee. The documents must communicate, without qualification, that without the franchisor, the franchisee would have no business to operate and without the franchisee, the franchisor would be unable to participate in the stream of revenue derived from percentage franchise fees related to the location.

Documenting the responsibilities of the franchisor and franchisee also assists with the determination of whether or not the business can be replaced in the immediate area. The most concrete evidence of what defines the immediate area is the trade area of the franchise defined by the franchise agreement. If a particular franchise location depends on specific population density, interstate visibility, traffic patterns and other typical site evaluation criteria, these factors help limit the trade area if they are incorporated in the franchise agreement or an ancillary document such as a site approval addendum. The better tailored to the circumstances the specific geographic trade area is for each location, the more difficult it will be for the condemnor to argue that a location could be replaced within the trade area. If the franchise agreement is silent or allows for a very large or generic trade area, it will more difficult for management and experts to testify that the business cannot be relocated within the immediate area.

It is possible to recover business value losses for both a franchisor and a franchisee when a condemnation totally destroys a business.

The ban on remote and speculative damages is easily overcome if the business is profitable and the business records meet commercial standards for properly maintained accounting records, which are typically required by the franchise agreement. Expert valuation testimony rooted in pro forma estimates and projections make this requirement difficult to satisfy. Again, consistency in the franchisor/franchisee relationship is critical. So long as the reality of the relationship conforms to the legal documents and practical experience does not disconnect from contractual mandates, so as to undermine the credibility of the financial records, experts can formulate loss estimates based on actual information reliably created in the ordinary course of business.

Our jury trial proved it is possible to recover business value losses for both a franchisor and a franchisee when a condemnation totally destroys a business. If a jurisdiction allows recovery for these value losses, the key to a successful recovery is proving the intertwined relationship between the franchisee and franchisor. The tools of proof lie within the conventional documentation and operation of the franchise, ready to be exploited for the benefit of both franchisee and franchisor.

Mr. Cadle is an attorney in our Macon office.

Baker Donelson Attorney Awarded Franchise Recognition

Joel Buckberg, an attorney in our Nashville office, was named a Franchise Times Legal Eagle for 2011. The Legal Eagle award recognizes lawyers who are considered rainmakers, go-to lawyers and ethical problem-solvers, and who are respected by their peers, adversaries and clients alike. This award is voted on by the *Franchise Times* editorial board and legal peers, and this is the fifth year Joel has received it. Congratulations, Joel!

2010 Security Report from Verizon Reveals New Patterns of Cybercrime

William K. Norton
615.726.7358
willnorton@bakerdonelson.com

Kelly L. Frey Sr.
615.726.5682
kfrey@bakerdonelson.com

Each year Verizon's RISK Team produces a report analyzing data and security breaches. The 2010 study, conducted in association with the U.S. Secret Service, analyzed 900 breaches and over 900 million compromised records. More sophisticated hackers are noted for targeting specific types of data (such as payment card data, social security numbers and bank account numbers). These attackers generally focus on the "Big Three" industries – financial services, hospitality and retail sites – where a single breach can reveal information on thousands of customers. The study outlines some simple steps hospitality businesses can take to maintain the security of their digital systems.

Surprisingly, the Verizon report concludes that an increasing number of breaches originate from sources internal to breached organizations – mostly lower-level employees with deliberate and malicious intentions. That said, the report confirms that the largest number of compromised data records still arise from outsider attacks.

The report concludes that hacking and malware make up the most widely used attack strategy. The term "hacking" includes attempts to intentionally access or harm information assets without authorization. "Malware," on the other hand, involves software or code developed specifically for the purpose of compromising or harming information assets. Hacking most frequently involves stealing credentials (either to gain access to personally identifiable information such as financial records or access to other features of the hacked system) and can be automated or accelerated using well-known tools. Web applications seem to be the most popular attack pathway for hacking actions and were responsible for nearly all the records reported compromised. Other recent reports indicate that hacking and malware attacks are expanding to mobile devices as these become more pervasive and have increased applications designed to support financial transactions and online commerce.

However, the report emphasizes that the vast majority of attacks arise from less sophisticated exploits. Of the breaches recorded by Verizon, only about 15% required advanced skills or significant customization by hackers. By making small changes, such as encrypting digitally-stored data or requiring authentication when logging onto a system, businesses can effectively deter many security attacks.

In their report, Verizon advises businesses to use industry standards, such as the new version of the Payment Card Industry Data Security Standard (PCI DSS) released last fall, to protect sensitive financial information of cardholders. Verizon found that of all organizations whose financial information had been breached, more than three-quarters had failed to comply with PCI DSS standards. The report suggests that most hackers simply don't want to put forth the additional effort required against protected digital system, and they are often perfectly happy to move on to the next victim if the targeted system appears to present any significant challenge.

What can be learned from these types of reports?

1) Monitor incoming and outgoing traffic

Verizon found that over 85% of attacks could be detected based simply on evidence in server logs. Thus, implementing automatic processes to search for common hallmarks of breaches in these logs can significantly reduce the risks and damages from a security incident.

2) Facilitate early warning of breaches

Data breaches are often reported not by the targets of the attack but by third-party fraud-monitoring services and the eventual victims of the data theft. So regularly monitoring public information about

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2010 Security Report from Verizon Reveals New Patterns of Cybercrime, *continued*

breaches and having a fraud-reporting number or contact within your company can facilitate early knowledge of data security compromises (and allow companies to minimize the impact of on-going attacks).

3) Restrict and monitor internal access

The report recommends limiting privileges to those who absolutely need access to data and separating duties wherever necessary to limit the amount of damage any one internal user can inflict. Logging user activity and flagging for certain types of misuse and "minor" policy violations often provide reasonable indicators of future breach.

4) Be wary of outsiders

Finally, simple restrictions like blacklisting of suspect IP addresses/websites and restricting administrative connections from outside sources can reduce a company's exposure.

In general, preventing data breaches is just a matter of common sense and following well-established security controls. Companies need to be proactive in monitoring tell-tale signs of attacks and implementing internal control processes to ensure compliance with company policies and industry standards. Last, companies need to have an easy method for reporting of security breaches and responding quickly to stop such attacks (and minimize their damage).

Mr. Norton and Mr. Frey are attorneys in our Nashville office.

Hunter Investment Conference Report

Joel R. Buckberg, 615.726.5639, jbuckberg@bakerdonelson.com

Your correspondent attended the March 6-8 Hunter Hotel Investment Conference in Atlanta. The mood was much more upbeat than recent hotel investment conferences, with the number of people claiming to be buyers almost in alignment with the people claiming not to be sellers (except at the right price). For those interested in what the forecasters predict, we recommend the conference's econometric presentations found on the Smith Travel Research (www.hotelnewsnow.com), RubiconGroup.com and Colliers PKF websites. My conference takeaways:

- REVPAR growth has reached a plateau after steady growth for much of 2010, but should resume as demand growth in most segments collides with steady or only slightly increasing supply
- Demand is returning in the business segment and long term group bookings but leisure remains last minute and subject to gas price shocks that siphon disposable income
- Economy and lower mid-scale may be permanently impacted by the loss of middle class jobs and the unlikely return of employment at comparable wage rates, while upper mid-scale and upscale segments see the benefit of pent-up demand by their customers whose portfolio values have recovered
- Banks are lending under highly restrictive covenants and tight springing guarantees for below replacement cost deals to quality sponsors, with strong brand support
- Brand deferrals of product improvement plans and brand standard upgrades are ending quickly, but with higher sensitivity to ROI and owner cash flow needs
- REIT buyers remain committed to gateway cities and trophy resorts while more flexible owners and funds are seeing good returns in suburban and top 25 markets
- CMBS deals are allegedly back at 50 to 65% LTV transactions although completion remains uncertain
- New construction financing is not likely to be available until late 2012 except for SBA loans and USDA loans in rural communities
- Non-traditional equity buyers may enter the market as inflation kicks in to ride the upswing in values from rising REVPAR as commercial real estate rents are committed long term to recently lowered rates, potentially leading to prices per key approaching unsupportable levels
- Rescue equity is available for a transaction that can be refinanced or reworked with existing lenders, original equity holders and new holders riding the rising values, but the owner must start well in advance of the CMBS maturity to accomplish
- Special servicers will hold auctions to sell assets that are not performing but are unlikely to negotiate transactions unless there is no interest in the asset; cash is king and no financing contingencies are acceptable
- Cap rates will hold in the mid-8s, well below the historical 10% level, with some trophy assets command-

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Hunter Investment Conference Report, *continued*

ing lower rates when deferred cap ex has been completed

- Brands will invest in enhancing brand.com and better revenue and inventory management tools for owners and managers to reduce the supply of rooms to and dependence on OTAs, with new Google capability an intriguing prospect for supplanting OTA inventory channels
- "Extend and pretend" may be ending as lenders believe that new owners with new loans, at the written down prices of the assets, can perform and remove non-performing assets from lender balance sheets

Please let us know if you plan to attend The Lodging Conference 2011, September 20-23, 2011 at the Arizona Biltmore in Phoenix, Arizona, where we will again be a sponsor. (www.lodging-conference.com/) We hope to see you there!

Mr. Buckberg is an attorney in our Nashville office.

Labor and Employment Issues in Special Servicer and Other Third-Party Management Agreements

Wesley Redmond, 205.250.8319, wredmond@bakerdonelson.com

When a special servicer or third-party manager takes over a distressed asset or franchise, no one thinks about labor and employment issues until a problem surfaces. While a special servicer or third-party manager with its own employees in the area can usually expect a smooth transition, these arrangements often occur in places that are far-removed from the headquarters or home office. A special servicer may simply assume that it is taking over the former operator's employees, and not think twice about other labor issues.

A troubled asset owner often ignores employee risk factors that more stable employers evaluate to decide whether to hire or pass on a job applicant. Here are some of the issues to be aware of:

• First, the special servicer or manager should determine if the employees, particularly sales people or other individuals who have contact with the customers or clients, may be subject to agreements that restrict their employment with the business. Employees may have non-competition covenants or agreements prohibiting them from working for any competing company, which could apply to the special servicer or manager, even if the covenants did not apply to the former asset owner. The new operator's hiring of an individual with a non-competition agreement could result in litigation against the employee for breach of the agreement, or against the new employer and its affiliates for interfering with that non-competition agreement. An employee may also have less obvious non-solicitation provisions that under certain circumstances prohibit that individual from soliciting their former customers or clients, which may restrict the effectiveness of the employee. If the prior employer has ceased to exist, then the agreements may unenforceable, but if the employer continues to exist, such an agreement can be enforced assuming that it meets the requisite state requirements for enforcement. In this economy, there has been a great deal of litigation in this area as employees have become more desperate and employers more protective.

• Second, the special servicer or manager will want to take steps to ensure that it is not considered a successor employer to the prior employer. This is important to avoid being liable for any of the employees' existing claims under the federal and state anti-discrimination laws. If the special servicer or manager assumes all of an entity's employees at a recognized location and has notice of potential claims for unlawful discrimination or retaliation, it runs the risk of assuming defense and liability for those claims from the prior employer. To mitigate the likelihood of that result, the special servicer should have all the employees go through the normal hiring process, including the application process and any background checks required of all new hires. If the special servicer is able to have contact with management of the prior employer, it should also ask if there are any pending charges of discrimination with the Equal Employment Opportunity Commission or any similar state agency, any internal complaints or grievances, or any pending lawsuits. Presumably the reporting covenants of the asset owner mandated notice of such events, but those reports need to be available to the human resource decision-makers. If any such claims are identified, the special servicer may want

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Labor and Employment Issues in Special Servicer and Other Third-Party Management Agreements, *continued*

to reconsider a wholesale hiring all of the current employees.

• Third, the special servicer or manager should give careful consideration to which entity will become the new employer. If a special purpose entity is created to operate as the asset manager, the manager may want the individuals to be employees of that entity in order to isolate the parent or any related company. Despite the temptation to use centralized payroll payment from the parent entity, the safer method is to pay the new employees of a manager out of the proceeds from the continuing operation of the business if possible, or capital contributed by the sponsor to the special purpose operating entity.

• Fourth, if the special servicer or manager anticipates hiring the employees who were already working at the entity, it must be clear with the employees and the former asset owner entity about when the employees will become the special servicer's employees and the when the special servicer will be responsible for providing them pay and benefits. A distressed franchisee or asset owner will probably not want to pay the employees past the day it lost control of the entity. It may take several days, however, for the special servicer to hire the new employees formally, while they continue to provide services as normal without being sure of their employer's identity. If only a few individuals are involved, the new operator may benefit from avoiding a fight with the prior owner over what entity is responsible for those few days when it was unclear for whom the employees were working. Moreover, the new employer probably does not want to start the relationship with these new employees by having a dispute over whether it owes them compensation for the time period before they actually were hired.

Although the financial and operational issues usually dominate the conversation about the taking over of an entity by a special servicer or a third-party manager, there are also important labor and employment issues that should be considered. Failure to consider these could result in disruption in the workplace, an inability to operate the business as expected and unanticipated potential liability.

There are also some practical issues to consider when taking over or running a distressed business. Because of its lack of profitability, a distressed business may have less revenue available to pay wages and, therefore, may need to hire workers willing to work for these lower wages. These types of workers may lack the credentials normally required to satisfy most screening criteria or may lack the documentation required by federal law. Moreover, a distressed company that is working with a reduced roster will be required to work its employees for longer hours. This could lead to employees working overtime without receiving the required additional pay or working off the clock, both of which are violations of federal and state wage and hour laws. These realities argue strongly for taking the steps necessary to insulate the successor owner/operator from pre-recovery liabilities for employees, and for careful, deliberate pre-employment screening of continuing employees.

Mr. Redmond is an attorney in our Birmingham office.

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