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Reducing the Risk of Liability for Someone Else's Wrongs: A Victory for Landowners in Georgia

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One of the risks inherent in being a property owner is the potential to be held liable for persons injured by a third party who entered the property and caused harm. Businesses have a duty under the law to ensure that their premises are reasonably safe for their patrons. They may risk significant civil damage exposure if they fail to do so. For example, if a bank fails to provide proper lighting around its ATM and a customer is robbed and beaten while trying to withdraw money, the bank itself could be held liable in certain circumstances for failure to maintain the property safe from foreseeable risks to its customers.

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Join the Crowd – Is Franchising Uniquely Suited for Crowdfunding?

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On April 5, 2012, President Obama signed into law the "Jumpstart Our Business Startups" Act (the JOBS Act) The intended purpose of the JOBS Act is to spur job creation by small companies and start-ups by relaxing the regulatory burdens of raising capital. In this article, we focus on Title III of the JOBS Act, otherwise known as "crowdfunding," and how franchisors and franchisees are uniquely suited to take advantage of this new registration exemption under the Securities Act of 1933, as amended, to sell unregistered securities to the public.

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Franchisor Escapes Franchisee Food Fight

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After an allegedly racially motivated fight over a free hamburger between a franchisee's employee and his supervisor in which the employee was knocked unconscious, the franchisor, McDonald's, was sued in U.S. District Court in Memphis along with the franchisee and the supervisor.

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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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Reducing the Risk of Liability for Someone Else's Wrongs, *continued from page 1*

Prior to 2005, Georgia law allowed for joint and several liability, as well as contribution, among co-defendants in premises liability cases. This meant that regardless of a landowner's level of fault in comparison to other defendants (i.e., the individual who actually robbed and beat the bank's customer), it could be held liable for all of the injured customer's injuries. The injured party could choose which wrongdoer from whom it would seek payment of the total final judgment. Given that landowners are often the ones with the deepest pockets and insurance, it is no surprise that they were often the parties that ended up paying 100 percent of any judgment under this system. While the landowner could then seek contribution from the other wrongdoers, it was often difficult if not impossible to do so, given that they were often judgment-proof, unknown or incarcerated. The amount of contribution was not proportionate to each party's level of fault. The allocation was based solely on the number of defendants (for example, if there were two defendants, the one who did not pay the initial judgment would be liable for 50 percent of the damages).

In 2005, Georgia enacted the Tort Reform Act, abolishing joint and several liability in favor of apportioning damages among defendants according to each defendant's percentage of fault. Since its enactment, the plaintiffs' bar in Georgia has been waging a relentless war against the apportionment aspects of the statute. In a victory for landowners, the Georgia Supreme Court recently decided two cases that clarify and uphold this portion of the Act.

First, in March 2012, in the case of *McReynolds v. Krebs*, the Supreme Court held that apportionment was required even in cases where the injured party was not comparatively negligent. The court also held apportioned damages were not subject to any right of contribution; that is, each defendant is only liable for his apportioned damages. The prior statute and case law had allowed – but not required – a jury to consider apportionment of liability, but only in cases where the injured party was to some degree at fault (i.e., where the injured party had somehow contributed to his own injury by acting negligently). Now, it is clear that apportionment does not depend on the injured party's comparative negligence. It must be applied in every case. In premises liability cases, *Krebs* means that apportionment will be applicable even in cases where the injured party did nothing wrong (e.g., was attacked by a third party).

Second, in July 2012, the Georgia Supreme Court decided the case of *Couch v. Red Roof Inns*, addressing a few additional issues that plaintiffs' attorneys have been pushing in their never-ending battle to limit the reach of apportionment. *Couch* involved a hotel guest who was attacked by an armed intruder while staying at a Red Roof Inn. The claim against the hotel was that it had provided negligent security, thereby allowing the armed intruder to enter the premises and attack the guest. The hotel guest argued that because the intruder had acted intentionally rather than negligently, apportionment should not apply. In other words, the argument was that the hotel's negligence in failing to provide adequate security should not be apportioned with the intentional act of the criminal. The court dismissed this argument, holding that a jury may apportion damages between the landowner that negligently fails to secure the premises against a foreseeable criminal attack and the criminal assailant who perpetrates the crime. The court also dismissed a variety of constitutional arguments that had been raised against apportionment since its 2005 debut, likely pushing the constitutionality issues aside once and for all.

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Reducing the Risk of Liability for Someone Else's Wrongs, *continued from page 2*

These cases are good news for Georgia business owners. Apportionment is an important tool in the defense of premises liability claims. Now that its applicability and enforceability have been upheld, the risk of significant damage awards for the acts of a third party is less than it once was. However, this is often a pendulum that swings both ways. Our experience with the real world application of the Act suggests that juries will find means to compensate innocent victims of crime from resources available to answer for the damages suffered. Should a landowner's invitee suffer injury in a third-party intentional crime, after a prior incident, the knowledge of the prior incident and any failure to take action to enhance protection as a result may well factor into the apportionment calculus.

Join the Crowd – Is Franchising Uniquely Suited for Crowdfunding?, *continued from page 1*

Crowdfunding enables small or start-up businesses that may not have access to traditional methods of capital financing to raise capital via the Internet and social media, typically from small-dollar investors.[1]

At first glance, crowdfunding appears to be an innovative and easy way for start-ups to obtain financing by using the vast reach of the internet. However, Congress's concerns over investor protection and fraud prevention are evident throughout Title III. Issuers, brokers and funding portals must comply with substantial informational disclosure requirements and undertake affirmative fraud prevention measures.[2] Aspiring crowdfunding issuers should note that the JOBS Act requires the Securities and Exchange Commission (SEC) to adopt "such rules as the [SEC] determines may be necessary or appropriate for the protection of investors" within 270 days after the JOBS Act being signed into law. Thus, the SEC, which openly expressed its opposition to crowdfunding prior to the passage of the JOBS Act (including criticism by SEC Chairwoman Mary Schapiro that crowdfunding regulation would be akin to "walking backwards"), will most likely implement burdensome compliance and disclosure requirements.[3]

Why is this good news for franchises? Unlike other potential issuers, franchisors, and to a lesser extent franchisees, are already subject to rigorous disclosure requirements.[4] Much of the disclosure mandated by Title III is already encompassed in a franchise disclosure document ("FDD").[5] Therefore, while complying with the extensive disclosure requirements of the JOBS Act may be cost prohibitive and time consuming for most start-ups, franchisors will have a leg up in that they've already prepared most of the disclosure.[6] From the franchisee side, much of the business planning, financial reporting and financial statement preparation mandated by a franchisor can provide the disclosure necessary to meet the likely standards, or at least provide the basis for rapid development of the necessary information.

The basics of crowdfunding are fairly simple. Crowdfunding offerings are capped at $1 million per year. The issuer must be a U.S. company and cannot be a reporting (i.e., filer of periodic reports under the Securities Exchange Act of 1934) or investment company. There are caps on annual investment amounts for investors. Investors with an annual income or net worth below $100,000 may only be permitted to invest, in the aggregate, the greater of $2,000 or 5 percent of such investor's annual income or net worth. For an investor with an annual income or net worth greater than $100,000, the aggregate annual investment is limited to 10 percent of such investor's annual income or net worth, with a maximum aggregate amount capped at $100,000. Except under certain circumstances, crowdfunded securities are restricted securities with a one-year holding period.

1 JOBS Act: Crowdfunding Summary, Practical Law Company (last visited Jun. 8, 2012), http://us.practicallaw.com/6-518-7396.
2 See H.R. 3606 §§ 302(b), 304(a).
3 Benn Protess, Regulator Seeks Feedback on JOBS Act, NYTimes.com (Apr. 11, 2012, 4:16 PM), http://dealbook.nytimes.com/2012/04/11/regulator-seeks-feedback-on-jobs-act/.
4 FTC Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. § 436.5 (2012).
5 Compare H.R. 3606 § 302(b), with 16 C.F.R. § 436.5 (2012).
6 16 C.F.R. § 436.5 (2012).

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Join the Crowd – Is Franchising Uniquely Suited for Crowdfunding?, *continued from page 3*

Conducting a crowdfunding offering requires substantial issuer and offering information disclosure. Issuers are required to file certain information with the SEC, and must provide the same to potential investors and intermediaries, including information regarding their business, ownership and capital structure, and the offering itself. A condensed version of some of the issuer disclosure requirements and liability risks appears below.

- Issuers must make an initial filing with the SEC which contains, among other things, (i) name, legal status, physical and website addresses; (ii) the names of directors, officers and 20 percent stockholders; (iii) a business plan and description of the business; (iv) financial information, which, depending on the size of the offering, may only include a certified income tax return for an offering of $100,000 or less, or audited financial statements for offerings of $500,000 or more; (v) a description of the purpose and intended use of the offering proceeds, the target offering amount, the price of the securities and the method of their valuation; (vi) the ownership and capital structure of the business, including the terms of the offered securities as well as each class of the issuer's securities, a description of how the issuer's principal stockholders' rights could negatively affect the purchasers of the crowdfunded securities, risks associated with minority ownership and examples of how future securities will be valued; and (vii) any other information required by the SEC.

- At least once a year, issuers must also file with the SEC and provide to investors their financial statements and reports of results of operations, as the SEC deems appropriate.

- Purchasers of crowdfunded securities will have a private right of action against an issuer's officers or directors for material misstatements and omissions in connection with the offering. An issuer will be liable if it makes an untrue statement of a material fact or omits a material fact required to be stated or necessary to make a statement not misleading, provided the purchaser did not know of the untruth or omission. Though crowdfunded securities are considered "covered securities," and thus not required to be registered with any state agency, an issuer will still be liable under state securities laws prohibiting fraudulent or unlawful conduct in connection with a securities transaction.

Issuers are also prohibited from advertising the terms of a crowdfunding offering, except for notices directing investors to the funding portal or broker, and may not compensate any third-party promoters without disclosing the compensation to investors.

Does this mean that a franchisor can slap a new cover sheet on an FDD and launch a crowdfunding offering? No, but with a modest supplement describing the corporate documents and attributes not otherwise covered in the FDD, a franchisor can be quickly compliant with the likely SEC rules and the launch of the offering will be achieved more quickly. Additional considerations will include obtaining consent from the auditors to use the franchisor's financial statements and audit opinion for such purpose, and creation of an investor questionnaire, modeled in many respects on the franchise application, that will elicit the eligibility and limitations of potential investors.

How often does a franchisee ask whether he or she can invest in the franchisor? With public companies, the answer is simple. With a new or small franchisor, the answer is usually not often, because the franchise and securities offering are separate. Crowdfunding offers franchisors the opportunity to consider

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Join the Crowd – Is Franchising Uniquely Suited for Crowdfunding?, *continued from page 4*

paired or "paperclip" offerings, where the prospective franchisee is also offered the opportunity to invest in the franchisor's equity.[7] Existing franchisees who are successful and committed to the success of the franchise concept offer another readily available pool of potential investors. The FDD Item 20 information about franchisee contact information is a potentially useful tool for a crowdfunding offering.[8] The regular communications vehicles between franchisor and franchisee offer the opportunity to promote the offering to a group of potential investors without the need for any public solicitation. That communication pipeline, together with the franchisor's extranet accessible only to franchisees with authorized access, could be a major benefit for the issuer-franchisor.

From a legal theory perspective, the legal duties, obligations and interests of the parties in a crowdfunded franchisor where franchisees are participating investors will need some further thought and guidance. The franchisor and its officers are not fiduciaries for its franchisees, but the officers are indeed fiduciaries for their franchisee-investors and the franchisor. Will a franchisee who is an investor be able to assert an aggressive position under the franchise agreement that can harm the franchisor without liability to co-investors? Defining these roles and the associated legal conduct standards will evolve as SEC enabling regulations permit crowdfunding to commence.

7 Franchisors would need to review and comply with state securities laws, often administered by the same regulatory authority as franchising in merit review registration states, before undertaking such an offering.
8 l16 C.F.R. § 436.5(t)(4) (requiring disclosure of "the names, and the address and telephone number of each of their outlets"). Franchise agreements routinely designate a legal notice contact for official notices, which is another source of the information.

Franchisor Escapes Franchisee Food Right, *continued from page 1*

The employee's theories against McDonald's included (1) negligent hiring/supervision; (2) racial discrimination under state and federal civil rights statutes (Tennessee Human Rights Act and 42 U.S.C. § 1981); (3) intentional infliction of emotional distress; (4) negligent infliction of emotional distress; (5) negligent training; and (6) premises liability.

The free hamburger that prompted the fight and litigation had been promised to the employee by another supervisor in exchange for the employee agreeing to work a previously unscheduled overnight shift. The morning shift supervisor was not aware of the informal arrangement and actually slapped several hamburgers out of the employee's hand each time the employee picked one up and attempted to leave.

In granting summary judgment for McDonald's, Judge Jon McCalla carefully analyzed the franchise agreement and the operating manual in ruling that there was insufficient proof that McDonald's was the employee's statutory employer under THRA or § 1981 cited above. Similarly, the court ruled that there was insufficient proof to survive summary judgment as to whether McDonald's retained and/or exercised control over the restaurant or the supervisor who knocked out the employee.

Readers may recall other cases where this franchisor has had mixed results on the question of whether the control over franchisee operations in the operations manual and its level of detail was sufficient to render the franchisor liable for franchisee misconduct as a joint employer in the labor law context or joint tortfeasor in the tort context. The transaction structure typically found involving McDonald's ownership of the real estate and lease to the franchisee engenders more complex analysis than a conventional franchise case.

Interestingly, the decision turned on certain deferential language in the operating manual – for example, instructing franchisees as to how "you can effectively execute your training program" or "through an analysis of your restaurant's process using specially designed tools you can identify areas where additional crew training may be useful." The court found that McDonald's only retained minimal control over such matters and granted summary judgment.

The premises liability theory was more easily dismissed as there was no proof that McDonald's, which leased the premises to the franchisee, had notice of the dangerous condition, i.e., the fist-throwing supervisor.

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Franchisor Escapes Franchisee Food Right, *continued from page 5*

The McDonald's operation and training manual includes a section on discrimination and harassment training. But, as noted above, the court was persuaded by the deferential language which "encouraged" rather than required the franchisee to develop and implement its own policy against discrimination. The one directive from McDonald's training manual along these lines was that the franchisee operator had to "make sure all employees understand McDonald's Policy Against Discrimination and Harassment, including how to bring concerns to the owner/operator's attention or the appropriate person under [the franchisee's] policy."

Franchisors wrestle with the question of how to promote sound personnel practices and appropriate human resources approaches by franchisees without exposure to joint employer or principal liability for an agent's actions. This court did not penalize the franchisor for encouraging proper management rather than commanding it, recognizing that encouragement is the right tone and balance in the operations manual.

Gambler Rolls Dice In Room Service Case, House Wins

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You spend a fun evening at a casino. You get a room in the casino hotel. The next morning you feel queasy and then become terribly ill. Chalk it up to a night of debauchery or blame it on room service food poisoning? In a recent case decided by the United States Third Circuit, a casino guest bet on the latter scenario and lost to the house.

Food poisoning is a food-borne illness caused by eating contaminated food. According to foodsafety.gov, infectious organisms – including various bacteria, viruses and parasites or their toxins – represent the most common causes of food poisoning. Food can become contaminated at any point during its processing or production; see the Mayo Clinic website for more background. Symptoms of food poisoning typically include nausea, vomiting or diarrhea, which can start just hours after eating contaminated food. In most cases, food poisoning resolves without treatment, but some cases are severe and require hospitalization. In a smaller number of cases, foodborne illnesses can trigger serious health problems months or years after victims suffer an initial bout.[1] These late effects are believed to make up a very small fraction of the nation's estimated 76 million annual food poisonings, but have been linked to such serious consequences as diabetes, chronic arthritis, brain and nerve damage, kidney failure and death.[2] The Centers for Disease Control and Prevention website predicts that this year alone, one in six people will get sick with food poisoning; 128,000 thousand people will be hospitalized for it; and 3,000 people will die from it.

Proving food poisoning in a court of law can be a definite gamble, as the plaintiff learned in the recent case of *Kim v. Marina District Development Company LLC d/b/a Borgata Hotel Casino and Spa*.[3] After a night at the Borgata Hotel Casino and Spa in New Jersey, plaintiff Dr. John Kim, a dentist from Maryland, ordered a breakfast of steak and eggs from the room service menu. At some point after eating the breakfast, Dr. Kim became ill and his symptoms grew progressively worse, prompting his girlfriend to summon the hotel emergency medical technicians. The following day, the hotel convinced Dr. Kim to visit its on-site medical clinic, ultimately leading to his hospitalization and an emergency room diagnosis of food poisoning. Dr. Kim subsequently filed suit in the United States District Court for the District of New Jersey, alleging negligence on the part of the Borgata in its food preparation and on-site medical treatment. He sought compensatory damages for his medical bills, loss of wages, bodily injury and pain and suffering, as well as punitive damages.

1 http://www.msnbc.msn.com/id/22771973/ns/health-diet_and_nutrition/t/food-poisoning-can-haunt-health-years/
2 http://www.foodsafety.gov/poisoning/effects/index.html
3 2012 U.S. App. LEXIS 14255 (3d Cir. July 12, 2012).

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Gambler Rolls Dice In Room Service Case, House Wins, continued from page 6

The Borgata prevailed on a motion for partial summary judgment, obtaining pre-trial dismissal of Dr. Kim's claims for negligent medical treatment and punitive damages.[4] After a jury trial, the jury returned a verdict in favor of the Borgata on the remaining negligence claim, finding that the Borgata had not been negligent in the preparation of Dr. Kim's food. On appeal, the United States Court of Appeals for the Third Circuit upheld the grant of summary judgment and the jury verdict.[5]

Three evidentiary rulings at trial proved crucial to the Borgata's victory on the negligent food preparation claim. First, the trial court allowed the Borgata to introduce evidence that Dr. Kim engaged in gambling in the Casino the very same evening that he consumed the allegedly tainted room service breakfast.[6] Second, the trial court excluded records relating to the health department's assessment of the three cooks alleged to have been involved in preparing Dr. Kim's breakfast, based on its finding that the records sought to be admitted consisted of assessments made after the incident in question and no evidence had been offered to explain the relevance of the assessments. Third, the trial court disallowed testimony by Dr. Kim's medical expert because the expert's opinion was based on information provided by Dr. Kim's counsel, not a personal examination or a first-person case history. One could argue here that "the House" knew the rules better than the customer.

In spite of the outcome in this recent case, and the widely acknowledged difficulty of proving a food poisoning claim, the hospitality industry should not treat food preparation and service lightly. The business of selling food involves the obligation to sell food that is not a danger to the consuming public. This author's research suggests that most food poisoning cases are resolved through pretrial motion practice or settlement, making it difficult to assess the risk of litigating through trial. Indeed, very few food poisoning cases are reported, particularly in view of the Centers for Disease Control statistics concerning the frequency of foodborne illnesses.[7] Nevertheless, the stakes can be high in a number of ways, as evidenced by a recent $8.3 million verdict against Kentucky Fried Chicken in Australia. Even the filing of a lawsuit alleging food poisoning can mean bad publicity and the erosion of goodwill for a business. And if a case proceeds to trial, courts have considerable discretion in determining whether certain evidence is relevant.[8] In this area of liability, "the House" does not always win, although this case turned into a good bet.[9]

4 See 2010 WL 2877784 *(D.N.J. July 16, 2010) (granting summary judgment on (1) negligent treatment claim, holding that casino did not have duty under New Jersey law to treat a patron who allegedly suffered from food poisoning, except to summon medical assistance if patron became "helpless," and undisputed facts showed plaintiff was at no point "helpless;" and (2) punitive damages claim, holding that the undisputed evidence did not permit a finding that defendant had showed a "wanton and willful disregard" for plaintiff's condition).

5 2012 U.S. App. LEXIS 14255.

6 *Id.* Also notable, although not the focus of the court's opinion, was evidence suggesting that Dr. Kim's girlfriend had also ordered room service breakfast and had not become ill.

7 Supra note 7. Anyone who has seen the movie Contagion, which features an airborne illness (and coincidentally, a flashback to a casino at which the virus spread) has to wonder why there are not more reported decisions on claims for foodborne illness.

8 See Averitt v. Southland Motor Inn of Oklahoma, 720 F. 2d 1178 (10th Cir. 1983) (upholding jury verdict awarding $375,000 in compensatory damages and $500,000 in punitive damages for food poisoning that resulted in ulcerative colitis and chronic colon disease, and admission into evidence of health department inspection reports covering a four-year period preceding the incident and evidence related to conditions unrelated to the specific type of poisoning suffered by the plaintiff).

9 Cf. *Corbi v. Harrah's Hotel & Casino*, 2010 WL 4226523 (D. N.J. Oct. 21, 2010) (denying summary judgment and discussing standard for establishing causation in food poisoning case)

The Line Brightens Between Franchisors and Franchisees Under the FLSA

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Earlier this year, the United States Fifth Circuit Court of Appeals (which covers Louisiana, Mississippi and Texas) affirmed summary judgment in favor of a part-owner of a Houston nightclub company in a bartender's class action seeking back wages under the Fair Labor Standards Act (FLSA). The Fifth Circuit found that individual members of limited liability companies are not themselves "employers" under the FLSA. This was the first time in roughly 16 years the court addressed this issue in a published opinion, and it offers new guidance for franchisors seeking to insulate themselves from liability for franchisee misconduct. The case is also good news for LLC members who are not involved in the day-to-day management and supervision of LLC employees.

Nicholas Gray, a bartender at Pasha Lounge, sued both Pasha Entertainment Group LLC and LLC member Michael Warren Powers in 2008, alleging that he and other bartenders were only paid tips and no wages in violation of the FLSA. The employee argued that as a member of this Texas limited liability corporation, Powers was an "employer" under the FLSA and was therefore personally liable for the LLC's violations. The district court in Texas granted summary judgment in Powers' favor, ruling he was not an "employer" as the term is used for purposes of the FLSA.

The Act requires, generally, that employees receive a minimum wage and receive compensation at one and one-half times their regular rate for all hours worked over 40 in a week. Unlike the typical concepts of employment found in Title VII, the ADA or the FMLA, the FLSA generally takes an expansive view of the employer/employee relationship. Under the FLSA, an employee can make a claim against someone other than his employer (such as a franchisor) based on a showing that the person or entity exercised sufficient control over the employee's work. That concept is often called "joint employment."

On appeal, the Fifth Circuit agreed Powers was not a "joint employer" by applying the "economic reality" test to evaluate the employer/employee relationship under the FLSA. This four-part test requires consideration of (1) the power to hire and fire, (2) supervision and control of work schedules and conditions of employment, (3) determining the rate and method of payment, and (4) maintaining employment records.

The Fifth Circuit emphasized that the "economic reality" test must be applied to each individual or entity alleged to be an employer, each must satisfy the four-part test, and that actual operational control is necessary.

The court noted that Powers visited the club on five or six occasions total during the 17 months the club was open for business. On one occasion, he told Gray he was doing a "great job;" and on two other occasions, he asked Gray to serve specific people while Powers was a patron at the club. Beyond these instances, Gray could not point to any other occasions where Powers specifically "directed" him as an employee.

Further, while the evidence showed that Powers occasionally signed several pages of pre-printed checks and bartenders casually told him how much they made in tips during his rare trips to the club, it was insufficient to indicate Powers determined employees' rate or method of pay. Finally, and of some importance to franchisors, there was no evidence that Powers maintained the employment records of the LLC.

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The Line Brightens Between Franchisors and Franchisees Under the FLSA, continued from page 8

With this decision, the Fifth Circuit made clear that the joint employer doctrine is not without boundaries. Given this ruling, franchisors should take care to structure their franchise agreements and practices in a way so as to mitigate any potential exposure for franchisee liability under the FLSA. Contractual rights of defense and indemnity for a franchisee's conduct in this area are elementary requirements, but a franchisor's prophylactic measures should extend further.

Specifically, implementation of quality control standards for franchisees are not problematic for FLSA purposes. But, asserting some element of control, approval or even accountability regarding specific pay practices or employment decisions of franchisees could pose trouble for franchisors, if not structured correctly. In practice, the economic control test does not subject an individual to FLSA liability for merely being a franchisor, holding company, officer or shareholder. Rather, only those who have true operational control over employees may be individually liable for FLSA violations. Similarly, franchisors should take care to ensure that expectations of quality control and product delivery do not over-reach into the day-to-day employment practices of franchisees.

FTC Modifies Franchise Rule

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On June 14, 2012, the Federal Trade Commission (FTC) amended its Franchise Rule to reset for inflation three exemption thresholds first set in 2007. These changes are likely to have little meaningful impact but do recognize that even low rates of inflation should push indexed thresholds to higher levels.

These changes were published in the *Federal Register* on June 18, 2012,[1] were effective July 1, 2012, and follow the Rule's original promise of inflation adjustments every four years.[2]

The first change affected the required payment limit to be paid by a franchisee during the first six months after the franchisee and the franchisor sign a franchise agreement. The FTC raised the amount from $500 to $540.[3] If the required payment is less than $540, then the transaction is exempt from the Franchise Rule disclosure requirements.

In the large investment exemption, a franchise that calls for a franchisee to invest more than a specified minimum amount will be exempt from disclosure requirements. The minimum investment amount was raised from $1 million to $1,084,900, excluding the value of undeveloped land and any portion of the investment that is financed by the franchisor or an affiliate.[4]

The other exemption affected is the large franchisee exemption, which exempts from disclosure a franchise transaction with a franchisee that has at least five years of business history and a net worth under GAAP of at least a specified amount. That amount was increased from $5 million to $5,424,500.[5]

The adjustments were made to match the inflation level in the Consumer Price Index, which the FTC measured at 8.49 percent. The $40 increase in the required payment level is a simple 8 percent, justified by the FTC on the basis of simplicity, since a precise increase would push the threshold to $542.45; close enough for government work.

1 77 Fed. Reg. 361459-50.
2 16 C.F.R. §436.8(b).
3 16 C.F.R. §436.1(s); 16 C.F.R. §436.8(a)(1).
4 16 C.F.R. §436.8(a)(5)(i).
5 16 C.F.R. §436.8(a)(5)(ii).

Hershey's Protects Candy Bar Design

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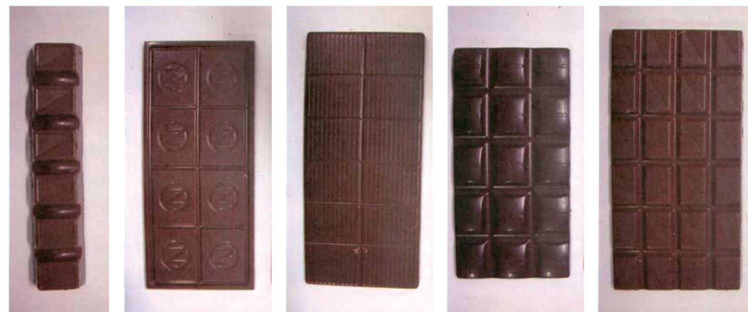
Hershey Chocolate and Confectionary Corporation ("Hershey's") recently gained registered trademark protection for the design and configuration of its candy bar after prevailing in an appeal before the Trademark Trial and Appeal Board (the TTAB)[1]. The candy maker sought protection for "twelve...equally-sized recessed rectangular panels arranged in a four panel by three panel format with each panel having its own raised border within a large rectangle," and while the individual design elements alone were insufficient to garner trademark protection on the grounds that each element is merely a functional configuration of the candy bar, the TTAB ruled that the "overall combination" of the design features entitled the candy maker to registered trademark protection. The TTAB also ruled that Hershey's had acquired the requisite "secondary meaning" for trademark protection in "production-design" trade dress. The decision has some interesting implications on the scope of product-design trademark protection, particularly as it relates to foods. First, it is important to understand how and why trademark law protects this type of food product design and the scope of the protection.

A trademark is any word, name, symbol or device, or any combination thereof, used to identify and distinguish goods from the goods sold or made by others.[2] Hershey's has a number of conventional registered trademarks, such as "Hershey's"[3] and "Hershey's Kisses"[4] for chocolate candy. In this case, Hershey's sought protection not for the word "Hershey's" or the Hershey's logo, but for the unique candy bar design that had been in use for more than 40 years. This type of trademark protection falls under the category of trademark law called "trade dress."

Trade dress includes trademark protection for both "product packaging" and "product design." "Product-packaging" trade dress "is composed of the overall combination and arrangement of the design elements that make up the product's packaging, including graphics, layout, color, or color combinations."[5] "Product-design" trade dress – the type of trade dress at issue in *In re Hershey* – "covers a product's shape or configuration and other product design features."

For both types of trade dress, the design or package feature cannot serve as a trademark if it is "functional," that is, "if it is essential to the use or purpose of the article or if it affects the cost or quality of the article," or if "exclusive use of the feature would put competitors at a significant non-reputation-related disadvantage."[6]

The examining attorney for the U.S. Patent and Trademark Office (USPTO) refused Hershey's trademark application for its candy bar design based on the functionality doctrine, reasoning that "the flat rectangular shape and the 'scoring' of [Hershey's] candy bar into smaller pieces represent functional features which constitute an absolute bar to registration."[7] On appeal, the TTAB agreed that "that scoring or segmenting candy bars, in and of itself, serves a useful function to enable the consumer to break the candy bar into smaller pieces for consumption." It also recognized that candy bars come in all sorts of segmented shapes, "comprised of squares, rectangles, triangles, ovals, and the like," which are "often arranged in a variety of common symmetrical patterns, including, one by six, two by four, three by ten, four by six, etc.," to conclude that "candy bar segmentation is a functional feature of such goods."



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1 *In re Hershey Chocolate and Confectionary Corporation*, (T.T.A.B. 2012) (non-precedential).
2 15 U.S.C. 1127.
3 HERSHEY'S, Registration No. 4,033,631.
4 HERSHEY'S KISSES, Registration No. 1,549,371.
5 Jeffery A. Handelman, "Stretching Trademark Law to Protect Product Design and Packaging," 4 No. 3 *Landslide* 30 (January/February, 2012). *Landslide* is a publication of the ABA Section of Intellectual Property Law.
6 *Qualitex Co. v. Jacobson Prods. Co., 514 U.S. 156, 195 (1995)* (*quoting Inwood Laboratories, Inc. v. Ives Labs., Inc., 456 U.S. 844, 850 n.10 (1982)*).
7 *In re Hershey*, at 6.
8 *Id.* at p. 8 (citing Hershey's May 3, 2010 Response to Office Action, at 8-18).

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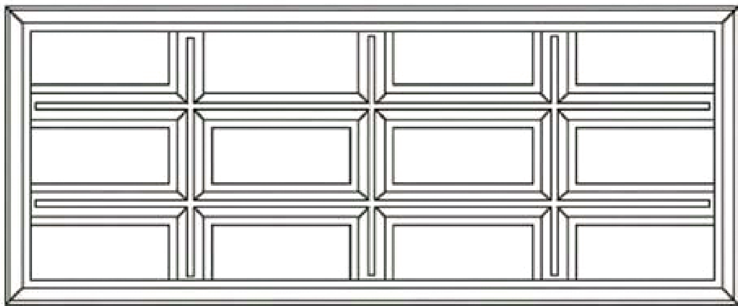
Hershey's Protects Candy Bar Design, *continued from page 10*

But, the TTAB also noted that Hershey's "is not seeking to register a segmented rectangular candy bar of no particular design. Rather, [Hershey's] is seeking to register a candy bar comprising all of the elements shown in the drawing and in the description of the mark, i.e., 'twelve...equally-sized recessed rectangular panels arranged in a four panel by three panel format with each panel having its own raised border within a large rectangle.'"



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While the rectangular shape or segmentation of the candy bar is a functional feature of the design, the TTAB observed that it must balance these functional elements against any non-functional elements to determine whether the mark as a whole is functional." Here, the TTAB identified other elements of the Hershey candy bar design, including the 12 recessed rectangles with a raised border design in a four by three panel format. The TTAB recognized that "candy makers often embellish their candy bars with decorative elements," and that "these raised borders and ridges decorate and embellish what otherwise would be a simple rectangular shape with a four by three pattern." Here, there was no evidence of any other candy maker using the particular combination of recessed rectangles with a raised border that Hershey's used.

The TTAB ultimately reversed the examining attorney's refusal to register the mark on the basis of functionality, observing: "When the significance of design of the recessed rectangles with a raised border is balanced against the rectangular shape including segments, we find that the mark as a whole is not essentially functional. The prominent decorative recessed rectangle and raised border design reduces the degree of utility present in the overall design of the mark so as to remove it from the category of functional...."

After clearing the functionality hurdle, Hershey's next had to show that its product design had achieved the requisite "secondary meaning." In the analytical framework of trade dress, there is a key difference between "product-design" trade dress and "product-packaging" trade dress. "Product-packaging" trade dress can earn trademark protection if it is either (1) "inherently distinctive" or (2) if it acquires "secondary meaning."[10] "Product-design" trade dress, on the other hand, faces a higher bar and can only be protected as a trademark if it achieves "secondary meaning." A mark is "inherently distinctive" if "its intrinsic nature serves to identify a particular source."[11] Given that Hershey's sought trademark protection as a product-design, it had to prove "secondary meaning" – that is, Hershey's had to show that its candy bar design had acquired distinctiveness over a period of time such that its relevant consumers (chocolate consumers) view the configuration as a trademark.

The examining attorney for the USPTO refused registration to Hershey's trademark application for its candy bar design on the grounds that the design had not established this "acquired distinctiveness" or "secondary meaning." A product design applicant faces a heavy burden in attempting to establish acquired distinctiveness.[12] "Ultimately, to establish acquired distinctiveness, an applicant must show that the product configuration sought to be registered is perceived by consumers as not just the product but, rather, that the design identifies the producer or source of the product."[13]

9 *Id.* at 2. See also U.S. Trademark Application Serial No. 77,809,223 (filed August 29, 2009).
10 *Wal-Mart Stores, Inc. v. Samara Brothers, Inc., 529 U.S. 205, 212 (2000).*
11 *Id.* at 210. The Court of Appeals for the Federal Circuit and the TTAB consider four factors to determine whether a design is inherently distinctive, including whether the mark is: (1) a "common" basic shape or design; (2) unique or unusual in the field in which it is used; (3) a mere refinement of a commonly-adopted and well-known form of ornamentation for a particular class of goods viewed by the public as a dress or ornamentation for the goods; and (4) capable of creating a commercial impression distinct from the accompanying words. See *Seabrook Foods, Inc. v. Bar-Well Foods, Ltd., 568 F.2d 1342, 1344 (Fed. Cir. 1977*). See also TMEP § 705.05 (5th ed. Sept. 2007).
12 *Yamaha Int'l Corp. v. Hoshino Gakki Co. Ltd., 840 F.2d 1572,* (Fed. Cir. 1988).
13 *In re Hershey*, at 13.

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Hershey's Protects Candy Bar Design, continued from page 11

Trademark law is silent on the amount of evidence required to show secondary meaning,[14] leaving "the exact degree of proof necessary to qualify a mark for registration to the judgment of the Patent Office and the Courts."[15] Here, the TTAB reversed the examining attorney's refusal to register Hershey's application because the TTAB found that Hershey's established a prima facie case that the candy bar configuration had acquired distinctiveness. The TTAB considered as direct evidence a survey of relevant consumers (those who had both purchased a chocolate bar in the past six months and plan on purchasing a chocolate bar in the next six months), who were asked to identify the maker of the "four by three" panel candy bar configuration. Forty-two percent of survey participants correctly identified Hershey's as the maker of the candy bar, a percentage that is higher compared to other cases in which survey results were used to establish secondary meaning.[16] The TTAB also considered circumstantial evidence submitted by Hershey's, including evidence that Hershey's had been using the mark for over 40 years, sales figures over a 12-year period exceeding $4 billion dollars, and $186 million in advertising products embodying the candy bar configuration. Lastly, the TTAB also considered a purported attempt by a third party to copy the design of the candy bar configuration for the shape of a brownie baking pan, where the words "CHOCOLATE" appear in each rectangle instead of "HERSHEY'S."

The Hershey's case represents another development in the evolving field of trade dress trademark protection. As the courts continue to leave clues to avoiding the functionality barrier and to proving either inherent distinctiveness or acquired secondary meaning, trademark applicants will have more ways to protect unique design features in their products.

14 See 15 U.S.C. § 1052(f); *Yamaha, 840 F.2d at 1581.*
15 *Yamaha, 840 F.2d at 1581* (quoting *In re Owens-Corning Fiberglas Corp., 774 F.2d 1116, 1125 (Fed.Cir.1985)*).
16 *In re Hershey*, at 14-15.

Restaurant Chain Founder Chooses FLSA Exposure Over Franchise Compliance

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Can a founder of a chain of restaurants be liable to an employee for unpaid wages even though he does not own the restaurant where the employee worked? A Texas district court says possibly so. In this case, the chain units were owned by a series of entities in which the founder had a varying ownership interest. The units were operated under common management. The case record and opinion are silent on whether the founder ever formally complied with Federal Trade Commission (FTC) and Texas laws governing franchises. Nor is there any record that the founder ever filed the notice with the Secretary of State required by the Texas business opportunity law to franchise in Texas.

The plaintiff was a cook at a pizza restaurant that was part of a multi-unit chain of restaurants. The defendant, the founder of the chain, owned some of the restaurants, but not the one where plaintiff actually worked. Nevertheless, the plaintiff alleged that the defendant was his employer and liable to him under the Fair Labor Standards Act (FLSA) because the restaurant where he

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Restaurant Chain Founder Chooses FLSA Exposure Over Franchise Compliance, *continued from page 12*

worked was part of the defendant's enterprise. The defendant filed a Motion to Dismiss, arguing that the employee did not demonstrate the existence of an enterprise and, even if such facts were pled, he fell under the franchise exception. The court disagreed.

The minimum wage and overtime provisions of the FLSA apply to employees of "an enterprise engaged in commerce or in the production of goods for commerce." The three main elements to find the existence of an "enterprise" are: (1) related activities, (2) unified operation or common control, and (3) common business purpose. While these factors would seem to impose FLSA liability on every individual who creates a franchise, there is a specific regulatory exception for certain types of franchises.

To fall within this exception, the individual establishment must: (1) be a retail or service establishment under the Act; (2) not itself be an enterprise large enough to fall within the FLSA's coverage; and (3) be under independent ownership. The Department of Labor (DOL) regulations provide that, if these three requirements are met, then the establishment may enter into the following arrangements without losing its status as exempt from enterprise coverage: (1) any arrangement that it will sell, or sell only, certain goods specified by a particular manufacturer, distributor or advertiser; (2) any arrangement it will have the exclusive right to sell the goods or use the brand name of a manufacturer, distributor or advertiser within a specified area; (3) any arrangement that it will join with other such establishments in the same industry for the purpose of collective purchasing; or (4) any arrangement whereby the establishment's premises are leased to it by a person who also leases premises to other retail or service establishments.

The DOL regulations do not define the term "franchise," so a factual analysis is required to determine the instances in which a franchise or other arrangement will have the effect of creating a larger enterprise for FLSA purposes. We note with some curiosity that the DOL has not borrowed from 34 years of guidance on the definition of a franchise infused in the FTC Franchise Rule.

In determining whether the establishment was excepted from enterprise coverage, the court considered the allegations that the defendant held meetings at the restaurant; dictated signage, menu items, recipes, cooking procedures, ingredients and vendors through the franchise agreement; negotiated/contracted with vendors and managers; instructed the store owner and managers on which products they should purchase; made monthly visits to monitor employees; met with and discussed performance of employees; managed an online system for fielding complaints; and instructed owners regarding the hiring and firing of employees. The court particularly noted the allegation that the defendant personally changed the plaintiff's work schedule. The court held these allegations sufficient to demonstrate that the restaurant was part of an enterprise operated by the defendant and also that the way that he operated his restaurants made the franchise exception inapplicable.

This case presents key lessons for: (1) franchisors who are tempted to become involved in the operations of their franchisees; and (2) restaurant chains ready to grow with investments from third parties. Franchisors intending to protect the franchise who participate in the daily business decisions of an independent store, including hiring and firing employees, blur or erase the line between franchisor and employer. FLSA lawsuits are at an all-time high and the DOL is focusing wage and hour audits on the service industry. Franchisors need be mindful of this risk. To

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Restaurant Chain Founder Chooses FLSA Exposure Over Franchise Compliance, *continued from page 13*

achieve this same level of control without the accompanying risk, franchisors should consider revising their agreements to remove opportunities for an employee to argue the franchisor has assumed control. In addition, the focus should be on examining whether the franchisor needs to promulgate requirements for employees of the franchise beyond training, uniforms and general appearance, and background checks for sensitive positions. Avoiding any procedures, customs and practices that are tantamount to participation in personnel management should be an objective.

Franchisors should also be mindful of the fact that some of the factors that the court considered in finding an enterprise are requirements that appear in virtually all franchise agreements, such as signage or software specifications. Franchisors should ensure indemnity provisions in favor of the franchisor expressly cover labor law claims, and whether the cost of employment practices liability insurance is worth the risk mitigation for both franchisee and franchisor.

Multi-unit operators seeking to expand without formally franchising should be cognizant of the parallel risk of FLSA enterprise liability that is unshielded by the franchise exemption. Imagine the operator's chagrin at having FLSA enterprise liability for independently operated units and liability under the FTC Act and, in this case, the Texas Business Opportunity Act, for violation when the minority investors claim their relationship is a franchise sold without compliance, or claiming the franchise exemption when there is no evidence that the steps to undertake franchise compliance were taken. The defendant has now admitted under oath that his transaction violated the FTC Act and state law. That scenario could be very expensive.

Franchisee's Disregard of LLC Formalities Creates Exposure for LLC Debts

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The limited liability company or LLC has largely replaced the corporation and limited partnership as a preferred form of business entity. Although the LLC requires fewer formalities than either of these more traditional forms of business entities, its members and managers are not free to ignore formality entirely. But franchisors who fail to understand the organizational chart of their multi-unit operators may find themselves without a practical means of collection. Recently, the Mississippi Court of Appeals opined on the standard for piercing the veil of an LLC in *Restaurant of Hattiesburg, LLC v. Hotel & Restaurant Supply, Inc., 84 So. 3d 32 (Miss. App. 2012)*. In a well-written opinion, the court held that the same test to pierce the veil of a corporation applied to LLCs and to "pierce the veil of an LLC the complaining party must prove LLC membership [of the defendant individual] as well as (a) some frustration of contractual expectations, (b) flagrant disregard of LLC formalities by the LLC members, and (c) fraud or misfeasance by the LLC member." *Id. at 40 (citing Gray v. Edgewater Landing, Inc., 541 So. 2d 1044, 1047 (Miss. 1989)*). The court also noted that in almost all the corporate-veil-piercing cases in Mississippi, the plaintiff brought the underlying contract or tort claim in the same action as the veil-piercing claim. But the court clarified that Mississippi law does not require this approach and a plaintiff can file a second suit for piercing the veil after a judgment is obtained against the entity.

In 2005, two individuals named Schafer and Brick opened various restaurants as Copeland's franchises. Schafer and Brick formed three separate LLCs: (1) Restaurant of Hattiesburg, LLC to operate a Copeland's in Hattiesburg, Mississippi, (2) Restaurant of Jackson, LLC to operate a Copeland's in Jackson, Mississippi and (3) SouthEastern Restaurant LLC, to manage the accounting and payroll of both restaurants. This is a common multi-unit

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Franchisee's Disregard of LLC Formalities Creates Exposure for LLC Debts, *continued from page 14*

franchisee structure, with a holding/services company sitting on top of the unit operating entities, allowing the efficient use of shared services and personnel with appropriate service fees paid by the operating entities. A supplier, Hotel & Restaurant Supply (HRS), delivered restaurant supplies to the Jackson Copeland's, which closed in 2006, owing HRS more than $29,000.

Later that year, HRS sued Restaurant of Jackson and SouthEastern. The trial court found Restaurant of Jackson and SouthEastern jointly liable to HRS for $36,816. HRS garnished SouthEastern's bank account, which contained a grand total of $36. Undeterred, HRS initiated post-judgment discovery. HRS then filed suit against Restaurant of Hattiesburg, Schafer and Brick. HRS sought to "pierce the veil" of SouthEastern and Restaurant of Jackson to the member level and hold the three defendants jointly and severally liable for the judgment against the affiliated but insolvent LLCs.

The trial court denied the defendants' motion for summary judgment and instead granted HRS' motion for summary judgment, finding that Restaurant of Hattiesburg, Schafer and Brick were jointly and severally liable for the $36,816 judgment, plus expenses of post-judgment discovery, plus attorney's fees and interest. Restaurant of Hattiesburg, Shafer and Brick appealed.

On appeal, the Mississippi Court of Appeals reversed the trial court and remanded the case for trial on the merits. The court noted that "[l]ike a corporation, an LLC is purely a creature of statute." The Mississippi Limited Liability Company Act is clear that a member cannot be personally liable for an LLC debt solely by reason of being a member. The court also noted that on January 1, 2011, the Revised Mississippi Limited Liability Company Act went into effect. The Revised LLC Act was adopted to provide greater clarity of existing LLC statutory requirements, to set up more default rules for LLCs without operating agreements, and to incorporate language from Delaware's LLC Act to enable Mississippi courts to look to Delaware law when interpreting the Mississippi's Revised LLC Act.

The Court of Appeals found the trial court used the right precedent for what a plaintiff must prove to hold an LLC member liable for the LLC's debt. The court held that HRS must prove the first test prong, frustration of contractual expectations. The court observed that without seeking a personal guarantee from Schafer or Brick, HRS continued to tender goods to Restaurant of Jackson, which it knew to be an LLC. The court noted that Schafer and Brick's ownership of the three LLCs is not enough in itself to treat the three LLCs as one. The court also noted SouthEastern, which managed both operators' accounts, wrote checks to HRS for Restaurant of Jackson's invoices. But the court noted that on remand, in order to hold Restaurant of Hattiesburg liable for the debt of the two other LLCs, HRS has to show actual frustration of identity due to the shared bank account. The shared bank account, by itself, was not sufficient to meet this prong.

The court also stated that analyzing the second prong (the flagrant disregard of LLC formalities by the LLC members) is more difficult with an LLC than a corporation because the LLC statute imposes fewer formalities on LLC members. The court held that like Texas, Mississippi declined to adopt a rule that LLCs sharing a bank account is per se an abusive practice. Citing *SSP Partners v. Gladstrong Investments, 275 S.W.3d 444, 455 (Tex. 2008).* There was evidence to create a factual dispute on this test.

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Franchisee's Disregard of LLC Formalities Creates Exposure for LLC Debts, continued from page 15

With respect to the third prong, a demonstration of fraud or other equivalent misfeasance on the part of the LLC member, the timing of Restaurant of Hattiesburg's opening its own bank account and ceasing to use SouthEastern's account created another fact issue. The Court of Appeals noted that while it is not fraudulent to limit the liabilities of each restaurant to its own debts, SouthEastern did conveniently claim the income of Restaurant of Hattiesburg until it was hit with a $36,000 judgment.

This result was fact-specific, but the opportunity for clarification is welcome since the laws relating to LLCs are still evolving. The bottom line for franchisors or suppliers is that a personal guarantee on the front end is critical to credit support for a multi-unit operator.

Piercing the veil of an LLC still appears to be difficult, despite a lack of formality and casual observance of banking protocols for separate accounts. For any LLCs, particularly multiple LLCs that have common member ownership, the managers must maintain the formality of the separate LLCs and keep good transactional and accounting records. For any distributions to members, documentation to explain the disbursement (e.g. repayment of loan) is critical. Keeping proper formalities and documentation could mean the difference between being dismissed before trial or having a jury decide whether the veil of the LLC should be pierced. More leeway for common asset management is allowed than for corporations, but the leeway has a still to be defined limit.

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