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The Hospitality Industry Newsletter from Baker Donelson

Leather Shop Strikes Out in Bid to Tag Its Distributor

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The latest chapter in a six-year-old antitrust case, a decision dismissing the complaint in *PSKS, Inc. v. Leegin Creative Leather Products, Inc.*, No. 03-cv-107(TJW), 2009 WL 938561 (E.D. Tex. April 6, 2009), offers further guidance on how the courts will examine vertical agreements — agreements on prices between distributors and their retailers and between franchisors and franchisees. Once again, the law favors the distributor and the franchisor, although legal perils still remain.

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Mississippi Extends Important Sales Tax Incentive Program to Casino Industry

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On March 17, 2009, Mississippi Governor Haley Barbour signed into law House Bill 1467 to extend the sales tax incentives of the Mississippi Tourism Rebate Program to casino developers that build non-gambling-related amenities such as theme parks, water parks, golf courses, hotels, spas, convention facilities and other non-gambling attractions. The program, administered by the Mississippi Development Authority (MDA), is designed to provide the owner of a qualified tourism project with a rebate equal to 80% of the sales

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Lessons from a Florida Franchise Race Discrimination Case

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There appears to be a sharp increase in lawsuits filed against franchisors alleging race discrimination under Section 1981 of the Civil Rights Act of 1866 (codified at 42 U.S.C. § 1981, "Section 1981"). This is a Reconstruction-era statute providing all people, including recently freed slaves, with the same right as white people to make and enforce contracts. In the 1970s, plaintiffs' lawyers began to use the statute to prosecute discrimination in the workplace based on an employee's race. While race-based discrimination was already made illegal by Title VII of the Civil Rights Act, Section 1981 was attractive to plaintiffs' lawyers because it: (1) has a longer statute of limitations (four years versus

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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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Two years ago, in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007), the Supreme Court abandoned a 90-year-old rule that an agreement between a manufacturer and a distributor to set minimum resale prices was per se illegal under the Sherman Act, deciding instead that the legality of such vertical agreements on price would be evaluated under the rule of reason. The distinction between per se condemnation of an agreement and analysis of the agreement under the rule of reason is crucial for determining what a plaintiff must show to prevail in a case under Section 1 of the Sherman Act, 15 U.S.C. § 1.

To survive a motion to dismiss a claim that defendants committed a per se violation of the Sherman Act, such as an agreement among competitors on the price they will charge their customers, a plaintiff need allege only that such an agreement plausibly existed. But if the allegedly illegal agreement is one that courts evaluate under the rule of reason, the agreement is illegal only if the anticompetitive effects of the defendants' agreement outweigh its procompetitive benefits. Thus, in a rule-of-reason case, the plaintiff must allege, among other things, that the agreement existed, that the defendants had the power to affect the relevant market adversely, and that the agreement in fact had an anticompetitive effect on the market.

In *Leegin*, the Supreme Court reviewed a jury verdict that had found that Leegin, a manufacturer of high-end women's accessories, had violated the Sherman Act when it entered into agreements with its retailers to set the minimum resale price of its Brighton brand of women's accessories. The jury awarded plaintiff PSKS $1.2 million and, pursuant to the Sherman Act, the court trebled the damages award and added the plaintiff's attorneys' fees and costs. Following *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911), the trial court considered Leegin's vertical minimum resale price maintenance agreement to be per se illegal under the Sherman Act and did not require that the plaintiff show that Leegin had market power in any relevant market or that the agreement had an anticompetitive effect. The Court of Appeals agreed. But the Supreme Court reversed, continuing a trend started 30 years ago in *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977), that treats vertical agreements more leniently than it treats horizontal agreements — agreements among competitors.

The reason for this different treatment is that a vertical agreement might have procompetitive benefits: an agreement between a manufacturer and its retailers limiting each retailer to a certain geographic area or certain type of customer (as was the case in *Continental T.V.*) might encourage retailers to make certain investments in customer service or advertising that would strengthen interbrand competition even

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Franchisee Tips for Troubled Times

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Retailers know their customers are difficult to attract, expensive to acquire and even more expensive to replace. In this economic environment, franchisors have recognized that a new corollary augments this adage: "and won't be replaced anytime soon." With so much invested in a franchise relationship and franchise asset by both sides, every effort should be taken to preserve brand affiliation when retention remains a viable option. The notion of interchangeable flags, or the flag as a flexible commodity, flies against recent experience that a brand — or the loss of a brand — matters to the financial performance of the asset. Brand preservation will benefit your opportunity to maximize asset value in most cases.

Yet some franchisees deliberately string along their brand companies, waiting for a default notice, or two, before taking action to restore a property to brand standard compliance, or to bring accounts current. This course of action is a dangerous game. If the power company sends a notice of shutoff, most electric service customers don't wait until a lineman arrives to remove the electric meter to pay the power provider. Can a hotel's cash flow survive a reservation system suspension or cessation of group bookings and meeting services, while the owner considers how to resolve franchise issues?

Like all business challenges, communication with key constituencies is critical for survival. Bankruptcy laws force unsecured creditors like the brand franchisor to take prompt action to protect their interests. The brand does not relish the prospect of brand image damage sustained by riding out a bankruptcy or reorganization. Brand patience will not

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Leather Shop Strikes Out in Bid to Tag Its Distributor, *continued*

if it limited intrabrand competition. The Supreme Court overruled *Dr. Miles,* reversed the Fifth Circuit, and remanded. The Court of Appeals in turn remanded the case to the Eastern District of Texas. *PSKS, Inc. v. Leegin Creative Leather Products, Inc.*, 498 F.3d 486 (5th Cir. 2007).

On remand, to proceed to another jury trial, plaintiff PSKS had to allege not only that there was an agreement among Leegin and its retailers, but also that Leegin had market power in a relevant, properly defined market and that the agreement had an anticompetitive effect. The court permitted PSKS to amend its complaint. In PSKS's second amended complaint, PSKS alleged that Leegin's agreement with its retailers adversely affected competition in two relevant product markets, the "retail market for Brighton's women's accessories" and the "wholesale sale of brand-name women's accessories to independent retailers." PSKS also added allegations of a per se horizontal agreement among Leegin and its retailers. Leegin moved to dismiss the complaint.

The court rejected both of the product markets that PSKS proposed. The first market, the court held, was an alleged market for a single brand of goods. It is well established that absent exceptional circumstances, a single brand in a market of competing brands cannot constitute a relevant product market for analysis under the Sherman Act. *See, e.g., Green Country Food Market, Inc. v. Bottling Group, LLC*, 371 F.3d 1275 (10th Cir. 2004); *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*, 732 F.2d 480 (5th Cir. 1984). PSKS argued that it was entitled to special treatment because it had identified a unique "submarket" that should be treated distinctly for antitrust purposes. But these are not the sort of special circumstances that might allow a court to conclude there was a separate market for a particular brand. For example, a plaintiff might arguably have been locked into a particular brand because of an earlier decision to enter into a business servicing a particular brand of equipment that requires investments in training, spare parts and diagnostic software, *see Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451 (1992). Perhaps a franchisee invests in a particular franchise, and subsequent to the investment the manufacturer of the equipment or the franchisor materially changes the terms of the business relationship. In those cases, there might be an argument that the service company or franchisee was locked into a market for a single brand. But no such circumstances existed here. PSKS instead argued only that the market for Brighton goods was a cognizable submarket. Because Leegin's Brighton brand accessories competed with accessories of other brands from other manufacturers, the court concluded that the alleged market for Brighton brand goods alone could not be a relevant product market for antitrust analysis.

PSKS's second product market was the market for the "wholesale sale of brand-name women's accessories to independent retailers." The court rejected this market as well because it did not describe a plausible market. The most important test of whether products are in one market or another is whether a particular product is readily interchangeable with another. PSKS did not show why the limitation of the market to independent retailers made sense when consumers could purchase substitute goods from other types of retailers. A market of "women's accessories" was too broad and too vague to define a relevant market. PSKS failed to show that a brand

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Franchisee Tips for Troubled Times, *continued*

be unlimited — and the owner's expressed intentions must translate into demonstrated efforts to maintain performance. The brand is much more likely to work with the owner if discussions are candid, truthful and open — and the ability to meet brand obligations and guest expectations is realistically assessed.

A written workout plan, with consequences of getting off track clearly understood, is a well-recognized means of brand retention. The plan should be clear in its milestones, include a product improvement plan with performance dates specified and result in the property being in full compliance with brand standards at conclusion.

The brand may offer (and the lender may require) an operational audit with property staff, additional training, or other methods of improving performance against brand norms if the hotel's test or guest satisfaction scores are below average. The owner should expect the franchisor to demand a release of any claims against the franchisor and its affiliates for breach of contract or arising from the offer and sale of the franchise as a condition to granting extensions of time to perform. Other benefits negotiated at the time of initial affiliation may be reduced, deferred or recovered as a condition of the plan, or restored only when the plan is completed to the brand's satisfaction.

Finally, if the asset is to be sold, the brand may allow the buyer to assume the plan as part of its affiliation agreement. If the brand affiliation has value, a workout plan may be the only alternative to a painful and expensive termination process.

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Leather Shop Strikes Out in Bid to Tag Its Distributor, *continued*

name was relevant to the substitutability of products. And the court found that limiting the market to wholesale sales was not relevant when the relevant question was the impact on the retail market.

Once the court found that neither of PSKS's alleged product markets was a relevant product market for antitrust analysis, PSKS's claims were doomed to fail. Market power and anti-competitive effects cannot be analyzed if there is no relevant product market.

The court rejected PSKS's claims of horizontal restraints for two reasons. First, PSKS had abandoned any such claims because it did not allege any horizontal agreement in its original complaint. Although the Supreme Court's decision in *Leegin* did indeed change well established precedent, which might entitle a party to revive a claim not pursued in an original proceeding, the rule that the Supreme Court changed related to vertical restraints, not horizontal ones. Moreover, that court held that the alleged horizontal restraint relied on Leegin's position as a dual distributor, both a wholesale distributor and a retail distributor. Such dual distribution systems are analyzed as vertical arrangements and therefore fall under the rule of reason. Any rule-of-reason claim will fail because, as discussed above, PSKS had failed to allege a cognizable product market.

The PSKS remand illustrates just how difficult it can be to survive a motion to dismiss where plaintiffs seek to establish that a vertical restraint, even a vertical agreement on prices, violated the Sherman Act. To be viable, a complaint must allege a plausible relevant product market. But distributors and franchisors should be aware that they should not engage in vertical pricing agreements without considering whether their particular proposed agreements might violate the antitrust laws. First, there are situations where distributors do indeed have sufficiently high market shares for their vertical agreements to have anticompetitive effects. Second, there are situations where the lock-in rule of *Kodak* arguably applies, something that franchisors who are contemplating significant changes to their relationships with franchisees on retail pricing of the brand's goods or services should consider. Third, most states have their own antitrust laws. Although many states interpret those laws consistently with the federal courts' interpretations of the Sherman Act, some, particularly those that are not bound by statute to follow federal antitrust precedents, have not adopted the Supreme Court's rule in *Leegin* with respect to vertical price maintenance agreements within particular states. In fact, some states have made clear that they will continue to treat minimum resale price maintenance arrangements as illegal *per se*, as they did when, after the Supreme Court's decision in *Leegin*, they objected to any modification of an earlier FTC order prohibiting a resale price maintenance scheme. *See, e.g.*, In the Matter of Nine West Group Inc., Docket No. C-3937 (FTC). Finally, Congress is considering legislation to reverse the rule in *Leegin*. The Discount Pricing Consumer Protection Act, S.148, 111th Cong. (2009), would amend Section 1 of the Sherman Act to condemn as illegal "[a]ny contract, combination, conspiracy or agreement setting a minimum price below which a product or service cannot be sold by a retailer, wholesaler, or distributor..." Therefore, although the tide has moved noticeably in favor of distributors and franchisors over the last several decades, distributors and franchisees are not immune from the antitrust laws.

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Mississippi Extends Important Sales Tax Incentive Program to Casino Industry, *continued*

tax collected from the project for a period of up to 10 years, not to exceed 30% of the total cost of the project.

Casino companies were previously excluded from participating in the rebate program. However, under the new law, casino-owned tourism projects may be eligible for the sales tax incentives if the project is in excess of development that the Mississippi State Gaming Commission requires for the issuance or renewal of a gaming license and is not part of a licensed gaming establishment in which gaming activities are conducted.

Tourism projects that qualify for the program include any of the following as may be approved by the MDA:

1. Theme parks, water parks, entertainment parks or outdoor adventure parks, cultural or historical interpretive educational centers or museums, motor speedways, indoor or outdoor entertainment centers or complexes, convention centers, professional sports facilities, spas, attractions created around a natural phenomenon or scenic landscape and marinas open to the public with a minimum private investment of not less than $10 million;
2. A hotel with a minimum private investment of $40 million in land, buildings, architecture, engineering, fixtures, equipment, furnishings, amenities and other related costs approved by the MDA. There must be a minimum private investment of $150,000 per guest room; or
3. A public golf course with a minimum private investment of $10 million.

In the past, the Mississippi Tourism Rebate Program also excluded any facility within a project whose primary business is retail sales, with the exception of pro shops, souvenir shops, gift shops, concessions and similar retail activities. House Bill 1467 expands on these exceptions to include retail activities that are part of a "resort development." A "resort development" is defined as a travel destination development with a minimum private investment of $100 million and which consists of (a) a hotel with a minimum of 200 guest rooms or suites and having a minimum private investment of $200,000 per guest room or suite, and (b) guest amenities such as restaurants, golf courses, spas, fitness facilities, entertainment activities and other amenities as determined by the MDA. Not more than 40% of the private investment may be expended for facilities that house businesses whose inventory consists primarily of upscale name brands or their equivalent. Developers who wish to take advantage of the "resort development" exception to the prohibition against retail sale developments must submit their application prior to July 1, 2014. The MDA will not approve any application submitted after June 30, 2014 for a project that includes a resort development.

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Lessons from a Florida Franchise Race Discrimination Case, *continued*

approximately one year); (2) does not require employees who sue under this claim to file a charge of discrimination with the Equal Employment Opportunity Commission or administrative agencies before instituting such an action in court (unlike Title VII); (3) has no requirement for a minimum number of employees (unlike Title VII); and (4) has unlimited compensatory and punitive damages (unlike Title VII), while still providing for an award of attorney fees. Therefore, plaintiffs' employment lawyers began to add Section 1981 claims to their Title VII race claims, at a minimum, to pursue greater damages than would otherwise be available under just Title VII.

A recent decision out of a federal court in Florida offers an opportunity to discuss how courts generally analyze these cases in the non-employment context. In *Elbanna v. Captain D's*, 2009 U.S. Dist. LEXIS 11425, the plaintiff alleged that he was rejected as a franchisee because he was Arab. He brought claims seeking damages from Captain D's for alleged violation of Section 1981, among other claims. He had been approved by Captain D's to be a franchisee in 2005 to develop a restaurant in the Jacksonville area. However, two sites Elbanna selected at that time were rejected by the defendant as unsuitable due to either poor demographics or because an existing structure was too large to be converted to a standard Captain D's restaurant. By 2006, new senior management came to Captain D's. With this change came new requirements to be a franchisee in its system. For example, it increased its liquidity and net worth requirements. It also instituted a new policy that it would inspect the restaurants of prospective franchisees who operated existing restaurants with another company to determine the quality of operational performance in those restaurants.

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Lessons from a Florida Franchise Race Discrimination Case, *continued*

In 2007, a Captain D's franchisee in Jacksonville sought to sell two existing restaurants and Elbanna contracted to buy them. Captain D's informed Elbanna that he would need to submit a new application because of the passage of time and because of the change in its net worth and liquidity requirements. After Elbanna submitted a new application, Captain D's sent one of its senior managers to conduct an unannounced inspection of Elbanna's existing restaurant operations. The inspections basically consisted of eating meals at three of Elbanna's restaurants and taking notes. After Elbanna's application was considered by Captain D's franchise committee, the defendant informed Elbanna that it could not approve the contract to purchase the existing Captain D's restaurants due to, among other reasons, "the observed quality of the operations of your existing restaurants."

In response to Plaintiff's lawsuit, Captain D's filed a motion for summary judgment, wherein it asked the court to dismiss the case because the evidence of discrimination was insufficient for a jury to consider. The court granted Captain D's motion. In analyzing Elbanna's Section 1981 claim, the court noted that, in order to recover, a plaintiff must demonstrate that he is a member of a protected class and that he suffered intentional discrimination because of this status which affected him in the making and performance of a contract. To establish a prima facie case of discrimination circumstantially (where there's no direct evidence of intentional discrimination), Elbanna must show that: (1) he belongs to a protected class; (2) he was qualified, meeting Captain D's legitimate expectations with regard to operating a transferred franchise; (3) he suffered an adverse action; and (4) Captain D's treated similarly situated persons outside his classification more favorably.

According to the court's written opinion, if Elbanna establishes a prima facie case creating a presumption of intentional racial discrimination in connection with the 2007 franchise denial, the burden then shifts to Captain D's to rebut the presumption by articulating a legitimate, non-discriminatory reason which is clear, reasonably specific and worthy of credence. *Hall v. Alabama Ass'n of Sch. Bds.*, 326 F.3d 1157, 1166 (11th Cir. 2003). At this stage, Captain D's has a burden of production, not of persuasion; "[t]he defendant's burden, like Plaintiff's *prima facie* burden, is easily fulfilled," and defendant does not have to persuade a court that it was actually motivated by the reason advanced. Hall, 326 F.3d at 1166 (citing *McDonnell Douglas Corp. v. Green*, 411 U.S. 792, 802 (1973)). The Eleventh Circuit has described this burden on the defendant as "exceedingly light." *Batey v. Stone*, 24 F.3d 1330, 1334 (11th Cir. 1994).

If Captain D's satisfies its burden, the presumption against the defendant is rebutted, and Elbanna must show that the defendant's proffered reason is merely pretext for an illegal motive. At this phase, Elbanna must "'introduce significantly probative evidence showing the asserted reason is merely pretext for discrimination.'" *Sheppard v. Sears, Roebuck & Co.*, 391 F. Supp. 2d 1168, 1180 (S.D. Fla. 2005). The court's inquiry in this third step in the analysis "proceeds to a new level of specificity...." *Brooks v. County Comm'n of Jefferson County, Ala.*, 446 F.3d 1160, 1162 (11th Cir. 2006). "The plaintiff may succeed in this either directly by persuading the court that a discriminatory reason more likely motivated the [defendant] or indirectly by showing that the [defendant's] proffered explanation is unworthy of credence." *Brooks*, 446 F.3d at 1163.

Plaintiff may defeat a motion for summary judgment by undermining the credibility of a defendant's explanations for its actions without directly showing that defendant harbored an illegal motive. *Arrington v. Cobb County*, 139 F.3d 865, 875 (11th Cir. 1998); *Barr v. City of Eagle Lake*, No. 8:06-cv-1568-T-27TGW, 2008 WL 717821, at *7 (M.D. Fla. March 17, 2008).

> [P]roof that a defendant's articulated reasons are false is not *proof* of intentional discrimination; it is merely evidence of intentional discrimination. However, *evidence* of intentional discrimination is all a plaintiff needs to defeat a motion for summary judgment. That evidence must be sufficient to create a genuine factual issue with respect to the truthfulness of the defendant's proffered explanation.

Howard v. BP Oil, 32 F.3d 520, 525 (11th Cir. 1994) (emphasis in original). Plaintiff may do this "by pointing to 'weaknesses, implausibilities, inconsistencies, incoherencies, or contradictions' in the proffered explanation."' Brooks, 446 F.3d at 1163 (citing *Jackson v. Alabama State Tenure Comm'n*, 405 F.3d 1276, 1289 (11th Cir. 2005)).

"A reason is not pretext for discrimination `unless it is shown *both* that the real reason was false, and that discrimination was the real reason."' *Brooks*, 446 F.3d at 1163 (quoting *St. Mary's*

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Lessons from a Florida Franchise Race Discrimination Case, *continued*

Honor Center v. Hicks, 509 U.S. 502, 515 (1993)). Elbanna cannot establish pretext merely by questioning the wisdom of Captain D's reasons, at least not where the reason is one that might motivate a reasonable franchisor. *Alexander v. Fulton County, Ga.*, 207 F.3d 1303, 1339 (11th Cir. 2000). Elbanna must meet Captain D's proffered reason - restaurant operations ability - head on and rebut it. *Austin v. Progressive RSC, Inc.*, 265 Fed. Appx. 836, 846 (11th Cir. 2008). Thus, Elbanna must do more than establish a prima facie case and deny the credibility of defendant's witnesses. *Howard*, 32 F.3d at 525-26 (citation omitted). "`Although the intermediate burdens of production shift back and forth, the ultimate burden of persuading the trier of fact" that the defendant intentionally discriminated against the plaintiff remains at all times with the plaintiff. *Brooks*, 446 F.3d at 1162. It is the Court's responsibility "for drawing the lines on what evidence is sufficient to create an issue on pretext." *Rojas*, 285 F.3d at 1344.

The court assumed, without deciding, that Elbanna established a prima facie case. In rebuttal, Captain D's proffered a legitimate non-discriminatory reason for not approving Elbanna in 2007 for the franchise transfers - unsatisfactory operations, defeating the presumption of discrimination. The court examined whether Elbanna produced evidence sufficient for a reasonable jury to find that the proffered reason was pretext of intentional discrimination based upon Elbanna's race. Elbanna attempted to rebut Captain D's proffered reason for denial - that his existing restaurant operations were not up to Captain D's standards - by merely disputing whether Captain D's inspection observations were accurate and truthful, contending that "direct evidence contradicts Captain D's witness."

However, the court correctly observed that the issue was whether Captain D's perception of Elbanna's performance, accurate or not, was the real reason for denying him the opportunity to purchase the franchises in 2007. The question was not whether Captain D's made an erroneous decision; it was whether the decision was made with discriminatory motive. *See Mayberry v. Vought Aircraft Co.*, 55 F.3d 1086, 1091 (5th Cir. 1995). "The existence of competing evidence about the objective correctness of a fact underlying a defendant's proffered explanation does not in itself make reasonable an inference that the defendant was not truly motivated by its proffered justification." *Little v. Republic Refining Co.*, 924 F.2d 93, 97 (5th Cir. 1991). The court stated:

The Court does not re-examine or second-guess Captain D's business decisions; rather the Court's inquiry is limited to whether Captain D's gave an honest explanation of its behavior. *See E.E.O.C. v. Total System Servs., Inc.*, 221 F.3d 1171, 1176 (11th Cir. 2000). This is not the forum to litigate whether or not Elbanna was in fact a good restaurateur. Where pretext is an issue, "the question the factfinder must answer is whether [defendant's] proffered reasons were 'a cover-up for a ... discriminatory decision."' The Court reviews Captain D's decision for discrimination, not soundness.

The court found "[n]othing in the record indicates that Captain D's singled out Elbanna for increased review or inspections of his other restaurant operations." Further, the judge wrote "different evaluations of his restaurants by different entities does not establish pretext." The final decision, the court wrote, was made by the company's franchise committee in consideration of its investigation reports. There was no evidence of bad faith on the part of the management persons who inspected the restaurants and the committee's decision not to verify the reports' accuracy does not establish pretext. *Hawkins v. Ceco Corp.*, 883 F.2d 977, 980 n.2 (11th Cir. 1989).

In this case, Elbanna was adamant that he was a good restaurateur. He offered affidavits of others who stated that he did a good job with his restaurants. But, as the court noted, Section 1981 cases are not about differences of opinion; they are about race discrimination. The burden always remains with the plaintiff to prove that race discrimination was the real reason for the challenged action.

Charles K. Grant defended Captain D's in the matter of Elbanna v. Captain D's. Mr. Grant is an attorney in our Nashville office.

Hotel Owner Not Liable for Value Loss After Rebranding

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A Texas hotel owner secured non-recourse financing of a Holiday Inn® hotel in Kansas City. The financing carried the typical "bad-boy" carve-outs which allow the lender recourse against the borrower for certain acts or omissions, including the concept of "waste" of the collateral. The mortgage documents were silent as to what the waste concept was intended to cover. The conventional interpretation involves intentional or grossly negligent destruction, loss or removal of tangible assets. In this case, the owner was faced with a product improvement plan (PIP) of $1.8 million from its franchisor to renew its Holiday Inn franchise, and elected instead to allow its Holiday Inn franchise to expire. The owner chose to rebrand as a Clarion® Hotel, which required a PIP of about $370,000. However, the owner informed the lender that the Holiday Inn franchise was not offered for renewal, citing a letter from the franchisor stating that the franchisor's intent was not to renew the franchise. The testimony of the franchisor revealed that the letter was sent to comply with the Missouri Franchise Relationship Law (MO. Rev. Stat. § 407.405) which requires 90 days' prior notice of non-renewal. The owner tapped the FFE Reserve for the costs of the Clarion PIP.

The hotel suffered a business decline after the rebranding. Rate and occupancy dropped, and the owner eventually was unable to meet debt service. The lender foreclosed on the hotel and sought damages for its loss of value, which an appraiser pegged at $3.85 million. The appellate court dismissed the lender's theory of waste because that concept is predicated on the impact of borrower actions on existing, not future, assets. The loan documents required the borrower to maintain the existing franchise but were silent on the issue of renewal. The original franchise ran until its intended expiration and was not renewed. *Interestingly, the court leaves open the important question of whether the borrower would be subject to full recourse under the waste carve-out in the mortgage if it causes asset value loss by failing to maintain the specified franchise.*

The lender's theory of fraud and material misrepresentation as a cause of its value loss in the hotel was also rejected by the appellate and trial courts. There was no testimony to the effect that, even if the borrower paid for the PIP, there was no certainty that Holiday Inn franchise would have been renewed. But, the appellate court found that the FFE Reserve disbursement to pay the Clarion PIP was obtained by material misrepresentation, so the owner was obligated to repay the withdrawn $370,000. The finding of owner liability also shifted the attorneys' fees burden, so the owner also became liable to pay the lender's legal fees, to the tune of over $450,000.

While the owner escaped liability for millions in value losses, the case demonstrates the importance of specific undertakings by lenders and borrowers about hotel franchises that form part of the collateral for the loan. If a loan spans the expiration of the existing franchise, what are the franchisee's obligations to make good faith efforts to renew? Is the lender's FFE Reserve balance available for performing a renewal or conversion PIP? The opinion leaves to another case the question of whether an owner's discretionary decisions that cause loss of a valuable brand franchise give the lender personal recourse against the owner for lost value of the hotel assets under the "waste" concept. The hindsight calculus is curious – instead of paying $1.8 million and the renewal fee on the original franchise, the owner rebranded, paid a franchise fee to the second franchisor, lost its equity in a $6 million property to foreclosure, and paid over $800,000 to the lender on a supposedly non-recourse loan. Under most franchise agreements, the owner would owe the second franchisor liquidated damages, too. Ouch!

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