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Hospitalitas

2012 Issue 1

News and Views for Your Hospitality and Franchise Business

BAKER DONELSON
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EXPAND YOUR EXPECTATIONS℠

Franchisee Scores with Florida Franchise Act Claim Against Hockey School Franchisor

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A franchise allows a business to utilize another's business model. A prospective franchisee assumes the franchise offered has a good track record of profitability; ease of duplication; detailed systems, processes and procedures; broad geographic appeal; relative ease of operation; and costs consistent with what is disclosed in the Franchise Disclosure Document (FDD).

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Franchisor's Addendum Enhances Franchisee's Right to Assign Store Lease

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Many retail store leases signed during the past several years of down markets reflect favorable rents and terms, often with tenant-favorable renewal options. When a franchisee-tenant wants to sell its store and assign its lease, can the landlord use the opportunity to wrestle the lease terms into current market rates and conditions? Tennessee courts say no, because the franchisor's lease addendum modifies the assignment clause in the original lease.

A physician and his wife formed a limited liability company to lease and operate a

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Franchisees Must Carefully Consider Renewal Provisions

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Do franchise transaction participants usually pay much attention to renewal provisions in the franchise agreement? They should. Not all renewal provisions are created equally. A California appellate court recently construed a renewal provision in a Mail Boxes Etc. (MBE) franchise agreement in a decision yielding surprising results. The unreported opinion is styled *G.I. McDougal, Inc. v. Mail Boxes Etc., Inc. et al.*, Cal. Rptr. 3d, 2012 WL 90083 (CA. App. 2012).

McDougal, the franchisee plaintiff, entered into a franchise agreement with MBE

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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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Franchisee Scores with Florida Franchise Act Claim Against Hockey School Franchisor, *continued*

The franchise agreement typically contains language that disclaims any promises of profitability to the franchisee, both generally and in the specific circumstances associated with the sales process for the franchise. However, such language may not necessarily protect a franchisor from claims by a Florida franchisee if the franchisee is not successful, and the franchisor has used financial performance representations that were strangers in the FDD.

The case of Hockey Enterprises, Inc. v. Talafous[1], concerns a hockey franchise gone awry. The franchisor and an affiliate, Total Hockey Worldwide and Total Hockey Products (collectively, "Total Hockey") entered into an agreement with Hockey Enterprises, Inc. (HEI) to franchise a business concept for operating hockey training facilities. HEI opened its franchise in Florida in December 2008 but, after experiencing an operating loss of more than $250,000, was closed by February 2010. HEI filed a lawsuit against Total Hockey, as well as Total Hockey's two owners, Dean Talafous and Brian McKinney. HEI's lawsuit claimed fraud, negligent misrepresentation and violation of the Florida Franchise Act by Total Hockey, Talafous and McKinney (collectively, "Defendants").

In its lawsuit, HEI argued that despite disclaimers in the franchise agreement as to any guarantees of profitability, the defendants made promises of franchise profitability to HEI. HEI specifically relied on projection worksheets provided by the defendants, which included a total annual revenue estimate of $437,000 and an annual profit estimate of $139,600. HEI claimed that McKinney made representations that the projection worksheet was reflective of other Total Hockey training centers and that HEI's center would be able to meet those numbers. Nevertheless, the projection worksheets contained a disclaimer that it was merely a projection template and that it did not guarantee the results based on the worksheet. HEI also relied on internal emails stating that other Total Hockey facilities were likely closing and might file bankruptcy. HEI argued that because the defendants had provided these projection worksheets and had failed to disclose the financial conditions of these other facilities, the defendants made misrepresentations to HEI.

After discovery, McKinney, who was an engineer and part-owner of Total Hockey, filed a motion for summary judgment as to HEI's claims against him. McKinney claimed that HEI had no evidence that he had committed fraud, made negligent misrepresentations or committed a violation of the Florida Franchise Act. McKinney therefore argued that based on HEI's lack of evidence, its claims against him should be dismissed.

As an initial matter, the court found that, even though the lawsuit was pending in Minnesota, Florida law applied since the franchise agreement contained a choice of law provision. The court agreed that HEI did not provide sufficient evidence of fraud. Specifically, the court found that there was insufficient evidence to establish that Total

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Third Time's A Charm

For the third year in a row, Baker Donelson has been named to FORTUNE's "100 Best Companies to Work For" list.

Here We Grow Again...

Baker Donelson continued its recent growth spurt with a second Houston acquisition. On February 1 the Firm announced a merger with Drucker, Rutledge & Smith, bringing its total number of attorneys and policy advisors to more than 630.

April 10 FBN Meeting to Feature Franchising in Canada - Part 2

Mark your calendars now for the Spring 2012 meeting of the International Franchise Association's Franchise Business Network on April 10. Topics will include "Northern Exposure: Franchising in Canada, Part 2." These quarterly lunch meetings are hosted by Baker Donelson in our offices across Tennessee, Alabama, Mississippi and Louisiana.

New ADA Regs Go Into Effect March 15 - Are You Ready?

Some lodging providers assume they are exempt from compliance with the new ADA regulations, or that past practices were acceptable. Baker Donelson Shareholder David Gevertz is quoted extensively in this recent hotelmanagement.net article on the new regulations that apply to all providers of transient lodging.

Gevertz notes, "There are a number of condo-hotels and corporate lodges who argue that they have not been covered by these regulations, and they haven't done the first thing to comply," he said. "The new rules now apply to them and they don't realize it."

Franchisee Scores with Florida Franchise Act Claim Against Hockey School Franchisor, *continued*

Hockey was in trouble financially or that McKinney knew of this financial trouble when the franchise was sold to HEI. The court accordingly dismissed HEI's fraud claim against McKinney.

However, the court denied McKinney's motion for summary judgment on the other two claims. For the negligent misrepresentation claim, McKinney argued that the franchise agreement, including the integration/merger clause, disclaimed any guarantees or warranties of profitability. McKinney further pointed to a questionnaire HEI signed at the closing in which HEI indicated that no employee or other person speaking on behalf of Total Hockey had made any statement or promise concerning the total amount of revenue that HEI would receive or the costs involved in the franchise.

The court acknowledged that the provisions in the franchise agreement and the questionnaire filled out by HEI presented evidence that refuted the reasonableness of HEI's reliance on the alleged misrepresentations. Nevertheless, the court found that it was an issue of fact that should be decided by a jury and not decided on a motion for summary judgment. The court also found that the issue of whether McKinney made representations to HEI without knowledge as to their truth or falsity should be submitted to a jury. In particular, the court found that a reasonable jury could find that McKinney, as an engineer and part owner of Total Hockey, had a duty to tell HEI that he did not have sufficient information to comment on Total Hockey's financial status or, at least, that he had a duty not to make statements to HEI concerning probability of success.

HEI's claim for violations of the Florida Franchise Act (the "Act") survived McKinney's motion for summary judgment. The court found that the issues underlying this claim should also be submitted to a jury. First, the court found that although McKinney was not a party to the franchise agreement, he qualified as a "person" doing business in Florida and was subject to the Act.

Second, the court noted that the standard required for showing a violation of the Act was lower than the above-discussed standard for fraud. Unlike fraud, which requires intentional false statement, the Act only requires that the franchisee relied to his detriment on the franchisor's "intentional words or conduct" concerning the profitability of the franchise "which are not in accordance with the facts." Based on this lower standard, the court found that a reasonable jury could find that McKinney, as an engineer and part owner of Total Hockey, was in a position to make representations concerning the financial condition of Total Hockey to HEI. Accordingly, the court found that HEI's claim for violations under the Act should be submitted to a jury.

In summary, the court found that the issue of whether McKinney's representations rise to the level of negligent misrepresentation or a violation of the Florida Franchise Act should be submitted to a jury and should not be disposed of on summary judgment. Notably, the court admonished both parties to settle by this bold dicta:

> It continues to be the Court's view that Plaintiff will have a difficult time prevailing in any significant way if this case proceeds to trial. Both parties bear some responsibility for this situation, and it is difficult for the Court to see how a trial would be in the interests of either party versus settlement of the case.

This case provides valuable lessons and cautions to any franchisor selling in Florida, particularly an early stage franchisor without a track record of successful franchise or company store operations. First, franchise agreement disclaimers of warranties or guarantees of profitability of the franchise are not sufficient to fend off claims by an unsuccessful franchisee based on negligent misrepresentation or violations under the Florida Franchise Act. Second, financial performance representations in the form of projections made to a potential franchisee as to profitability or costs of the franchise are a high-risk proposition. Finally, the principals of a franchisor may be held to answer personally for alleged misrepresentations as to the franchise if the franchisor has no basis in fact for the representations, even if they have no personal knowledge of the current status of the franchisor's finances or franchisee financial condition. The principals could wind up in the penalty box for someone else's infraction.

Ms. Ho is an attorney in our Orlando office.

1. No. 10-2943, 2012 U.S. Dist. LEXIS 3322 (D. Minn. Jan. 10, 2012).

Franchisor's Addendum Enhances Franchisee's Right to Assign Store Lease, *continued*

Quiznos sandwich shop, which was to be staffed by their son. The LLC leased a store in Jackson, Tennessee, for a five-year term, with two options to renew for additional five-year terms exercisable on 180 days' notice. If the first renewal option was not exercised, the tenant would be obligated to repay half of the tenant improvement costs borne by the landlord. The lease and renewal documents prohibited assignments of the lease and the renewal options by the tenant. The landlord also signed the franchisor's lease addendum, which provided for transition arrangements if the franchise was sold or taken over by the franchisor or an affiliate. The tenant had the absolute right to assign the lease or sublet the premises to the franchisor and its affiliates. The addendum allowed either the franchisor or the original tenant the right to assign the lease and any related options to renew or extend to a duly authorized franchisee with the consent of the landlord, which was not to be unreasonably withheld or delayed.

After several years of operation, the franchisee wanted to sell the business. A purchaser was identified and approved by Quiznos' franchisor to become the authorized franchisee for the store. Since a short time remained on the initial lease term, the landlord refused to honor the addendum and instead offered to allow the successor to sublease the space (but only for the balance of the original term) and assign the lease for the balance of the original term and one renewal term but not the full two renewal terms. However, the landlord wanted the original tenant improvement cost to be escrowed for payment to him if the lease was not renewed.

The prospective successor balked at these terms and negotiated a lower purchase price to the seller franchisee, with an escrow of the tenant improvement cost put up by the seller and only one renewal option. The buyer walked away after the original lease term expired, leaving the seller to forfeit its escrow. The seller filed an action against the landlord for its damages. After discovery, a denied motion for summary judgment by the landlord and a bench trial, the court found for the seller and awarded the purchase price differential and the escrow amount.

The Tennessee Court of Appeals affirmed the trial court's decision. The court looked at prior Tennessee precedent in articulating a narrow standard for reasonably withholding consent. The language "not unreasonably withhold or delay" is read to mean that the landlord must act in a commercially reasonable manner. Consent may not be withheld on the basis of personal whim or taste, or for other arbitrary reasons. The landlord must act in good faith in a commercially reasonable manner and can only withhold consent purely on the basis of whether the landlord reasonably perceives the prospective assignee to present financial or other risks that are different from the risks accepted with the assignor. The landlord's desire to extract an economic concession or its aversion to working with an assignee who is a tough negotiator or perceived to be personally difficult were found not to be permissible reasons for withholding consent.

In this case, the franchisee benefitted from the franchisor's lease addendum, which changed the lease's assignment provision. The landlord had no obligation not to withhold consent unreasonably in the original lease language. The effort to obtain the landlord's signature on this frequently forgotten document was well rewarded. The overriding assignment provision designed to allow for easier transfers of the franchise would have worked well, had the landlord cooperated, to preserve value for the selling franchisee.

This court also erased any distinction under Tennessee law between "not unreasonably withhold" and "commercially reasonable" standards of conduct for parties with the right to consent. Indeed, the court limits the consent right to the consideration of the financial qualification of the proposed assignee and its ability to perform the contract to be assigned. The court foreclosed the landlord's notion that a request to consent to assign was an opportunity to renegotiate the terms of the contract or back out of a deal that may no longer make economic sense under changed market conditions. Tennessee contract drafters will need to be more specific if such rights are to be reserved and exercised at the time of assignment under this formulation of the Court of Appeals, if this precedent applies outside the lease context. Franchises should retain a higher level of discretion, because the economic interest of the franchisor is more complex and nuanced than that of a landlord. The court leaves open the possibility that withholding of consent is reasonable when the franchised unit is likely to fail at the proposed purchase price because of some intrinsic issue, such as a size too small to be sustainable given its level of investment. Withholding consent will likely need some articulated commercially tenable reason relating to the risk of future performance in future situations in Tennessee when a covenant not to unreasonably withhold consent is part of the bargain between the parties.

Mr. Buckberg is an attorney in our Nashville office.

Franchisees Must Carefully Consider Renewal Provisions, *continued*

on February 5, 1994. In 2001, UPS acquired MBE, which became a wholly-owned subsidiary of UPS. UPS and MBE offered certain financial incentives to MBE franchisees who re-branded from "Mail Boxes Etc." to "The UPS Store" and undertook certain other obligations. More than 90 percent of the MBE franchisees accepted the UPS brand and associated obligations/benefits. McDougal did not.

At the time McDougal signed the franchise agreement in 1994, the relevant part of the renewal provision stated:

> Such renewal shall be effected by the execution of an appropriate document extending the term of this Agreement *on the same terms and conditions as are contained in the then current Franchise Agreement for the sale of new MBE Centers.*

By the time McDougal's MBE franchise came up for renewal, McDougal was required to execute an agreement for The UPS Store as a condition of renewal. He refused and alleged that UPS and MBE breached the MBE franchise agreement by refusing to renew the MBE agreement. McDougal claimed the franchise agreement had to be renewed without change.

The court honed in on the words italicized above to reject McDougal's claims. The court first stated that if the italicized language was interpreted literally, McDougal would have no right to renewal because the franchisor no longer offered a franchise agreement for new MBE centers. The court then noted that the franchise agreement allowed MBE to change proprietary marks under certain circumstances. Consequently, MBE did not have to renew the franchise "intact and without change." Next, the court noted that in connection with the change in proprietary marks, the franchisor no longer offered MBE franchises and instead only offered "The UPS Store" franchises, which is what was offered to McDougal.

McDougal also argued that the 1994 franchise agreement did not allow modification unless by mutual consent. That argument was quickly dispatched by the court because the mutual consent language addressed the 1994 franchise agreement, not the offered agreement, and the offered agreement was "on the same terms and conditions as are contained in the then current Franchise Agreement for the sale of new MBE Centers." Similarly, the 1994 franchise agreement acknowledged that MBE may evolve, develop and change and that is exactly what happened through the acquisition by UPS.

McDougal's last stab was to argue that the renewal provision violated the implied covenant of good faith and fair dealing because it did not expressly reserve to MBE the right to condition renewal upon McDougal's acceptance of a materially different agreement. This argument also fell short because any implied covenant grows out of express terms and the renewal provision expressly allowed renewal "on the same terms and conditions as are contained in the then current Franchise Agreement," which is exactly what was offered to McDougal.

So what is the big takeaway from this case? Both franchisees and franchisors must seriously consider the renewal provision when drafting or negotiating agreements and not view the provision as "boilerplate." Franchisors need the flexibility to present renewing franchisees with franchise agreements that reflect the dynamically evolved franchise system, which will necessarily be different than those signed years earlier. The evolved brand franchise agreements may even offer different parties, products and business method requirements. Franchisees need to understand that the initial term may be the only term it receives a license to use and operate under a certain brand at the time of signing, and that at renewal, they may not have a chance to select the same terms for the same brand as they enjoyed at the inception, or the new offering. Material changes may be required to maintain and continue with the franchise affiliation, and their choice is to renew or cease operation.

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Puppies Too Frisky for ADA Shelter

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A Burger King franchise was sued recently for violating the Americans with Disabilities Act (ADA) when an owner and his service dog-in-training were asked to leave the restaurant. A federal district court in California sided with the Burger King and dismissed the case in the last few weeks. The court focused on whether the puppy, a 13-week-old Great Dane named Barack, was actually a service dog under the ADA.

Privately-owned businesses that serve the public, such as restaurants, hotels, retail stores, taxicabs, theaters, concert halls and sports facilities, are prohibited by the provisions of the ADA from discriminating against individuals with disabilities. The law requires these businesses to allow people with disabilities to bring their service animals onto business premises in whatever areas customers are generally allowed. A restaurant, for example, cannot segregate a person with a service dog from other guests at the establishment, and the service dog and its owner can go in whatever areas other customers can access.

So what is a service animal? The ADA defines a service animal as any guide dog, signal dog or other animal individually trained to provide assistance to an individual with a disability. If they meet this definition, animals are considered service animals under the ADA regardless of whether they have been licensed or certified by a state or local government.

A service animal is not a pet. Service animals perform some of the functions and tasks that the individual with a disability cannot perform for him- or herself. Guide dogs are one type of service animal, used by some individuals who are blind. This is the type of service animal with which most people are familiar. But there are service animals that assist persons with other kinds of disabilities in their day-to-day activities. Some examples include:

- Alerting persons with hearing impairments to sounds
- Pulling wheelchairs or carrying and picking up things for persons with mobility impairments
- Assisting persons with mobility impairments with balance

In the Burger King case, a man with a degenerative back condition entered the restaurant with the 13-week-old Great Dane puppy. When he attempted to order food, the worker informed him the restaurant had a "no dog" policy. The man asked to speak to a manager. She pointed him to the restaurant's policy and the sign on the door which read "No animals except for service animals." The man explained that the puppy was a service dog in training, but when the manager asked to see the dog's service dog ID, his owner advised he did not have it. The manager told the man he could not stay in the restaurant, but he could either take his order to go or leave the puppy outside. The man left the restaurant, took a camera from his car and photographed the signs.

The restaurant asserted that Barack the Great Dane puppy was not fully trained as a service animal and only had basic obedience training. His owner, who was training the puppy to assist him with walking and balancing, countered that the puppy had a service dog tag from the county that was issued prior to the restaurant visit. The restaurant provided expert testimony that the puppy still had a "playful streak" and was too young to have complete control over its bladder and bowels for extended training periods.

However, the court focused on the fact that although the owner stated that the puppy was being trained to assist him with walking and balance, the puppy was not large enough at that point to assist with walking and balancing. According to the restaurant's expert, the owner could have actually injured himself and the puppy if he had leaned on the puppy for balance. The court found that the puppy was not a service dog, because it had not been trained to perform tasks for the benefit of the individual with a disability, and the work or tasks performed by a service dog must be directly related to the individual's disability.

So what does this mean for businesses such as restaurants and hotels? Generally, service animals, not just guide dogs, must be permitted to accompany the individual with a disability to all areas of the business where customers are normally allowed to go. Posting a "no pets" policy does not comply with the ADA regulations, because a service dog is not a pet. If someone enters a restaurant or hotel with a pet, it is reasonable

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Puppies Too Frisky for ADA Shelter, *continued*

to make an inquiry to determine if the animal is a service dog. Some, but not all, service dogs wear special collars or harnesses. Some, but not all, are licensed or certified and have identification papers. If the employees are not certain if the animal is a service animal, they may inquire of the person with the animal if it is required because of a disability. A person who is going to a restaurant will likely not be carrying documentation of his or her disability so the establishment cannot require proof of a disability or certification of the animal as a condition to providing service to the customer.

In addition, the business cannot charge any sort of maintenance or cleaning fee, even if deposits are routinely required for pets, such as at hotels, for example. However, if a service animal causes damage and it is the regular practice or policy of the establishment to charge non-disabled customers for such damage, the establishment can charge fees relative to any damage caused by the service animal.

What if a service animal is being disruptive or the animal's behavior otherwise poses a threat to the health and safety of other customers? It is perfectly reasonable to exclude an animal that displays aggressive behavior toward other guests or customers. But an establishment cannot make assumptions about how a particular animal will likely behave, simply based on experience with other animals of the same breed, for example. If a service animal should be excluded, the establishment should allow the individual with a disability the option of continuing to enjoy the establishment's goods and services without the service animal on the premises.

Although the Burger King case is an example that hospitality providers do not have to give unfettered access to customers with animals represented as service animals, they should exercise caution and common sense when encountering individuals with service animals.

Ms. Thompson is an attorney in our Knoxville office.

Broken Glass, Cut Tendon, No Franchisor Liability: Standards Versus Control Over Day-to-Day Operations

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A frequent question in franchise agreement negotiations is: who is liable when a customer is injured by an article required under franchise system standards and specified by the franchisor? In the recent case of *Karnauskas v. Columbia Sussex Corp.*,[1] a New York court found that in a broad variety of circumstances where the franchisor does not exercise day-to-day control over the franchisee, and there is no evidence of product selection, the franchisor is not liable for negligence in product selection or maintenance.

A hotel guest was injured when the glass coffee carafe from her Arizona Marriott hotel room shattered around her hand, severing a tendon. The guest sued Marriott International, Inc. as well as the franchisee and operator of the hotel, Columbia Sussex Corporation. The guest alleged that Marriott should be held vicariously liable based on its license agreement with Columbia Sussex. Accordingly, the central question of the case was whether Marriott could be liable for the alleged negligence of the franchisee based on that license agreement alone.

Initially, the New York federal court, (applying Arizona law) noted that a majority of courts apply a "degree-of-control analysis to determine whether a licensor is liable for the negligent operation of a licensee." The court surveyed a number of jurisdictions, including the Georgia case of *Pizza K., Inc. v. Santagata*[2] and the New York case of *Hart v. Marriott Intern., Inc.*[3]

Ultimately, the court held that "Marriott did not have a duty of care to plaintiff because it did not have any day-to-day control over the hotel and did not select, recommend, or inspect the coffee carafe at issue." The court found a clause in the license agreement establishing that distinction particularly helpful: "Licensee shall retain and exercise full operating control of the Hotel... [and] shall have the exclusive authority for the day-to-day management of the Hotel." That clause, combined with the fact that Marriott did not own the hotel, or play any part in the day-to-day operation of the hotel, was ultimately persuasive for the court in resolving any negligence maintenance issue. The court cited *Capriglione v. Radisson Hotels Intern., Inc.*,[4] in which the court found the defendant franchisor not liable because the franchisor of a hotel did not own or control the hotel on day-to-day basis. Although the court thoroughly analyzed day-to-day operations, the true nature of this

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Broken Glass, Cut Tendon, No Franchisor Liability: Standards Versus Control Over Day-to-Day Operations, *continued*

defective design case suggests that the court actually decided in favor of Marriott because the plaintiff "produced no evidence showing that Marriott selected, recommended, or inspected the coffee maker at issue."

While most franchisors anticipate that courts apply a "degree-of-control analysis" to determine whether a franchisor is liable for its franchisee's negligence, and have included a clause in the license agreement similar to Marriott's clause in this case, a franchisor should be wary about liability if it goes ahead and exercises control in fact. If a franchisor seeks to avoid liability, not only should the franchise agreement reflect the intention to stay out of day-to-day operations, but the actual business relationship should as well. In an Arizona case, the court reasoned that because a franchisor selected, recommended and inspected the article at issue, it functioned as a gratuitous supplier within the meaning of Section 324(a) of the Restatement 2d of Torts and could therefore be held liable for injury involving the equipment.[5]

Karnauskas is a positive case for franchisor liability, particularly in circumstances where Arizona law applies. The decision establishes great persuasive authority for summary judgment in Arizona with respect to circumstances where a plaintiff produces no evidence that a franchisor selected, recommended or inspected a product that caused or contributed to injury. Additionally, the decision provides a useful guide for franchisors to avoid certain forms of vicarious premises liability by: (1) avoiding specific selection, recommendation and inspection of potentially dangerous products for use at franchisee locations when possible; (2) carving out day-to-day operations in the licensing agreement as the sole domain of the franchisee; and (3) abstaining from any day-to-day management in fact of the franchised hotel. Day-to-day operations will be important to a court's analysis in a case of negligent maintenance; and selection, recommendation and inspection of products will be important for the analysis of defective product design on a franchisee's premises.

For franchisees who place coffee makers in hotel rooms, the *Karnauskas* court found enough evidence for the plaintiff to go to trial against the franchisee based on evidence that one-cup coffee makers are safer than glass coffee carafes.[6] The same path to trial would have likely occurred for the franchisor if the plaintiff had introduced evidence that Marriott had selected, recommended or inspected the coffee carafes. Hotel franchisors and franchisees alike should consider the costs and benefits of a switch to one-cup models from glass carafe models.

More importantly, as franchisors seek alternative remedies to termination of a weak performing franchise, and those remedies include periods of active supervision and management, the analysis in this case serves as a reminder that any such undertaking of active management will strip away this liability shield, and open the door to joint and several liability to parties injured or damaged at the franchised premises.

Mr. Anderson is an attorney in our Birmingham office.

1. 2012 U.S. Dist. LEXIS 8988, (S.D.N.Y. 2012)
2. 547 S.E.2d 405, 406-07 (Ga. App. 2001) (pizza franchisor not liable for auto accident caused by franchisee delivery driver because franchisor was "not authorized under the agreement to exercise supervisory control over the daily activities of [franchisee's] employees")
3. 304 A.D.2d 1057, (N.Y. 3d Dep't 2003) (hotel franchisor not liable for alleged negligence of franchisee because franchise agreement did not give franchisor day-to-day control).
4. 2011 U.S. Dist. LEXIS 115145, at *2 (D. N.J. 2011)
5. *Papastathis v. Beall*, 723 P.2d 97, 99-100 (Ariz. App. 1986) (franchisor recommended and inspected soda machine involved in harm at franchise location)
6. *See* "One-Cup Coffeemakers Gaining Wider Acceptance in Lodging Industry: Upscale, Full-Service And Gaming Hotels Lead Latest In-Room Beverage Trend," Hotel Business, August 2006.

New IRS Regulations On Repair Expenditures Impact Hospitality Industry

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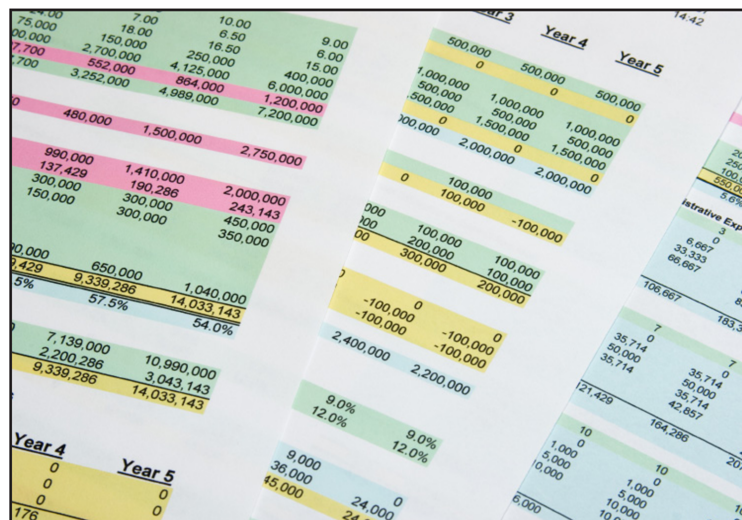
The Internal Revenue Service (IRS) recently released long-awaited regulations governing the tax treatment of expenditures incurred to repair tangible property. These new regulations attempt to clarify and expand upon the current regulations that exist under Sections 263(a) and 162(a) of the Internal Revenue Code, and also attempt to address issues associated with tangible property subject to Code Section 168.



Taxpayers must comply with the new regulations, even though they are in temporary and proposed form. They do have the potential to affect any taxpayer that owns, improves or repairs tangible property. The new regulations could impact owner/operators in the hospitality industry who may have previously deducted certain costs associated with their commercial real estate. As the economy continues to improve, and hotels and restaurants begin undertaking previously deferred upgrades and repairs, owner/operators should be aware of these new regulations to understand their impact on tax accounting for these costs.

Background

The new regulations have been an ongoing project within the Treasury Department for nearly a decade. The distinction between currently deductible expenses and expenditures that must be capitalized has generally been an analysis driven by the facts and circumstances of a taxpayer's particular situation. A taxpayer can generally deduct the full cost of a repair in the year that the expense is incurred; however, improvements constituting more than just repair generally must be capitalized over a fixed life of the repaired asset. Thus, the distinction over what constitutes a repair as compared to an improvement, as well as what piece of property was improved, led to much confusion and litigation. The IRS endeavored to simplify the process by releasing several hundred pages of proposed regulations in 2006, which were later withdrawn, as well as another set released in 2008.

The just-released new regulations retain many of the provisions of the 2008 draft, which incorporated much of the already existing authority that had been promulgated under the relevant Code sections; however, there are some significant changes in the new regulations as well.

Some Significant Changes

One significant change in the new regulations is the application of the improvement or repair standards to buildings. The expenditure in question for a building must be looked at for its effect on major components or systems of the building as opposed to the building as a whole. Thus, the taxpayer must determine whether a repair or improvement was made to the elevator system, the HVAC system or the plumbing system instead of determining whether a repair or improvement was made to the building generally. The specific building systems listed in the new regulations are HVAC, plumbing, electrical, escalators, elevators, fire protection and alarm, security, gas distribution and any other system identified in published guidance.

The new regulations also now allow taxpayers the ability to take a retirement loss for major building components such as those discussed above. Although the cost of a new component will have to be capitalized, the fiscal blow is somewhat softened by the fact that, under the new regulations, the taxpayer may take a loss equal to the amount of basis allocated to the retired property that is being replaced.

What the New Regulations Mean for Taxpayers

Perhaps the biggest change that taxpayers involved in the hospitality industry may encounter is that costs that were currently deductible may no longer be, and must be depreciated instead. The fact that individual building systems are now considered a unit of property as opposed to the building as a whole will greatly impact taxpayers who previously took an aggressive stance concerning expenditures associated with tangible property. This means that an expense that could have once arguably been deducted as a repair due may now be considered a capitalizable expenditure as it will almost always have a greater impact when examined for its effect on an individual building system as opposed to the building as a whole.

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New IRS Regulations On Repair Expenditures Impact Hospitality Industry, *continued*

For example, costs associated with the replacement of an HVAC compressor that may have once been deductible may now have to be capitalized, depending on the effect on the system as a whole. Similarly, the outlays required to return an elevator car to service could very well be considered a capital expenditure, depending upon the nature of the repair and to what extent it modifies the elevator system in its entirety.

The preamble to the new regulations states that they "are generally effective for amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012." Although taxpayers may not see the effect of these new regulations on taxable income until their returns for fiscal year 2012 are filed, proper accounting procedures should be put in to place as soon as possible to ensure that the returns conform to the new regulations. Additionally, taxpayers must consider that in many cases the implementation of the new regulations could require a Section 481 change in accounting method since the IRS is not allowing the new regulations to apply to the 2011 tax year.

Any taxpayer called upon to renovate, upgrade, replace and refurbish in the improved economy should consult with a tax advisor to understand the impact of these new regulations.

Mr. Pierce is an attorney in our Memphis office.

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