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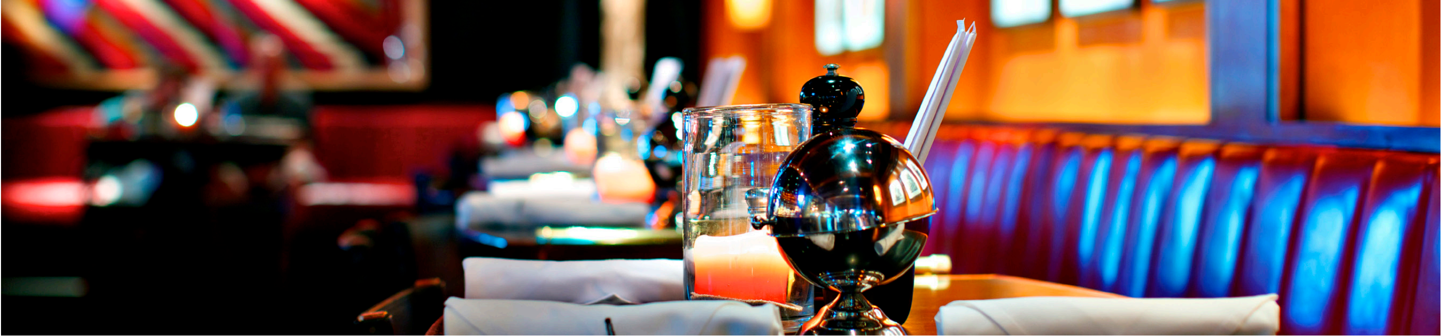
HOSPITALITAS

News and Views for Your Hospitality and Franchise Business



Summer 2017

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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.

DISTRICT COURT PROTECTS FRANCHISOR AGAINST ANTI-CONTRACTUAL COMPETITION IN *FRYE*

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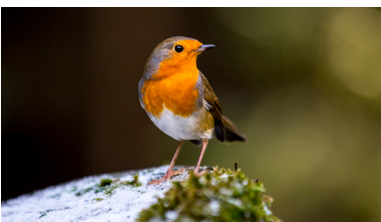

On Valentine's Day of 2017, the United States District Court for the District of Maryland gave franchisors the legal equivalent of two dozen roses when it decided *Frye v. Wild Bird Centers of America, Inc.*, 2017 WL 605285 (D. Md. Feb. 14, 2017). *Frye* centered around a dispute between Wild Bird Centers of America, Inc. (WBCA), which franchises Wild Bird Center stores across the United States, and one of its franchises in Boulder, Colorado. The parties' Franchise Agreement provided that the franchisees would operate within a defined geographic area for a period of ten years, at which point the Franchise Agreement would expire unless renewed. The Agreement included a Non-Competition Provision that restricted the franchisees from operating a similar business for "a period of 24 months after termination," and it contained language requiring the franchisees to comply with this Non-Competition Provision "in the event of termination or expiration" of the Agreement "for any reason."

At the expiration of the Agreement's ten-year term, the franchisees neither renewed the Agreement nor discontinued operating the store as a WBCA store. In fact, they continued operating their store as they had before the expiration of the Agreement, including keeping the WBCA sign on the building. Naturally, WBCA insisted that the franchisees comply with the Non-Competition Provision of the Agreement. After unsuccessful attempts at mediation, WBCA filed a demand for arbitration per the terms of the Agreement,

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DISTRICT COURT PROTECTS FRANCHISOR AGAINST ANTI-CONTRACTUAL COMPETITION IN *FRYE*, *continued*

primarily seeking enforcement of the Non-Competition Provision. After a hearing, the arbitrator ruled for WBCA and issued an order enforcing the Non-Competition Provision of the Franchise Agreement for two years from the time that the franchisees first complied with his order.

The franchisees then filed an action in the federal district court, seeking to vacate the arbitrator's award on two grounds. First, they argued that the arbitrator should not have enforced the Non-Competition Provision, because the Franchise Agreement was not terminated – the franchisors maintained that it merely "expired," and by its terms the Non-Competition Provision only applied "after termination." Second, they argued that, even if the Non-Competition Provision applied, the arbitrator should not have ordered the two-year period to run from the time of compliance with the Order, but rather from the expiration date of the Franchise Agreement. Their argument was based on the language of the Non-Competition Provision itself, which stated that it was to run "[f]or a period of 24 months after termination of this Agreement."

To determine whether the Non-Competition Provision should have been enforced, the court considered whether the arbitrator's decision drew from the "essence" of the Franchise Agreement. The court looked to the Effects of Termination provision, which provided for enforcement of the Non-Competition Provision in the event of termination or expiration of the Agreement. The District of Maryland determined that, despite the fact that the Non-Competition Provision appeared to apply only in the event of a termination, the Effects of Termination provision specifically provided for enforcement of the Non-Competition Provision upon expiration of the Franchise Agreement's term. Therefore, the court upheld the arbitrator's Order on that point.

The court then took up the question of whether the Non-Competition Provision should have been enforced for two years from the time the franchisees complied with his order or from the expiration of the Franchise Agreement. In upholding the arbitrator's order, the court found that it is reasonable for a franchisor to expect the full period of non-competition to which it is entitled under an agreement. Important to the court's decision was the fact that the franchisees had openly operated their store in violation of the Non-Competition Provision since the Franchise Agreement had expired. At the time of the arbitrator's order, the franchisees had been operating in that manner for one year and eight months, which would have left only four months of the non-competition period if it had run from the date the Franchise Agreement expired. The court observed that the arbitrator's ruling ensured that the franchisees would be subject to the Non-Competition Provision's requirements "for the length of time originally agreed to by the parties," and noted that other courts had extended non-competition periods for the same reason. As a matter of equity, therefore, the franchisees should not be rewarded for their blatant disregard of the terms to which they had agreed. The court noted that failure to enforce the full period of non-competition would reward breach of contract and encourage protracted litigation.

Frye represents strong support for and protection of contractual non-competition clauses in franchise agreements. To take advantage of this particular judicial valentine, franchisors should ensure that the triggering language in their non-competition clauses is specific and clear.

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FEDERAL COURT RULES AGAINST YUM! BRANDS IN THIRD-PARTY FRANCHISE SALE CASE – WHAT FRANCHISORS NEED TO KNOW

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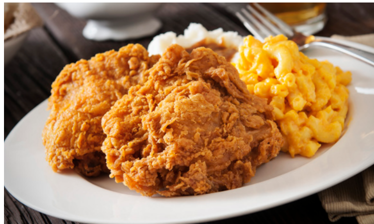

A federal court in Kentucky recently denied a franchisor's request to dismiss its franchisee's claim for intentional interference with prospective economic advantage. Based on this ruling, franchisors should proceed with caution when evaluating a franchisee's proposed third-party franchise sale. *Raheel Foods, LLC v. Yum! Brands, Inc.*, 2017 WL 217751 (W.D. Ky. Jan. 18, 2017) involved a franchisee's proposed sale of a number of Yum! Brands stores and underlying properties (the "Franchises") to a third party. Franchisee Syed Raheel, via several approved business entities, found a qualified buyer to purchase all of the Franchises in a package deal.

Under the applicable franchise agreements and Yum! Brands' standard operating procedures, Raheel was required to obtain Yum!'s approval of both the potential purchaser as a franchisee and the proposed deal as a whole. Raheel alleged that Yum! routinely approved franchise sales, especially when proposed purchasers were existing Yum! franchisees, which was partially the case here. Raheel claimed he submitted at least ten prospective buyers to Yum! for approval, at least four of whom had engaged in extensive negotiations with Raheel. According to Raheel, instead of genuinely considering the proposed sales to four would-be buyers, Yum! unreasonably denied Raheel's approval request and later executed its own purchase agreements with Raheel's four prospective buyers. Raheel also alleged that one potential purchaser, J.A., made an offer to purchase all the Franchises. J.A. was already an approved Yum! franchisee and Yum! approved J.A. for the Raheel sale.

However, Yum! subsequently withdrew its approval of J.A.'s purchase of certain stores owned by the franchisee's related entity (which was not a party to the suit) and instructed the related entity to terminate its contract with J.A. Because Raheel's entire proposed sales package was contingent upon Yum!'s approval of J.A.'s purchase of the related entity's stores, this move by Yum! effectively scuttled Raheel's deal. Months later, Yum! offered J.A. 70 of its corporate-owned stores and 11 underlying properties at a substantial discount, and J.A. accepted. Based upon these facts, Raheel sued Yum! for, among other claims, intentional interference with prospective economic advantage. Yum! moved to dismiss all claims. While most claims were dismissed, the *Raheel* court ruled that Raheel could proceed against Yum! on its intentional interference claim.

Intentional Interference with Prospective Economic Advantage

Under Kentucky law, liability for the intentional interference with a prospective economic advantage arises when a party improperly interferes with another's valid business expectancy. The majority of jurisdictions in Baker Donelson's footprint have adopted similar definitions of this tort. Rejecting Yum!'s argument to the contrary, the *Raheel* court held that this claim could be asserted between business competitors and articulated certain factors to determine whether interference is improper. Specifically, plaintiffs must show malice or some significantly wrongful conduct. Interference is not improper unless it is malicious or without justification, or is accomplished by unlawful means, such as fraud, deceit or coercion. However, a party can act with malice without ill will; in fact, malice may be inferred by proof of lack of justification. In other words, malice can be shown through intentional interference without justification. The central question is whether the actor's conduct was fair and reasonable under the circumstances. In determining whether a defendant's conduct was fair and reasonable, pertinent factors include recognized standards of business ethics and business customs and practice, the concepts of fair play and rules of the game.

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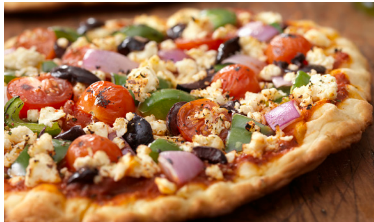
FEDERAL COURT RULES AGAINST YUM! BRANDS IN THIRD-PARTY FRANCHISE SALE CASE – WHAT FRANCHISORS NEED TO KNOW, *continued*



Facts Alleged to Support Raheel's Intentional Interference Claim
Raheel alleged that its entities presented their proposed purchasers to Yum! for approval as required by the parties' franchise agreements. As a result, the proposed purchasers' identities and offered terms were disclosed to Yum! Raheel further alleged that Yum! routinely approved franchise sales, especially when proposed purchasers were already approved as franchisees, which was partially the case here. Instead of objectively vetting the proposed sales, Yum! supposedly undercut Raheel by offering the proposed purchasers corporate-owned stores at below-market prices or refusing to approve the proposed purchasers when presented by Raheel, but later approving them for the purchase of corporate-owned stores.

Yum! argued that because it had the right to deny any proposed sale, its denial of the involved sale could not be improper interference and the court acknowledged that the exercise of legitimate contract rights could not give rise to an intentional interference claim. However, Yum! was only entitled to exercise its legitimate approval rights in good faith, and not for an improper purpose (i.e., to take Raheel's buyers for itself). According to Raheel, Yum!'s only motive for its conduct was to increase profits. Yum! argued that said profit motive justified its conduct because the parties were business competitors. The court recognized that legitimate competition necessarily interferes with prospective business relations and that, as between competitors, competition alone is not an improper basis for interference. In this case, however, Raheel pointed out that it could not sell its franchises and underlying properties in a package deal without Yum!'s approval. Because Yum! was privy to the terms of the deal and allegedly used its contractual rights to handcuff Raheel and poach its potential purchasers, the Court distinguished Yum!'s conduct from cases involving ordinary competition. Based on these allegations, the *Raheel* court ruled that Raheel had adequately alleged that Yum!'s conduct ostensibly violated concepts of fair play and the rules of the game and denied the franchisor's motion to dismiss.

***Raheel's* Potential Implications for Franchisors**
Franchisors should pay attention to the *Raheel* decision and its potential implications for several reasons. First, franchisors should not withhold or withdraw approval of franchisees' proposed sales absent objectively reasonable grounds for doing so, especially in situations where the franchisor has previously approved the proposed third-party buyer. Furthermore, because approval processes entail the exchange of significant and sensitive business information, franchisors should be extremely cautious about pursuing a sale with an approved purchaser if a proposed deal with a franchisee fails. At a minimum, franchisors should wait a reasonable period of time after the proposed sale is terminated before approaching the would-be purchaser. Certain franchisors may want to consider amending the approval provisions in their franchise agreements to include a non-exhaustive list of valid business reasons for: (1) disapproving a proposed purchase; (2) withdrawing approval of a proposed purchase; and/or (3) pursuing a sales opportunity with a franchisee's prospective buyer. Ideally, these reasons would guide the franchisor's third-party sales approval process. That said, such guidance, if not carefully adhered to, could simultaneously create additional risks for a franchisor who rejects a franchisee's proposed sale. A disappointed franchisee could point to such provisions and claim that its franchisor's refusal to approve a proposed purchase was arbitrary or based on an improper purpose if the franchisor's reason(s) for the disapproval are not clearly articulated. In sum, franchisors should pay close attention to the *Raheel* case and tread carefully and strategically when evaluating franchisees' third-party sale requests.

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THE ROAD TO CONFIRMING A SECRETARY OF LABOR

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While the process likely did not go as President Trump originally anticipated, the long wait for a leader of the U.S. Department of Labor (DOL) finally concluded in April. After Trump's first choice, Andrew Pudzer, withdrew in the face of congressional opposition, Trump selected Alexander Acosta. Unlike Pudzer, Acosta had not publically taken a position on many of the hot issues such as the increased overtime and the changes to joint employment evaluation developed under the Obama Administration. On April 27, 2017, almost a month after testifying before the Senate Health, Education Labor and Pension (HELP) Committee, Acosta was finally confirmed by Senate in a vote of 60-38.

Acosta is from Miami, Florida, where he served as Dean of the Florida International University Law School. He received his undergraduate degree and juris doctorate from Harvard and practiced labor and employment law as an associate with Kirkland & Ellis from 1995 until 1997. Acosta served as law clerk to Justice Samuel Alito Jr. when he was serving on the Third Circuit Court of Appeals. He was appointed by President George W. Bush in December 2002 to serve on the National Labor Relations Board, where he participated in approximately 125 decisions – some pro-employer but not all, usually siding with Republicans. In August 2003, Bush appointed Acosta as head of the Department of Justice's Civil Rights Division, where he served for about two years before becoming the U.S. Attorney for the Southern District of Florida in 2005.

While we are not completely certain as to Acosta's strategies regarding many of the hot button issues that face the hospitality industry, he did testify during his hearing before the HELP Committee that he believed a raise of the previous overtime threshold was probably due. However, he indicated that the abrupt move to almost double the prior threshold was excessive and that he would be working with DOL staff to determine whether pursuing the appeal of the Fifth Circuit's stay of this rule is the best course of action. Acosta appeared to suggest that his strategy as leader of the DOL will also include reversal of or reigning in the joint employer liability doctrine developed by the Obama Administration.

Acosta has been described as an independent thinker, pro-free market and pro-free enterprise. He is a strong proponent of diversity and testified before Congress in support of protecting Muslim Americans in 2011. He has been the subject of investigation in the past as to whether his case assignments were made according to political affiliation. Generally, it seems that Acosta has many of the same views that were publicly expressed by Pudzer, but he is expected to be more balanced and mainstream in his approach and strategy for reaching his goals. His strategy and approach as head of the DOL will certainly be affected by the 21 percent budget cut Trump has proposed for the DOL. While we still don't have all the answers on what we can expect to see from the DOL under Trump's Administration, the long-empty seat of the Secretary of Labor has finally been filled and it at least appears that employers can look forward to some relief from the burdens of the labor regulatory dilemma created during the eight years of Obama's Administration.

SECOND CIRCUIT "DRIVES" FORWARD CLASSIFICATION OF WORKERS AS INDEPENDENT CONTRACTORS

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In an April 2017 decision, the Second Circuit affirmed the dismissal of a proposed class action brought by New York-area "black car" drivers, workers providing high-end transportation services in limousines and other upscale vehicles. *See Saleem v. Corp. Transportation Grp., Ltd.*, 854 F.3d 131 (2nd Cir. 2017). These drivers had sued their employer for violations of the Fair Labor Standards Act (FLSA), alleging they were improperly classified as independent contractors. The New York district court, however, found the drivers were properly classified as independent contractors under the FLSA, and the Second Circuit agreed.

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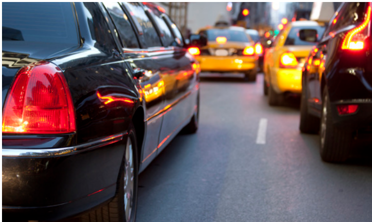
SECOND CIRCUIT "DRIVES" FORWARD CLASSIFICATION OF WORKERS AS INDEPENDENT CONTRACTORS, *continued*



But how might this holding affect employers and employees? This article provides a summary of the Second Circuit's reasoning and the practical implications of the decision.

The Road Ahead for Employers: Classifying Workers as Independent Contractors
Saleem sets a path for employers to follow if they want their workers classified as independent contractors.

The plaintiffs in *Saleem*, a group of a dozen drivers employed by Corporate Transportation Group, Ltd. (CTG) and nearly a half-dozen others employed by CTG's affiliates, claimed they were improperly classified and thereby denied overtime payments in violation of the FLSA.

The New York district court had followed the Second Circuit's application of a totalities of the circumstances test, which addressed the "ultimate concern" of whether, as a matter of "economic reality," the drivers depended upon the Defendants' business for the opportunity to render service or were instead businesses in and of themselves.

The Second Circuit's Reasoning
In finding the black car drivers were independent contractors, the Second Circuit also relied on the economic realities test, considering multiple factors and the totality of circumstances related to the drivers' own control of the services they offered.

The Second Circuit addressed those factors relevant to separating employees from independent contractors in the context of the FLSA first set out in *United States v. Silk*, 331 U.S. 704, 713 (1947), but noted the factors were "merely aids to analysis..." The court explained that the factors must be used to clarify the economic reality of the arrangement at issue and that relevant FLSA precedent cautions against the factors with a mechanical application.

In *Silk*, the Supreme Court decided whether truck drivers in two consolidated cases constituted "employees" for the purpose of the Social Security Act, setting out the following factors: (1) the degree of control exercised by the employer over the workers; (2) the workers' opportunity for profit or loss and their investment in the business; (3) the degree of skill and independent initiative required to perform the work; (4) the permanence or duration of the working relationship; and (5) the extent to which the work is an integral part of the employer's business.

Saleem has expounded upon the factors, noting that it is not what a plaintiff could have done that counts, but what they actually do as a matter of economic reality that is dispositive. To that point, the Second Circuit noted that the plaintiffs could pick up non-CTG clients and had other autonomy in their schedules. Evidence showed that the drivers provided rides for multiple, competing black car companies, rather than driving for CTG or its affiliates only. Moreover, the plaintiffs regularly drove personal clients and picked up passengers via street hail, despite apparent prohibitions against this practice.

The court was persuaded heavily by the drivers' ability to toggle between different car companies and personal clients and their ability to decide how to do so as to increase their own profits. Because drivers were afforded the opportunity to decide how best to obtain business from CTG's clients, the court believed the drivers' profits increased through their own "initiative, judgment, and foresight" – all of which were considered qualities of the typical independent contractor. The court found that despite any "control" CTG exerted over certain aspects of the drivers' business (such as negotiating fares and providing drivers with institutional clients), the plaintiffs retained economic status that could be and was traded to other car companies, and thus, as a matter of economic reality, the drivers merely generated income from the defendant companies.

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SECOND CIRCUIT "DRIVES" FORWARD CLASSIFICATION OF WORKERS AS INDEPENDENT CONTRACTORS, *continued*

The Take-Away
The Second Circuit's reasoning and discussion of the economic realities test in *Saleem* offers guidance to employers wishing to classify their workers as independent contractors. Courts may now take a more holistic view of the employment relationship in determining independent contractor status, shying even farther away from allowing any one factor of the *Silk* "economic realities" test to be dispositive.

Practically speaking, for those companies that want their workers to be considered independent contractors, the facts in *Saleem* offer a model: give workers control of their schedules and allow workers to serve clients of your company and others; providing institutional clients to your workers who offer services may not mandate an "employee" classification.

Along with implications under the FLSA (the statute at issue in *Saleem*), the independent contractor classification has other favorable implications for companies. For example, that classification may limit the scope of liability an employer could face for the negligent actions of their workers. Employers hoping to gain this and other benefits regarding classification should "shift gears" and follow the "road paved" by *Saleem*.

NEWS BRIEFS

Baker Donelson Team Recognized for Client Service
Hospitality team members Joel R. Buckberg, Eugene J. Podesta Jr. and Sara M. Turner have been recognized in BTI Consulting Group's 2017 Client Service All-Stars list. The 16th annual guide is comprised of 319 attorneys who were identified for their exceptional client service by more than 300 corporate counsel and legal decision makers from organizations with $1 billion or more in revenue. Baker Donelson was one of only 56 firms with more than one all-star attorney. Honorees are noted for being proactive in providing value-added service, demonstrating superior client focus by understanding the client's business and combining innovative thought-leadership with legal skills to deliver outstanding results.

Tennessee Tourism and Hospitality Law Symposium July 13
Baker Donelson will once again host the Tennessee Hospitality and Tourism Law Symposium on July 13. This all-day workshop will provide a comprehensive overview of current legal issues facing members of this industry in Tennessee, including updates on health care, tax reform, development/financing and more. If you are interested in attending, email Laura Ellis.

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