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Message from the Chair

By Elizabeth M. Weldon, Haynes and Boone, LLP

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Please mark your calendars for the Forum on Franchising's 47th Annual Meeting that will take place in Phoenix, Arizona, on October 16–18, 2024. We are already well into the planning for this next meeting and are thinking about how we will see friends in person again this Fall. Our Co-Chairs for the 2024 Annual Meeting are Earsa Jackson and Erin Johnsen, and they are supported in their work for the Forum by a Planning Committee of last year's meeting Co-Chairs, Nicole Micklich and Heather Perkins, the following year's Co-Chairs, Caroline Fichter and Dan Oates, as well as the Immediate Past Chair, Ron Coleman, and me.

Starting right after the 2023 Annual Meeting, our Co-Chairs commenced planning and prepared an initial program for the 2024 Annual Meeting. They presented the program to the Planning Committee in December 2023 and then to the Governing Committee and Senior Appointed Leadership of the Forum in January 2024, at our Mid-Winter Governing Committee meeting. We took input from our leaders to finalize the program and make it interesting, timely, and appealing to a wide section of members across our Forum. I am pleased to report that our Co-Chairs have lined up another year of very talented speakers to present papers and programs about important developments that continue to happen in franchise law. If you are one of the speakers for the 2024 Annual Meeting, I want to say "thank you" in advance for the hard work and critical thinking that you are doing in preparing your materials for the meeting. In addition to comradery and networking, our members come to see you and your programs. This is the core of our Forum!

The Forum's efforts to create great publications and continuing legal education in the area of franchise law continues. We had a great new Forum publication debut at the 2023 Annual Meeting in Dallas, the book *Representing Franchisees*. In addition, in fiscal year 2023, the Forum published the updated *Covenants Against Competition in Franchise Agreements*, Fourth Edition, and *International Franchise Sales*, Third Edition. I hope you consider buying each of these books for your practice. They are amazing resources that will help you and your clients, and are authored

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Big Changes for Fast Food Franchises in California . . . and Maybe Beyond

By Aaron Van Nostrand and Kyle Lennox, Greenberg Traurig, LLP

Assembly Bill 257, also known as the Fast Food Accountability and Standards Recovery Act (the "FAST Act")—which sought to regulate the wages and certain working conditions for employees of fast food franchises in California—was signed into law on September 5, 2022. Originally set to come into effect on January 1, 2023, the FAST Act immediately met resistance from the business community in California because of the significant impact that it would have on the fast food and franchising industries. Then, on September 28, 2023, following a series of meetings between representatives from labor unions and the fast food industry facilitated by the governor's office, California Governor Gavin Newsom signed Assembly Bill 1228 ("AB 1228") into law, repealing the FAST Act in favor of more targeted legislation. The new law took effect on January 1, 2024. This article explains the evolution of the FAST Act, signed in September 2022, to the final version of AB 1228, passed into law just over one year later, and provides guidance regarding the impact that AB 1228 may have on the fast food industry and franchising in general.

The Evolution of the FAST Act to AB 1228

The origins of the FAST Act are attributable to the increasing unionization of the restaurant industry, which began in 2012 with the "Fight for $15" movement that advocated for a $15 minimum wage for restaurant workers. At that time, a series of fast food worker strikes in various cities around the country pushed for increases to the minimum wage, as well as improving paid sick leave and other benefits. Notwithstanding this public pressure, it took almost ten years for legislation to pass in California.

The FAST Act was first introduced in January 2021, but it failed to gain any traction until it was amended in August 2022, and subsequently passed in September 2022. The FAST Act targeted "fast food chains," defined as large, national franchised restaurant chains with 100 or more establishments nationally (whether company-owned or franchised) and imposed a minimum wage of $22 per hour for all fast food workers at such national chains. The FAST Act also created a state commission (the fast food council) empowered to regulate working conditions at fast food restaurants governed by the law.

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But the FAST Act met with immediate resistance. Within two days of its passage, a coalition of major fast food restaurants gathered enough signatures to temporarily suspend the Act's enactment until a statewide referendum could be held (originally scheduled for November 2023, and later postponed to November 2024), which would have allowed the citizens of California to vote on whether to repeal the FAST Act.

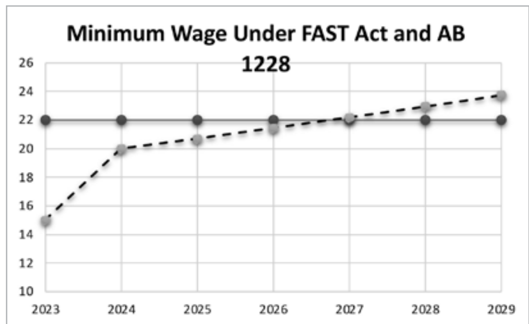
Before the FAST Act could be presented for a state-wide vote, however, the California Assembly introduced AB 1228, a free-standing bill that in many ways was a more onerous version of the FAST Act. For example, AB 1228, as originally proposed, reintroduced many of the joint liability provisions from earlier versions of the FAST Act bill that had been cut before Governor Newsom signed the bill in September 2022. The joint liability provisions under the original version of AB 1228 (like those in the originally proposed FAST Act) would have required that a national fast-food franchisor share in civil liability for its franchisee's violations of California's labor laws, and would have prohibited any waiver in a franchise agreement or any other provision that would otherwise limit a franchisor's liability in this regard. Additionally, the originally proposed AB 1228 gave franchisees the power to sue franchisors if a franchisor created a "substantial barrier" to its franchisees' compliance with California laws, whether through a franchisor's system standards, operations manual, or otherwise.

Throughout 2023, parties on both sides, including representatives from labor unions and the fast food industry, met to negotiate the provisions of the FAST Act and the newly proposed AB 1228. These negotiations led to a revised AB 1228, which removed the joint liability provisions discussed above, and pared back the broad authority granted to the fast food council under the FAST Act. The final version of AB 1228, which was signed into law on September 28, 2023, replaced and superseded the FAST Act, mooting the referendum on the FAST Act.

Stakeholders are still analyzing the real world impact of AB 1228. The minimum wage provisions of the law have garnered considerable attention. But other provisions of the bill may also impact both franchisors and franchisees.

Minimum Wage

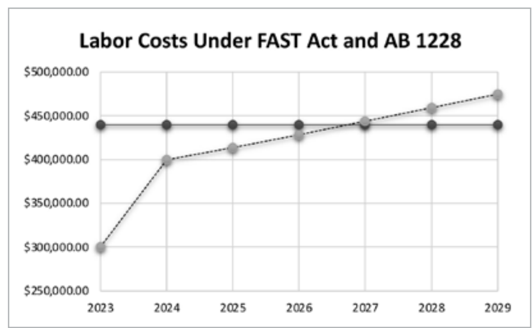
Fast food chains largely have hailed the new minimum wage provisions in AB 1228, as a welcome improvement from the $22 per hour minimum wage mandated by the FAST Act. Under AB 1228, the minimum wage was raised to $20 per hour as of April 1, 2024, and the fast food council has the power to increase the minimum wage on an annual basis until January 1, 2029, by no more than the lesser of 3.5% or the annual percentage increase in the Consumer Price Index. Assuming that the fast food council opts for 3.5% annual increases, the minimum wage for workers at fast food chains will exceed $22 per hour by 2027, and will continue to increase through 2029. In 2030, the fast food council will have an opportunity to propose a new minimum wage to the legislature.



Solid Line = FAST Act; Dashed Line = AB 1228

As this chart illustrates, while the minimum wage starts $2 per hour lower under AB 1228 than under the old FAST Act in 2024, over time, the minimum wage under AB 1228 will rise and could potentially exceed the FAST Act's $22 per hour minimum wage, assuming the fast food council approves increases each year.

To understand the impact, consider a hypothetical fast food franchise that employees ten full time employees each working 2,000 hours per year. Assuming that the fast food council approves 3.5% increases each year, when comparing AB 1228 to the FAST Act, under AB 1228, the franchise employer will start to incur greater labor costs in 2027, as indicated in the chart below:



Solid Line = FAST Act; Dashed Line = AB 1228

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Under the FAST Act, this hypothetical employer would have paid a total of $3.08 million in labor costs between 2023 and 2029, whereas under AB 1228, the same employer will pay $2.9 million for the same period–a savings of 5%. Thus, the overall difference between the labor costs under the FAST Act and AB 1228 is not as drastic as some have argued. The main difference is that AB 1228 spreads out those added labor costs, giving franchise owners an opportunity to prepare for increased costs over time.

Exceptions to "Fast Food Chain"

An important aspect of AB 1228 that has not garnered as much attention as the minimum wage provision is the exceptions to the definition of "fast food chain." The first exception is for a "bakery" that produces "bread" (as defined under Part 136 of Subchapter B of Chapter I of Title 21 of the Code of Federal Regulations) for sale as a stand-alone item and not solely as part of another menu item. This exception appeared to apply to chains such as Panera, though California disputes this characterization, distinguishing between bread produced entirely on-site and bread made from dough that has been sourced from a central location. Other franchises—such as a doughnut franchise that sells stand-alone bagels, arguably a form of bread—may argue it applies to them as well. Fast food chains considering adding bread to their menu to avoid the strictures of AB 1228 are out of luck. Bread must have been a menu item as of September 15, 2023, to qualify for the exception.

Another exception is for fast food restaurants located in a "grocery establishment" where the grocery establishment, rather than the fast food franchise, employs the individuals working in the restaurant. This provides an incentive to fast food chains that operate in grocery stores to tailor their hiring and employment relationships so that the grocery store, rather than the fast food franchisee, is the employer of the fast food workers.

Power of the Fast Food Council

Under AB 1228, the power of the "fast food council" is significantly reduced in comparison to the FAST Act. Whereas the FAST Act gave the fast food council the power to publish standards, repeals, and amendments under the FAST Act on an annual basis subject to veto from the state legislature, including to raise minimum wage based on the then-current cost of living standards in California, AB 1228 only permits the fast food council to make recommendations to the Labor Commissioner, who must then follow the formal rulemaking process to promulgate these recommendations. Not only does the rulemaking process have a formal public comment period, but the timing before a rule is promulgated stretches for well over a year. This change in the law was a significant victory for fast food franchisors and franchisees.

Elimination of Joint Liability Provisions

Another major victory for fast food franchisors was the elimination of the joint liability provisions in the final version of AB 1228. The originally proposed versions of both the FAST Act and AB 1228 included a provision that would make franchisors jointly liable for their franchisees' employment law violations. That provision would have significantly expanded liability for franchisors over and above the National Labor Relations Board's joint employer standard. The final version of AB 1228 omits that provision, maintaining the status quo where individual franchisees are principally responsible for employment law violations, absent a judicial finding of joint employer liability under the facts and circumstances of specific cases.

Copycat Laws in Other States

The passing of AB 1228 will likely impact restaurants and other industries in and outside of California. Proponents of the legislation have made it clear that California is a starting point, and copycat legislation is likely to follow in other states in the not-too-distant future. For example, Virginia legislator Irene Shin introduced HB 2478 to the Virginia House of Delegates in January 2023. That bill largely mirrors the FAST Act and AB 1228, but in some ways, calls for more oversight on franchisees and franchisors as it regulates training programs provided to fast food workers. HB 2478 failed in the state committee process after being introduced.

Additionally, New York state Senator Jabari Brisport introduced a fast food franchisor accountability act in January 2023, which also mirrors the FAST Act, but contains the joint employment standards that were in earlier versions of the FAST Act and AB 1228. Specifically, New York's bill aims to hold fast food restaurants and franchisors jointly liable for violations of certain labor laws and requires new rules and regulations

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The Intersection of Community Property Laws, Personal Guarantees, and Franchise Agreements

By Michael Volin and Carriann Sillman, Anywhere Real Estate Inc., and Rachel O'Connor, Lathrop GPM LLP

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Franchisors commonly require a franchise owner to sign a personal guarantee, and in many states, they may also require the franchise owner's spouse to sign a guarantee. This may seem counterintuitive to a business owner, who likely created a legal entity to shield their personal assets should the business fail; however, franchisors have a variety of reasons for requiring personal guarantees, including spousal guarantees.

Spousal guarantees and consents can be useful tools for both the franchisor and franchisee to clarify the rights and obligations of a franchisee's spouse. They can identify which assets of the franchisee and spouse might be subject to collection, how a divorce might impact the franchise, and whether and how franchise agreement obligations or restrictions apply to the franchisee's spouse. Both documents clarify the parties' expectations at the outset of the franchise relationship. Absent an enforceable spousal guarantee or consent, state marital property laws, like community property and equitable distribution, may determine the assets from which a franchisor might seek to recover and the impact that a divorce will have on a franchise relationship.

Furthermore, absent a consent or guarantee, how and where disputes with parties other than the franchisee will play out depend on the law of the jurisdiction and the specific facts. Often, those facts are beyond the franchisor's control, and in the case of a divorce involving a franchise owner, perhaps beyond the control of the franchise owner. This can lead to costly litigation to determine the rights of the franchisor, franchisee, and the spouse or other non-signatory.

This article discusses important pre-execution considerations related to spousal personal guarantees and consents, as well as important considerations when a dispute arises that may invoke such guarantees and consents.

While beyond the scope of this article, franchise relationship laws can also impact the scope and enforceability of spousal consents and guarantees. In addition, the Equal Credit Opportunity Act, which prohibits discrimination based on marital status, could prevent a franchisor from mandating the franchisee's spouse to execute a guarantee.

Spousal Guarantee v. Spousal Consent

A personal guarantee only provides a franchisor with the right to seek payment from the individual assets of the franchise owner if the franchisee entity defaults under the financial terms of the agreement, but a spousal guarantee protects the franchisor by making the status of the marital relationship irrelevant, allowing the franchisor to collect against marital assets. Ronald A. Giller, Lisa K. Garner, and Adam L. Sheps, *Yours, Mine, Ours, and Theirs: The Role of Spousal Guarantees and Consents in the Franchise Relationship*, 33 Franchise L.J. 71 (2013). A spousal consent, on the other hand, provides additional non-financial protections by binding the spouse to any non-financial commitments in the franchise agreement, such as the covenant not to compete or restrictions on the transfer of the franchise. It can also address financial concerns outside the scope of the franchise agreement, including binding marital assets to the franchise relationship. *Id.*

A franchisor can shape a spousal consent to a particular situation, such as what will occur in the event of a divorce, the creation of a trust, or other vehicles under which a franchise owner may attempt to shield personal or marital assets. A spouse may hesitate to sign a personal guarantee or a consent, especially if they do not participate in the franchise business. The less that a franchisor weighs spousal assets in the analysis for granting the franchise or the franchisee obtaining financing, the weaker the rationale for the franchisor to require any consent. However, parties can explore middle-ground approaches, such as agreeing to limit the risk under any personal guarantee by applying caps – either time or monetary based, or based on ownership interest (which the parties

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should amend over time if ownership interests change during the term of the agreement).

Additionally, a franchisor might consider requiring a spouse to co-sign a promissory note only where the franchisor provides financing, in lieu of the spouse providing a full personal guarantee. This limits spousal exposure to the amount of the financing granted under the promissory note and does not subject the spouse to other liability under the agreement.

The Impact of Spousal Guarantees and Spousal Consents on Financing

Franchisors that grant financing to franchisees have even more reason to secure a personal guarantee from the franchise owners and spouses, particularly in those states where the law makes it challenging to attach marital assets. Franchisors have reason to assess not only the financial health of the franchise entity, but also the net worth and financial security of the franchise owner and their spouse prior to granting financing. As stated by Susan Metcalfe and Evan Goldman in their article *Point/Counterpoint: Personal Guarantees*: "[b]anks routinely require personal guarantees in connection with business loans. Why should a franchisor settle for less protection?" Susan V. Metcalfe and Evan M. Goldman, 36 Franchise L.J. 1, 9 (2016). The personal guarantee serves to not only protect the franchisor if a franchisee defaults on payments to the franchisor, but requiring a personal guarantee also impacts the financial health of the franchise system, protecting system resources for product development, marketing, advertising, and promotion that benefits everyone.

The FTC Rule requires that a franchisor include the terms of the financing in Item 10 of the Franchise Disclosure Document ("FDD"), such as the interest rate, consideration, number of payments, and default terms, and the FDD must also specify if franchisees must waive any defenses or other legal rights to obtain financing. As such, if applicable, franchisors should include in Item 10 the requirements for waiver of any defenses or rights in their form guarantee.

Disclosure Requirements

The FTC Rule requires a franchisor to include in its FDD all proposed agreements that a franchisee must sign during the term of the franchise agreement. This includes any personal guarantees. Additionally, the franchisor must disclose any requirements regarding the personal guarantee and consistently apply those requirements. For instance, if the FDD states only owners with at least a 25% ownership interest in the franchise must sign a personal guarantee, then a franchisor cannot later require new owners with less than a 25% ownership interest to sign a personal guarantee, including if the parties later assign or transfer the agreement.

The FTC Rule does not require the franchisor to include guarantees or consents on the FTC cover page; however, state regulators may require a franchisor to include additional presale disclosures on a separate cover page or in a state addendum. For instance, if the franchisor requires a spousal guarantee, a state regulator will generally require the franchisor to include a risk factor before it approves the FDD for use in that state. Although outside the scope of this article, if a franchise system operates outside the United States, certain countries with franchise laws may also require the disclosure of guarantee responsibilities.

Collection Issues

Spousal rights can potentially complicate whether, and how much, a franchisor may collect from a franchisee in the event of a monetary dispute.

In tenancy by the entirety states, for example, the franchisor may have difficulty reaching assets that a franchise owner holds with its spouse. *In re Hinton*, 378 B.R. 371, 377 (Bankr. M.D. Fla. 2007). If a spouse did not sign a guarantee, the franchisor may not collect on property held in tenancy by the entirety, even if the franchise owner signed a personal guarantee. *Id.* State law varies on this concept, but states that apply some form of tenancy by the entirety include Alaska, Arkansas, Colorado, Delaware, District of Columbia, Florida, Hawaii, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Michigan, Missouri, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, West Virginia, and Wyoming.

In addition to keeping marital property as a potential collection asset, a spousal guarantee or consent can lessen the risk that a franchisee will seek to hide or shield assets with a spouse. If the non-franchisee spouse signs a guarantee, then transferring assets to that spouse will not shield the franchisee in a collection effort.

Divorce

A franchisee going through a divorce can obviously disrupt the operation of a franchise. The absence of an enforceable spousal consent or guarantee can magnify that disruption.

Community property states generally hold that community property encompasses property

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Primer on Important Amendments to the Chinese Company Law

By Dominic Hui, Ribeiro Hui

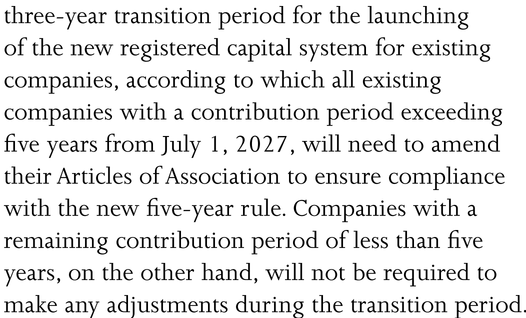
Many American and European franchisors have entered the Chinese market by setting up subsidiaries or associated entities in China. Some of these entities are wholly owned subsidiaries that operate direct stores in China, while others provide support to Chinese franchisees, and others are joint venture vehicles. Like every other company registered to do business in China, these subsidiaries and associated entities are governed by China's Company Law.

At one time, China's Company Law was not particularly demanding. But the Chinese government recently passed a series of amendments to the Company Law, which enact substantial regulation in areas such as capital contribution, corporate governance, and management responsibilities. These new laws took effect on July 1, 2024. This article highlights some of the most important changes to the Company Law and offers general guidance for compliance with the new requirements.

Capital Contribution

China's Company Law has always required some amount of committed registered capital—a minimum level of capital that shareholders must contribute to the company they own. But in the past, the Company Law did not regulate a specific required timeline for capital contributions. It was not uncommon for shareholders of Chinese companies to withhold considerable amounts of outstanding capital contributions until after the entity started generating income.

Under the new amendments to the Company Law, a shareholder of a limited liability company must contribute their subscribed registered capital in full within five years from the date of the company's formation. By analogy, the increased part of registered capital applies the same five-year timeline. On the same date the amendments to the Company Law took effect, the People's Republic of China State Council released new implementing rules, effective immediately, governing registered capital—the Provisions on the Implementation of Registered Capital Registration Management System of the Company Law ("Provisions on Registered Capital"). Thes rules provide for a



three-year transition period for the launching of the new registered capital system for existing companies, according to which all existing companies with a contribution period exceeding five years from July 1, 2027, will need to amend their Articles of Association to ensure compliance with the new five-year rule. Companies with a remaining contribution period of less than five years, on the other hand, will not be required to make any adjustments during the transition period.

The new law also provides teeth to these requirements. In the event that a shareholder fails to pay the required capital contribution, or the actual value of the in-kind capital contribution made by a shareholder is significantly lower than the amount of capital subscribed, all the shareholders at the time of the company's formation will be jointly and severally liable for the shortfall in capital contribution. This is a powerful incentive to ensure that all shareholders provide timely capitalization.

Under the new Company Law, the Chinese company registration authority—the Administration for Market and Regulation or "AMR"—is vested with the power to examine the amount and the permitted period of capital contribution. AMR can require shareholders to adjust their contributions.

Accordingly, with the amendments to the Company Law taking effect imminently, management of companies registered in China should check to see (i) whether any shareholders still owe outstanding capital contributions, and (ii) whether it might be necessary or desirable to reduce the registered capital.

Employee Participation in Corporate Governance

Under the old Company Law, only state-owned companies are required to have employee representatives on their board of directors. The newly amended Company Law goes further, extending application of the employee representative rule to private companies with more than 300 employees, unless the company has a board of supervisors on which employee representatives sit. Either way, employee representatives must be elected by the

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company's employees through the employees' congress or meetings.

For companies with less than 300 employees, if there is only one supervisor (instead of a full board of supervisors), the new Company Law does not require the company to have any employee representatives. However, if the company has a full board of supervisors, the new amendments require that no less than one-third of that board be constituted by employees.

In light of these changes to the Company Law, Chinese companies should (i) check to determine whether they are above or below the 300-employee threshold, and (ii) if they are under that threshold, consider whether they have a supervisory board as opposed to a single supervisor. If the company exceeds the threshold, or the company has a board of supervisors, they will need to ensure sufficient employee participation in the management of company affairs.

Legal Representative

The old Company Law allows the chairman of the board, the sole executive director (if there is no board of directors), or the general manager of a limited liability company to act as the company's legal representative, regardless of whether such person is actually involved in the company's business. The new Company Law both expands and contracts the pool of candidates that may serve in that role to any director who "handles company affairs" on the company's behalf or the general manager.

While it is not clear what is meant by "handles company affairs," it is likely that any current legal representative could keep his or her position as legal representative by, among other things, attending board meetings that consider resolutions on major business matters and the execution of contracts. Prospective legal representatives must take notice, however, that the newly amended Company Law imposes greater duties and obligations on them. For example, in the event that the Chinese government prosecutes officers for regulatory violations, the new Company Law no longer allows the defense of absence of knowledge of the wrongful acts. Moreover, the new Company Law requires legal representatives to affirmatively exercise reasonable diligence. Accordingly, under the new Company Law, ignorance is not a defense, and legal representatives have a strong incentive to educate themselves regarding the company's business operations.

The new Company Law also clarifies that if the legal representative resigns from his position as a director or manager of the company, his office as the legal representative is vacated simultaneously with that resignation. The company must appoint a new legal representative within 30 days from the date of resignation.

In view of the heightened obligations placed on directors and officers under the newly amended Company Law, companies operating in China should consider implementing enhanced compliance and ethics policies with periodic audits to ensure compliance. Implementing quick corrective action when violations of the Company Law are discovered can help to mitigate exposure and potential liability.

Duties of Loyalty and Diligence

The newly amended Company Law defines the fiduciary duties of loyalty and diligence as follows:

(a) directors, supervisors, and senior management must take measures to avoid conflict of interests with the company, and they should not use their authority to seek improper personal benefits; and

(b) directors, supervisors, and senior management must perform their duties in the best interests of the company with the reasonable level of care normally expected of management personnel.

Additionally, the controlling individual shareholders and the actual controllers of a company who do not serve as directors of the company, but in an executive role, also bear duties of loyalty and diligence. As these provisions are broad and somewhat vague, it should be expected that their precise meaning and application will be tested over time.

Liability of Directors and Senior Management

The new amendments to the Company Law expand the grounds upon which a company and its directors and senior management may be held liable. Under the new law, if a director or senior manager causes losses to a third party while performing their duties for their company, the company can be held liable for such losses. The directors or senior managers may also be held personally liable if the third party's losses were caused by willful misconduct or gross negligence.

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If a controlling shareholder or an "actual controller" (a non-shareholder who can nevertheless control a company through voting rights, investment relations, or by agreements) of the company instructs a director or senior manager to perform any act that violates the law or harms the interest of the company or its shareholders, the controlling shareholder or actual controller may be held jointly and severally liable, together with the acting director or senior manager, for any damages caused by the conduct they directed. In this situation, ordinary supervisors are excluded from the definition of senior management. The prevailing opinion in China remains that, unlike directors and senior management, a supervisor can only cause loss to the company by his or her own acts or omissions in the performance of his or her duties.

Directors and senior management, on the other hand, are required to exercise independent judgment and ensure compliance with all applicable laws while performing their duties. To minimize the risk of liability and safeguard the best interests of the company, as well as its officers and senior management, companies registered in China will be well served by crafting and implementing a careful compliance policy and reinforcing that policy through robust periodic training programs.

Conclusion

The formal amendments to the Company Law are only the start. Businesses operating in China can expect the Chinese government to pass implementation rules or transitional measures that should help to clarify gray areas. Such implementation rules can be expected in the coming months. In the meantime, franchise-affiliated entities in China should keep an eye on further developments concerning the new Company Law. Companies should also consult directly with their local Chinese counsel and advisers, as the precise scope and application of the new Company Law will become clearer as it is enforced by Chinese regulators. ■

Big Changes for Fast Food Franchises in California . . . and Maybe Beyond

Continued from page 5

relating to employment and worker safety. This bill is presently in committee.

Conclusion

Even though AB 1228 is a toned-down version of the FAST Act, it will still have a significant and long-term impact on the California restaurant industry, and likely restaurants and other industries beyond California. California is one of the most expensive and complex states in which to operate a restaurant, and the passing of AB 1228 may cause operators and brands to rethink business in California. As costs have escalated sharply over the past several years, many companies have looked to technology to replace labor or to reduce the cost of labor. That trend may accelerate now. Increased labor costs may also be passed to consumers in the form of higher prices at restaurants. A substantial wage increase will affect all restaurants in California, not just "fast food" restaurants, as all businesses will likely be pushed to raise wages to be competitive in the market for labor. Moreover, as discussed above, California's innovation is likely to spread to other states, potentially causing nationwide shifts in the restaurant industry.

Franchisors may wish to communicate with their franchisees to ensure they understand the potential impact of AB 1228 on their independent businesses. While AB 1228 removed the express provision creating a joint employment relationship between a franchisor and franchisee, franchisors must still be mindful of the potential risks associated with interjecting themselves in a way that blurs the traditional joint employment delineation, such as by controlling or recommending hourly wages for employees. For those franchised restaurants subject to the statute, franchisors and franchisees should consider operational changes designed to offset increased operating costs. These changes could include reduction in menu items; carve-outs from promotional pricing programs; increased prices for all menu items; a reduction in hours of operation to reduce staffing needs; a reduction of standards for minimum staffing levels; and the implementation of digitalized artificial intelligence solutions to replace workers and further reduce labor costs. ■

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acquired during the marriage, while property acquired by one spouse pre-marriage remains the property of that spouse. Divorcing spouses each have rights to any community property, including, potentially, a business entity of one spouse. *Kozen v. Kozen*, 230 Cal. Rptr. 304 (Cal. Ct. App. 1986).

In the absence of a spousal consent or guarantee designating the franchise as individual property, a court could award the non-franchising spouse money based on the value of the franchise. *Martin v. Martin*, 752 P.2d 1038, 1044 (Ariz. 1988) (discussing generally monetary awards in a community property jurisdiction). Further, a court could order the sale of a business to facilitate an equal division of the community property. *Brehm v. Brehm*, Case No. 14-99-00055-cv, 2000 WL 330076 (Tex. App. Mar. 30, 2000).

In equitable distribution states, as the name implies, absent a distribution agreement between the spouses, courts will divide the property in a way that it deems equitable and fair. *See, e.g., Hoverson v. Hoverson*, 828 N.W.2d 510 (N.D. 2013). Courts will look at things like the length of the marriage and what assets and contributions each spouse has made to the marriage. *Id*. As part of that analysis, courts will clarify property as marital or separate. A spousal consent can serve to define the franchise as an individual asset. However, if marital assets are co-mingled to the benefit of the franchise business, or if the business has been supported by the marital estate, that can change the analysis. A court could find that the couple converted the franchise into a marital asset or that the court should consider any increase in value of the franchise as marital property and subject to distribution. *Smith v. Smith*, 798 S.W.2d 442, 447 (Ark. Ct. App. 1990) (noting it was appropriate to recognize the spouse's contributions towards the increase in value of the TCBY franchise business when making a property division).

Finally, while beyond the scope of this article, practitioners should examine the extent to which state relationship laws may impact the enforceability of certain provisions in a spousal consent or guarantee.

Non-Compete Restrictions

Franchise agreements often contain non-compete covenants to prevent the franchisee from operating a competing business during or after the franchise relationship. Franchisors may wish to bind the spouse to those provisions by spousal consent or guarantee, given that they often have a front-seat view of how the business operates and the support provided by a franchisor.

Absent an explicit consent, a franchisor may still take action against a non-signatory spouse based on conspiracy and abetting theories. *See, e.g., McCart v. H & R Block, Inc.*, 470 N.E.2d 756 (Ind. Ct. App. 1984); *HouseMaster SPV LLC v. Burke*, Case No. 21-cv-13411, 2022 WL 2373874 (D.N.J. June 30, 2022) (granting preliminary injunction against non-signatory associates). However, given that actions to enforce a non-compete seek immediate injunctive relief, a franchisor my find difficulty demonstrating these factors right out of the gate.

Dispute Forum Issues

Consents and guarantees, or a lack of them, can also impact the forum for resolving a dispute. Often the franchise agreement will provide for exclusive jurisdiction in the court of the franchisor's domicile or headquarters, subject to state franchise registration and relationship law requirements. In the non-compete example above, where a franchisor might have claims against both the franchisee and a non-signatory spouse, the franchisor would still need to establish personal jurisdiction over the non-signatory spouse and that venue is appropriate. *Fitness Together Franchise, LLC v. EM Fitness, LLC*, Case No. 20-cv-2757, 2020 WL 6119470 (D. Colo. Oct. 16, 2020) (finding personal jurisdiction over non-signatory entities controlled by former franchisees and forum selection clauses bound such non-signatories).

Finally, while franchise agreements often require arbitration to resolve disputes, these arbitration provisions will generally not bind non-signatories in the absence of a consent, unless the franchisor can demonstrate a preexisting relationship between the non-signatory and franchisee and that the non-signatory is a third-party beneficiary. *Goergen v. Black Rock Coffee Bar, LLC*, Case No. 22-cv-1258, 2023 WL 1777980 (D. Or. Feb. 6, 2023).

Conclusion

While a franchisor and franchisees may have different goals surrounding the issues that arise with guarantees and consents, addressing those issues at the outset of the relationship can benefit both parties. A guarantee or consent can clarify expectations during the franchise relationship and also reduce costs and uncertainty if the relationship does not work out. Franchisor and franchisee attorneys should include these considerations on their diligence checklists and be prepared to advocate on behalf of their clients. ■

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The Trend Toward Franchisor Liability in Federal Sex Trafficking Cases

By Cliff Davidson, Snell & Wilmer LLP

The past several years have seen an uptick in litigation against franchisors under the federal Trafficking Victims Protection Reauthorization Act ("TVPRA"), 18 U.S.C. §§ 1591 et seq., for alleged violations at franchised locations. As of the end of 2023, there were approximately 94 federal civil cases involving TVPRA claims against franchisors available via Westlaw. Of those, 88 appeared to be against hotel franchisors. Sixty-three of those 88 lawsuits generated opinions within the past three years. By contrast, according to the Westlaw database, there were only 25 opinions issued in cases involving the TVPRA and franchisors, from the Act's enactment in 2000, through 2020.

It seems likely this trend will continue, particularly considering recent media attention to the subject. In August 2023, the *New Yorker* published an article titled, "Should Hotel Chains Be Liable for Human Trafficking?" Bernice Yeung, *Should Hotel Chains be Held Liable for Human Trafficking?*, The New Yorker, July 26, 2023, *available at* https://www.newyorker.com/news/a-reporter-at-large/should-hotel-chains-be-held-liable-for-human-trafficking. The piece discusses several district court actions against franchisors under the TVPRA, as well as lawsuits against hotel owners. According to Hospitality Net, TVPRA lawsuits against hotel owners yielded awards of $84 million in 2020. Danielle Dudai, *Recent Case Against Hotel Clarifies Responsibilities Regarding Sex Trafficking*, Hospitality Net, July 25, 2023, https://www.hospitalitynet.org/opinion/4117407.html. Given the litigation landscape, plaintiffs are likely to continue to name deep-pocketed franchisors in addition to franchisees.

Although the majority of civil TVPRA lawsuits against franchisors concern hotel chains, the unfortunate reality is that human trafficking can occur at many types of establishments, especially ones near highways or transit hubs.

Cliff Davidson
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An Introduction to Sections 1591 and 1595 of the TVPRA

Section 1591 of Title 18 of the U.S. Code criminalizes the trafficking of children and adults by force, fraud, or coercion (direct liability), and benefitting financially from such activity (beneficiary liability). The Section states, in relevant part:

> (a) Whoever knowingly—
>
> (1) in or affecting interstate or foreign commerce, or within the special maritime and territorial jurisdiction of the United States, recruits, entices, harbors, transports, provides, obtains, advertises, maintains, patronizes, or solicits by any means a person; or
>
> (2) benefits, financially or by receiving anything of value, from participation in a venture which has engaged in an act described in violation of paragraph (1), knowing, or, except where the act constituting the violation of paragraph (1) is advertising, in reckless disregard of the fact, that means of force, threats of force, fraud, coercion described in subsection (e)(2), or any combination of such means will be used to cause the person to engage in a commercial sex act, or that the person has not attained the age of 18 years and will be caused to engage in a commercial sex act, shall be punished as provided in subsection (b).

18 U.S.C. § 1591(a).

Section 1591 goes on to define certain statutory terms, including:

- *Commercial sex*: any sex act, on account of which anything of value is given or received by any person;
- *Venture*: any group of two or more individuals associated in fact, whether or not a legal entity; and
- *Participation in a venture*: knowingly assisting, supporting, or facilitating a violation of 18 U.S.C. § 1591(a)(1).

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Id. § 1591(e).

As particularly relevant to this article, Section 1595 provides a civil remedy for violating Section 1591:

> An individual who is a victim of a violation of this chapter may bring a civil action against the perpetrator (or whoever knowingly benefits, or attempts or conspires to benefit, financially or by receiving anything of value from participation in a venture which that person knew or should have known has engaged in an act in violation of this chapter) in an appropriate district court of the United States and may recover damages and reasonable attorneys fees.

Id. § 1595(a).

Despite the use of the term "participation in a venture" in the Section 1595 civil liability provision, which is identical to the term used in the Section 1591 criminal prohibition, several courts, including one federal court of appeals, have held that the term is to be construed using its plain meaning in the Section 1595 context, rather than the definition contained in Section 1591. *G.G. v. Salesforce.com*, 76 F.4th 544, 555-558 (7th Cir. 2023). The implications of this are readily apparent in the *Doe #1* case, described below.

The TVPRA and Franchisors: *Doe # 1 v. Red Roof Inns, Inc.*

In 2021, the Eleventh Circuit became the only federal appeals court to consider a franchisor's potential civil liability under the TVPRA. In *Doe #1 v. Red Roof Inns, Inc.*, 21 F. 4th 714 (11th Cir. 2021), four sex trafficking victims who were trafficked at Atlanta-areas hotels sued the operators, employees, owners, franchisees, and franchisors of those hotels. *Doe #1*, 21 F. 4th at 719. The plaintiffs alleged they were "victims of the conspicuous and open sex trafficking that occurred at Defendants' hotels." *Id.* The plaintiffs further alleged that hotel employees worked with the traffickers by acting as lookouts, in return for cash or drugs. *Id.* at 720. Plaintiffs leveled additional allegations of complicity against hotel management. As to the franchisor defendants, plaintiffs alleged they controlled policies, standards, and training, and that the franchisors had actual knowledge of the trafficking activity based on inspections performed at relevant hotels. *Id.* The plaintiffs alleged the franchisors "turned a blind eye" to the safety and security issues at the franchised hotels because they profited from royalties and other revenues generated by the traffickers. *Id.* at 721.

The trial court dismissed the claims against the hotel franchisors for failure to allege plausible claims for relief. *Id.* The Eleventh Circuit affirmed the dismissal. The court rested its holding on the fact that the specific venture alleged in the complaint was a sex trafficking venture, as opposed to a venture of some other kind. *Id.* at 726-27. The court held that the allegations related to the franchisors' knowledge (i.e. the visits by inspectors "who would have seen signs of sex trafficking," and consumer reviews "mentioning sex work occurring at the hotels") were insufficient to show franchisor participation. *Id.* at 727.

The opinion, which was of first impression, is a mixed bag for franchisors because of how broadly the Eleventh Circuit construed the "participation in a venture" element of Section 1595, and how narrowly the court construed the specific venture at issue. "Participation in a venture" has a specific definition in Section 1591—"knowingly assisting, supporting, or facilitating a violation" of Section 1591—but Congress prefaced the definitions in Section 1591 with the words "[i]n this section." The Eleventh Circuit held that preface meant that when the phrase "participation in a venture" appears in the civil liability language of Section 1595, it does not have the same meaning as in the criminal prohibition contained in Section 1591. Instead, the Eleventh Circuit parsed the plain meanings of 'participation' and 'venture' to hold that, within the meaning of the civil liability statute (Section 1595), the "participation in a venture" element required only that plaintiffs "allege that the franchisors took part in a common undertaking or enterprise involving risk and potential profit." *Id.* at 724-25. The Eleventh Circuit repeatedly emphasized the plaintiffs' choice in the district court to stand on their complaint limiting the venture to a sex trafficking venture, before pivoting on appeal to "commercial ventures to operate hotels." *Id.* at 727.

Federal district courts considering TVPRA claims against franchisors, both in the Eleventh Circuit and in the District of Ohio, have applied the precedent from *Doe #1 v. Red Roof Inns* narrowly. For example, in *C.T. v. Red Roof Inns, Inc.*, No. 2:22-cv-834-JES-KCD, 2023 WL 3510879, at *2, *4 (M.D. Fla. Mar. 11, 2023), the Middle District of Florida noted the Eleventh Circuit's holding was "narrow" and, in reviewing a motion to amend held, C.T. should be allowed to allege a TVPRA claim that the franchisor "participated in commercial ventures to operate hotels that violated the TVPRA" by "conducting business with the hotel where she was trafficked, a common undertaking which would further the

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commercial venture her claims are based on." *C.T.*, 2023 WL 3510879, at *4.

On the other hand, the Eastern District of California has held that merely alleging a franchisor-franchisee relationship is insufficient to plead the existence of a venture—though the plaintiff subsequently amended to cure this deficiency. *J.M. v. Choice Hotels Int'l, Inc.*, No. 2:22-cv-00672-KJM-JDP, 2022 WL 10626493, at *4 (E.D. Cal. Oct. 17, 2022).

Section 1595 "Venture" in Another Context: *G.G. v. Salesforce.com*

On August 3, 2023, the Seventh Circuit filed its opinion in *G.G. v. Salesforce*.com, 76 F. 4th 544 (7th Cir. 2023)—a case that did not involve a franchisor. Plaintiffs alleged Salesforce.com had violated Section 1591 and therefore was liable under Section 1595. Plaintiffs alleged they had been trafficked through advertisements on Backpage.com, a well-known source of sex trafficking that every U.S. governor and 21 attorneys general have condemned. Plaintiffs alleged that Salesforce had participated in a business venture with Backpage.com through a series of contracts—entered into after Backpage.com became known for sex trafficking—and efforts to expand and improve its business. Unlike the plaintiffs in *Red Roof Inns*, the plaintiffs alleged a business venture and not a venture to commit sex trafficking. *Id.* at 554 ("While a 'venture' can certainly run the gamut from an isolated act of sex trafficking to an international sex-trafficking enterprise, it can also be a business whose primary focus is not on sex trafficking. . . . The 'venture' was Backpage's business itself[.]")

The court held that under Section 1595, a defendant does not need to have knowledge of a particular sex trafficking victim; it is enough "that the defendant had constructive knowledge that a venture *generally* has violated Section 1591." *Id.* at 558. The court also held the "participation" element could be satisfied through a "continuous business relationship," which could permit a factfinder to "infer that the participant and trafficker have a tacit agreement[.]" *Id.* at 559-60. In other words, the Seventh Circuit picked up where the Eleventh Circuit left off; unlike the Doe defendants in *Red Roof Inns*, G.G. alleged a general business venture in which Salesforce participated by helping Backpage.com's business over many years.

Potential Safeguards for Franchisors

What steps can franchisors take to mitigate liability under the TVPRA? One step is to contract with academics and other subject-matter experts who can assist with identifying and preventing human trafficking and integrating that advice into inspections and operational requirements of franchised businesses. Additionally, franchisors can consult with the National Center for Missing and Exploited Children, which offers professional training on identifying and preventing human trafficking, particularly of children. At a minimum, franchise agreements and manuals should explicitly forbid human trafficking and require franchisees to report suspected human trafficking to appropriate law enforcement agencies.

Franchisors can also shore up their insurance coverage. Civil claims under 28 U.S.C. Section 1595, which provides for civil liability where a franchisor "knew or should have known" of sex trafficking, can, in the right circumstances, trigger insurance coverage. *See, e.g., Ricchio v. Bijal, Inc.*, 424 F. Supp. 3d 182, 193 (D. Mass. 2019) (noting that the TVPRA's "knew or should have known" language "echoes common language used in describing an objective standard of negligence"). Franchisors therefore should ensure that their franchisees' policies do not expressly exclude civil TVPRA claims, and that the franchisors are "other insureds" under such policies.

One pattern emerges from the district court opinions post-*Doe #1*: Where a plaintiff alleges franchisor control of the day-to-day operations of its franchisees, a court is more likely to find the plaintiff has alleged facts plausibly inferring the requisite knowledge of trafficking. Franchisors thus should consider potential civil TVPRA liability when structuring franchise agreements and creating policies requiring franchisees to report unlawful conduct to franchisors. In addition to taking the usual steps to prevent vicarious liability, Franchisors should also review the indemnification language in their franchise agreements and tailor the language to address particular liability in this area.

Conclusion

As the Eleventh Circuit noted in *Doe #1 v. Red Roof Inns, Inc.*, courts are "all over the map" in construing the TVPRA. *Doe #1*, 21 F. 4th at 726. It thus remains to be seen what types of franchisor-franchisee relationships, and what levels of knowledge of local conditions, are more or less likely to result in TVPRA liability. Franchisors should continue to monitor developments, consult with knowledgeable professionals to assist in eliminating trafficking activity at any of their locations (franchised or corporate), and review their agreements to protect themselves from liability. ■

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Message from the Chair

Continued from page 1

by our talented Forum on Franchising members. We continue to develop new publications and hope to debut further publications at the meeting in Phoenix. In addition to publications, we have online CLEs coming up. Be on the lookout to register for those.

Additionally, the ABA is updating the format and functionality of the websites of each section, division, and forum. We are slated for the update for the Forum on Franchising's webpage to occur in Q4 of 2024. We are planning updates to the website to increase its functionality for our Forum members. If you have ideas and thoughts about what you would like to see on our Forum website, please reach out to me and Tiffany Goldston soon so that we can incorporate all ideas into the planning process. As part of the focus on increasing our Forum members' access to information from the Forum on the website, we are renewing a prior Governing Committee role—the Information Officer—who will add increased focus on maintaining the Forum's information, both in terms of publications and our historical records. As we speed closer to the 50th Forum on Franchising in 2027 (I know that is hard to believe, and it will be here before we know it), the Governing Committee is thinking about the Forum's rich history and legacy, both to maintain what has been done and to set us up for the next fifty years of being the preeminent forum for the study of franchise law.

Our 2023 Annual Meeting was a great success due in part to the strong attendance of our Forum members. Our Forum on Franchising supports itself and its publications, legal education, and planning by the attendance of our members at the Annual Meeting. Please make sure to save the date and consider what colleagues you may be able to invite or bring to Phoenix. The future of the Forum depends on both our current membership continuing to be engaged and involved and bringing new attorneys into our ranks. The best way to do that is to bring them to the Annual Meeting to experience the scholarship and friendship that is the hallmark of our Forum.

Thank you for being a member of the Forum on Franchising and for making this organization the special, engaging, and welcoming place that it is. We will continue our planning for the 2024 Annual Meeting. Please contact me with ideas on how we can improve service to our members or how you or your colleagues can be more involved with the Forum. My email is Elizabeth.weldon@haynesboone.com and my direct dial is 949.202.3011. ■

Message from the Editor-in-Chief

By Justin L. Sallis, Lathrop GPM LLP

The minutes, hours, and days are long, but the year is flying by. We find ourselves more than halfway through the year, and just months from another spectacular Annual Meeting. You're sure to be enriched by this *Franchise Lawyer* article lineup, whether you're enjoying it poolside, deskside, or otherwise. This issue includes informative articles addressing California's AB 1228; new amendments to China's Company Law; the intersection of community property laws, personal guarantees, and franchise agreements; and potential franchisor liability under the Trafficking Victims Protection Reauthorization Act.

As you enjoy this issue of *The Franchise Lawyer*, consider writing for a future issue. Writing represents a great way to get (or stay) involved with the Forum; enhance its considerable knowledge library; and, potentially, open the door for other ways in which to contribute to the Forum, including through speaking opportunities and committee membership. If you're interested in writing for a future issue of *The Franchise Lawyer* or have a topic idea that you'd like to see covered, please reach out to me directly at Justin.Sallis@Lathropgpm.com or 202-295-2223.

Finally, a sincerest thank you to Associate Editor Dan Deane for agreeing to continue as an editor for a second term. ■

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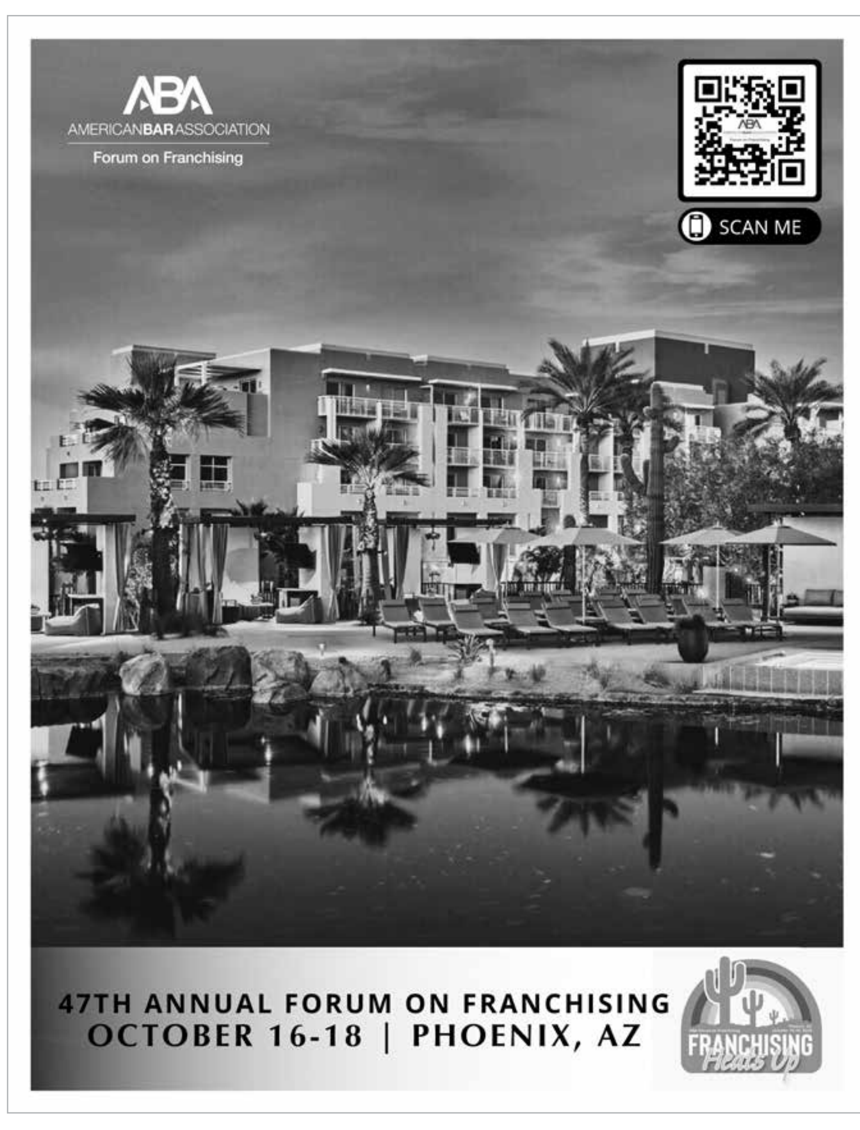

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