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The Franchise Transfer From Hell

AFA Helps Secure Tax Relief Package

AFA Joins Fiscal Responsibility Coalition

Blimpie Intl. Directed to pay $820,000

Representing the interests of small business franchisees nationally.

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The Franchise Transfer From Hell

By Marc N. Blumenthal, Esq.

Can you imagine buying a business where you'd be liable for not only your own transgressions but for the defaults of the individual who owned the business before you? No, you say, it can't happen. My lawyer would protect me from that circumstance. Well, buyer—and lawyer—beware. It can happen when you buy a franchise and it almost happened to one of my clients because the provision I'm going to tell you about could be so easily overlooked in any transfer situation.

The damaging language I am referring to was located in the franchisor's Transfer and Release Agreement. The franchisor required not only the transferring franchisee to sign the Transfer and Release Agreement but also the transferee. I vehemently objected, making the argument that my client should not be subjected to two franchise agreements. The franchisor explained that it would be done simultaneously and that the then current franchise agreement would control. By using the language in their document, I proved that was incorrect.

I pointed out that if my client stepped into the shoes of the current franchisee, he would be subject to the obligations of both transferor and transferee. At the time, the transferor had three units, one of which was in default. During the negotiation, the unit my client was purchasing also went into default. *(Continued on page 2)*

"The middle way is no way at all. If we finally fail in this great and glorious contest it will be by bewildering ourselves in groping for the middle way." ***--John Quincy Adams***

AFA Mission Statement

The mission of the AFA is to promote and enhance the economic interests of small business franchisees.

AFA Helps Secure Tax Relief Package

Last year the AFA joined the Tax Relief Coalition (TRC) in order to promote enactment of the President's tax relief package. On Saturday, March 9, 2002, President Bush signed the Job Creation and Worker Assistance Act of 2002 into law. This signing culminates months of effort by the President, the TRC and the AFA to secure passage of legislation which is designed to help the economy recover from the effects of September 11th.

Some of the other members of the TRC include the National Restaurant Association, National Federation of Independent Business, U.S. Chamber of Commerce, Food Marketing Institute, Food Distributors International, National Association of Wholesalers-Distributors, National Independent Automobile Dealers Association and the National Association of Manufacturers, among others.

A few of the most significant provisions of the Job Creation and Worker Assistance Act of 2002 include:

- Businesses will be able to write off 30% more in depreciation of capital investments for the next 3 years than is the case under current law. This bonus also applies to computer software.
- Passenger automobiles owned by businesses (with gross weight below 6,000 pounds) will be depreciated faster; an additional $4,600 may be deducted in the first year of use.
- For tax years 2001 and 2002, businesses will be able to apply for tax refunds (as far back as 5 years) when they have failed to make a profit. This provision was previously limited to 2 years.
- Unemployment benefits are extended by 13 weeks, up from the 26 weeks limit in most states.
- Tax incentives are established for investment in lower Manhattan.

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Had my client agreed to enter into the Transfer and Release Agreement as presented for signature and had the franchisor not insisted the transferor make sufficient payment at closing to become current, my client would have simultaneously purchased a very expensive franchise unit, and found himself immediately in default.

Catastrophe averted? Not quite. Since the provision states the transferee assumes the obligations of the transferor as if the transferee had signed the transferor's franchise agreement, enter the dreaded "cross default" clause. Being a staunch proponent of removing cross defaults wherever I encounter them, this one, in particular incensed me. In effect, my client could have bought much more than a franchise with a built in default. He could have bought past and future defaults.

Since the transferee was now both theoretically and legally obligated under two franchise agreements, the first of which had a cross default provision--and the transferor was in default on two of its units--the cross default provision would immediately apply to the transferee, placing him in default at the time of execution. Had that default been cured by requiring the transferor to become current in the transferred unit the transferor then buys the franchise complete with a default from the transferor's second unit. If the franchisor--as some do--required that all agreements be in good standing to approve the transfer, the transferee would then be home free. Right? Wrong. A clean bill of health today means nothing for the future.

Should the transferor go into default at any time in the future and be unable to cure for example, a serious monetary default, the transferee could conceivably be required to step up to the plate. After all, the transferee stepped into the shoes of the transferor at the closing. I viewed this provision as a tri-level cross default, one of the worst I have ever seen. Paranoia you say? Over lawyering? The franchisor did not think so. The franchisor knew he had the hook to look to the transferee for the transferor's transgressions. I made it a deal point, refusing to give the franchisor an inch, having considered the incredible ramifications to my client.

In the end, the franchisor agreed that my client would not be responsible for any defaults the transferor currently had, or could previously have been attributed to him for either the unit my client was purchasing, or any of the transferor's other units. The franchisor amended the document and the cross-default provision was deleted.

This was one of the most egregious clauses I have reviewed in twenty years of practicing franchise law. What intrigued me most was the myriad of ways my client could not only be responsible for the defaults for the unit he purchased prior to its purchase--whether the default was monetary or non-monetary--but that he could actually purchase and be legally obligated for defaults for which another franchisee's units--completely outside his control--were liable. Additionally, my client would remain liable for the transferor's future defaults. This raised the possibility that my client could default himself out of a franchise and not even know it. During the negotiations, I considered whether a court would really uphold this. I was not prepared to risk it.

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AFA Joins Fiscal Responsibility Coalition

AFA recently joined the Fiscal Responsibility Coalition (FRC), a newly-formed group composed of organizations joined together in support of the size and scope of the budget outlined by the President to win the war on terrorism, assure homeland security and strengthen the American economy.

The FRC will play a similar role to the Tax Relief Coalition (TRC) in working with the White House and administration officials as well as Congressional leadership in an effort to oppose increases in total federal spending larger than the increases put forward by the Administration.

If you have any questions about either the TRC or the FRC, please contact Samuel Crawford, Director of Public Policy for the AFA, at 312-431-0545 or SJCrawfordAFA@aol.com.

Welcome!

New Association Members

★

Council of Hygiene Franchisees (dba Swisher)

★

Independent Warehouse Grocers Assoc. of Northern California

★

Toasted Subs Franchisee Association (dba Quizno's)

Blimpie Intl. Directed to Pay $820,000 to Former Franchisees

By Michael Einbinder, Esq. and Julianne Cowan Lusthaus, Esq.

The year 2001 proved costly for Blimpie International, Inc. as arbitrators in four separate proceedings found Blimpie liable to former franchisees for various disclosure violations, and required Blimpie to pay those franchisees more than $820,000.00.

In the first arbitration, *Jamm Enterprises, Inc. adv. Blimpie International*, the arbitrator determined that Blimpie, a franchisor located in New York, was liable for failing to provide Jamm with a UFOC in accordance with the New York Franchise Sales Act prior to Jamm becoming a Blimpie franchisee. Jamm started operating the franchise on December 2, 1999; however, it did not execute a franchise agreement until February 10, 2000. Although Blimpie provided Jamm with a UFOC prior to the execution of the franchise agreement (on December 28, 1999), the arbitrator determined that Jamm was actually entitled to receive the UFOC prior to December 2, 1999 because as of that date, Jamm became a franchisee "in fact." This determination was made notwithstanding Blimpie's argument that Jamm had purchased the franchise from a former franchisee rather than from Blimpie. Jamm was awarded over $92,000.00, which included not only all of its losses in connection with the purchase and operation of the franchise, but also lost income for Jamm's officers and $30,000.00 in attorneys fees.

In *Sheskier, et.al. v. Blimpie International*, a three-member arbitration panel determined that Blimpie's sales representative made numerous misrepresentations of material fact prior to the franchisee's purchase of a Blimpie franchise. Blimpie argued that it was not liable for such misrepresentations because its company policy prohibited the sales representative from making misrepresentations. The arbitrators rejected Blimpie's argument and found that under New York law, Blimpie was in fact liable for the misrepresentations made by its subfranchisor representative. In this case, the franchisees were awarded over $300,000.00 in damages.

Similarly, in *Upchurch v. Blimpie International*, franchisees instituted an arbitration proceeding against Blimpie and alleged, among other things, that Blimpie had made improper earnings representations to them in connection with their acquisition of a Blimpie franchise. The arbitrator found in favor of the claimant franchisees and directed Blimpie to pay them over $230,000.00. The misrepresentations made by the Blimpie subfranchisor prior to the Upchurchs' purchase of the Blimpie franchise included claims that the average annual sales of Blimpie stores open over three years was $300,000.00.

In *Peacox Ventures, Inc. v. Blimpie International*, Peacox (a 3-store franchisee) received an award of $200,000.00, plus costs from Blimpie based on common law fraud committed during the sale and disclosure process. All of Peacox's pre-sale contacts were with Blimpie's subfranchisor for the territory. Blimpie was held liable for the actions of its subfranchisor, and was found by the arbitrator to have made intentionally false statements to Peacox. The statements related to actual revenues of existing Blimpie outlets, and were made in order to induce Peacox to buy its first franchise. The arbitrator found that the UFOC given to Peacox did not contain language expressly limiting the subfranchisor's authority to speak for Blimpie. As to Peacox's purchases of later franchises, the arbitrator found that Blimpie's new form of franchise agreement, which expressly limited the authority of the subfranchisor, put Peacox on notice that the subfranchisor's statements would not be chargeable to Blimpie.

Taken together, these cases clearly highlight the disclosure obligations of franchisors. Each of the cases also emphasize the responsibility of franchisors for the conduct of their subfranchisors, except where there is an express limitation of authority as was in the case of Peacox.

The authors, Michael Einbinder, Esq. and his associate, Julianne Cowan Lusthaus, Esq., practice law at the New York City based law firm of Rosen, Einbinder and Dunn, PC. Contact Michael at 212-888-7717 or me@redlawfirm.com.

AFA Affiliate Member Michael Einbinder represented the franchisees in the first arbitration, Jamm Enterprises, Inc. adv. Blimpie International.

AFA Affiliate Member Robert Zarco, Esq., of the Miami, Florida law firm of Zarco & Pardo, PA, represented the franchisees in the second arbitration, Sheskier et al v. Blimpie International.

AFA Affiliate Member Peter Lagarias, Esq., of the San Rafael, California based The Legal Solutions Group represented the franchisees in the third arbitration, Upchurch v. Blimpie International.

AFA Affiliate Member Patrick Carter, Esq., of the Sebastapol, California law firm of Carter & Singler, LLP, represented the franchisees in the fourth arbitration, Peacox Ventures Inc. v. Bimpie International.