Holmes Lofstrom
Franchise & Business Counsel

Lori M. Lofstrom
Margaret E. Narodick
Sandra G. Gibbs
David E. Holmes (RETIRED)

FRANCHISE ADVISORY

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To:	Clients of Holmes Lofstrom, PC
Subject:	Trending Topics for 2019

Franchise renewal season is a good time for franchisors to evaluate their documents and consider some tweaks and improvements in order to take advantage of new opportunities while avoiding new pitfalls. In this Franchise Advisory, we discuss some trending topics in franchising that may counsel adjustment to certain provisions in your franchise documents.

New FASB Standards

Over the past two years, we have alerted you to an upcoming change to the Accounting Standards guidelines adopted by the Financial Accounting Standards Board (FASB). This change, which requires that franchisors amortize initial franchise fees over the term of the franchise rather than recognize them as income in the first year, can have a substantial negative effect on a franchisor's financials. The results of having to recognize franchise fee revenues over long durations can include state regulator-imposed impounds, escrows, bonds or fee deferrals due to revenue levels which no longer meet registration or exemption requirements. The new FASB rule is now in effect for all non-public companies for reporting periods beginning after December 15, 2018.

One way to minimize the negative impact of this new standard is to restructure initial franchise fees, "unbundling" distinct component fees, such as training fees or site evaluation fees, so as to reduce the amount of pure "franchise fees" – meaning fees solely for the right to use the franchisor's marks and system – that will be subject to this rule. In 2019 FDDs, franchisors may either restate all three previous years' financials using this rule (the full retrospective method) or apply the new rule only to the 2019 financials while presenting the original 2018 and 2017 financials (the modified retrospective method).

If you have not already reviewed your fee structure in light of this FASB rule, you should consult your accountants to discuss the revised rule and its implications for your financial statements. We can then help you ensure that your 2019 FDD and related documents properly reflect any structural adjustments you decide to adopt.

No Poaching Provisions

In 2018, we saw a high-profile attack on provisions of franchise agreements that restrict franchisees from hiring one another's employees. A common feature of many franchise systems, these so-called "no poaching" provisions – which are primarily intended to promote employee training and minimize

intra-system disputes – have been characterized as efforts to limit employees' wage growth and even as anticompetitive agreements that may be deemed to violate antitrust laws.

Criticism of "no poaching" provisions started with a New York Times article in September 2017, and has been picked up by state attorneys general in a dozen states, including Washington, Massachusetts and New York. A number of franchisors, including McDonald's, Carl's Jr. and Arby's, have agreed to drop this type of provision from their franchise agreements and/or not to enforce the provisions in existing agreements. Federal legislation that would ban this type of restriction has been proposed and, while unlikely to be enacted, has intensified the scrutiny of these provisions.

This enforcement effort is continuing, and claims based on "no poaching" provisions have already found their way into at least two antitrust class action lawsuits against franchisors. Franchisors who currently have "no poaching" provisions in their franchise agreements or recently eliminated such provisions may be at risk, even if there have been no active efforts to enforce them. If your franchise agreement contains any restrictions on franchisees hiring one another's employees, we should discuss with you alternatives to help address the potential risks of maintaining such provisions in the current environment.

Joint Employer Saga

Since 2012, service employee unions have driven a multi-pronged campaign to have franchisors reclassified as so-called "joint employers" of their franchisees' employees. By abandoning the "actual, direct and immediate control" standard that has traditionally defined the employer-employee relationship, in favor of a much looser standard based on notions of "indirect" and "reserved" control, these interests hope to streamline unionizing activities across the franchising industry.

The past several years have seen a great deal of administrative, legislative and judicial activity on this front, yet no resolution appears imminent. The U.S. Department of Labor's proceeding against McDonald's for unfair labor practices, based on a joint employer theory, continues. The National Labor Relations Board's 2015 *Browning-Ferris* decision, in which the NLRB announced a new and substantially broader definition of the term "employer," was recently upheld, in part, by the U.S. Court of Appeals for the D.C. Circuit and remanded for further proceedings. At least nineteen states have enacted laws codifying the "actual, direct and immediate control" standards of an employment relationship. Similar federal legislation has been introduced in Congress but has not passed. The NLRB initiated a rulemaking proceeding in September 2018 proposing to revert to the traditional definition of "employer."

The only certainty, at this point, is that this issue will continue to attract attention and resources in the franchise community. In the meantime, franchisors are well advised to look carefully at their franchise agreements, manuals, and interactions with their franchisees to ensure that they are minimizing, to the extent possible, the risk of being deemed a joint employer of their franchisees' employees. We can work with you to help identify and address these issues.

Best regards and Happy New Year!