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System-wide Change in the Time of Covid

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I. Introduction

The Covid 19 pandemic that has gripped the nation since March 2020 delivered the franchise industry its first true existential moment. By the IFA's own estimates, the first six months of the Covid-19 pandemic caused the closure of an estimated 32,700 franchised businesses, with 21,834 businesses closed temporarily and 10,875 businesses closed permanently.[1] Additionally, franchising lost an estimated 1.4 million jobs, of which 40.2% were permanent.[2] As noted by the IFA's Six-Month COVID-19 Impact Analysis on Franchising Market complied by FranData, the following chart demonstrates the damage inflicted on franchising:

	Total Franchised Business Establishments	Total Unit Losses	Unit Closure Rates	Temporary Unit Losses	% of Losses that Are Temporary	Permanent Unit Losses	% of Losses that Are Permanent
Commercial & Residential Services	239,491	(3,335)	-1.4%	(1,819)	54.5%	(1,516)	45.5%
Retail Food, Production & Services	156,016	(5,944)	-3.8%	(3,075)	51.7%	(2,870)	48.3%
Hospitality	29,781	(2,069)	-6.9%	(1,478)	71.4%	(591)	28.6%
Restaurant	230,515	(14,146)	-6.1%	(10,051)	71.1%	(4,095)	28.9%
Personal Services	119,753	(7,215)	-6.0%	(5,411)	75.0%	(1,804)	25.0%

By FranData's estimates, the hospitality industry's franchise employment declined by approximately 215,000 jobs and $21.5 billion in losses on output.[3]

Under these circumstances, franchise systems were forced to quickly evolve their systems to address the far-reaching threats posed by the pandemic. These changes required franchisors to pivot their systems, whether it be through new products, alternative channels of distribution, or effective use of new technologies. As we hopefully enter the final throws of the pandemic, this paper will touch upon certain strategies utilized by franchisors to meet the challenges posed by the pandemic, as well as those provision of the franchise agreement that franchisors should include in a franchise agreement to allow the franchisor the ability to meet the next crises.

II. Responding to the Pandemic

Few franchisors will admit that their franchise systems were ready to address the far-reaching effects of the national declaration of emergency issued on March 13, 2020 and subsequent state stay at home orders that followed.

In the following weeks, franchisors scrambled to learn their way through a new reality. As most franchise agreements contemplate the payment of royalties and advertising fees on

[1] IFA's Six-Month COVID-19 Impact Analysis on Franchising Market complied by FranData.
[2] Id.
[3] Id.

gross sales, royalty streams and advertising contributions disappeared overnight. For those systems with a minimum royalty, franchisors were inundated with franchisee requests for royalty abatements.

Franchisors were also force to familiarize themselves with boilerplate force majeure clauses to determine whether the pandemic excused the franchisee's performance, but also as their own performance under the franchise agreement. Training and other pre-opening requirements of the franchisor could no longer be carried out as contemplated by the terms of the franchise agreement on account of travel restrictions. Opening deadlines could no longer be met.

For those businesses that were able to remain open, the potential for health and safety claims from employees and patrons alike remained a viable threat. Since March 12, 2020, there have been 2,193 lawsuits (including 179 class actions) filed against employers due to alleged labor and employment violations related to the coronavirus. States with the most filings include: California (550); New Jersey (261); Florida (174); New York (168); and Ohio (124).[4]

III. Franchise Sales and the FDD

The pandemic also forced franchisors to confront their franchise sales processes, which for most came to a crashing halt. Of primary concern were the relevancy of disclosures in franchise disclosure documents, including financial performance representations ("FPRs") contained in Item 19, reflecting 2019 data. Such concerns prompted the Franchise and Business Opportunities Project Group of the North American Securities Administrators Association to issue guidance concerning historical financial representations during COVID-19.[5] NASAA noted:

> "Under some circumstances, an FPR that discloses historically accurate data may contain an omission of a material fact, or an untrue statement of material fact, if material changes have occurred to that FPR by the time it is provided to a prospective franchisee." [6]

NASAA noted that franchisors could not ignore the effects of the pandemic on franchise systems and formulated the following factors in determining whether a franchisor could continue to use a historical FPR in 2020 (and beyond) reflecting 2019 data:

- Whether the franchise business has been significantly impacted by the COVID- 19 pandemic;
- The type of data the franchisor includes in the FPR;

[4] https://www.littler.com/publication-press/publication/covid-19-labor-employment-litigation-tracker
[5]NASAA Disclosing Financial Performance Representations in the Time of COVID-19 issued by NASAA, June 10, 2020
[6] Id.

- The reasonable inferences a prospective franchisee can draw from the FPR;
- When the franchisor estimates a prospective franchisee can expect to open for business after entering into a franchise agreement;
- Whether and how the franchisor adapts the franchise business to account for current market conditions resulting from the COVID-19 pandemic; and
- Whether and how the franchisor adapts the franchise business to account for future market conditions resulting from the COVID-19 pandemic.[7]

NASAA further included a prohibition on franchisors using historical FPRs that fail to account for material changes to the business model implemented on account of the COVID-19 pandemic. NASAA specifically referenced food service establishments and fitness franchises as industries forced to change the methods in which they deliver their services and goods to the general public, whether by expanded take-out and delivery services or limiting the number of members allowed in a facility at one time. The guidance noted:

> Some of these adaptations may be temporary, but some franchisors may alter their business models permanently to adapt to new consumer demands and attitudes in a post-COVID world. Once management of a franchisor concludes that it will make changes to its franchise system or business model that will materially impact a Historical FPR, the franchisor no longer may include a Historical FPR that is not updated to reflect those changes and their impact on the FPR.[8]

NASAA concluded it guidance with the following directive:

> If franchisors do make a Historical FPR in 2020 (and beyond) based on pre-COVID-19 data, they cannot avoid the obligation to update that disclosure to reflect a material change by stating that the Historical FPR is not representative of what prospective franchisees can expect as a consequence of COVID-19, that the franchisor cannot predict how the franchise system will be affected by COVID-19, or otherwise suggest that prospective franchisees should not rely on the disclosure.[9]

As a practical matter, Franchisors filing in registration states that chose not to amend a 2020 Item 19 on account of the pandemic should expect to receive a comment from a state examiner seeking an explanation for why an amendment was not prepared. It should that not all franchisors were negatively impacted in a significant way by the COVID-19 pandemic. This is especially true of businesses deemed essential by state and local government or those industries, such as home maintenance and repair, which

[7] Id.
[8] Id.
[9] Id.

experienced an increase in revenues with no material modification to the operations of the franchise system. As such, a franchisor or its counsel should be prepared to demonstrate such fact in responding to an examiner. Additionally, franchisors should be cognizant of the potential liability resulting from sales made in 2020 in which a prospect was not disclosed with updated Item 19 information per NASAA's guidance.

III. Implementing Systemwide Changes

In responding to pandemic related shutdowns, franchise systems were forced to take a critical look at their current processes and procedures and adapt them to confront the challenges presented. Implementing systemwide changes, whether they be providing curb side delivery or online ordering platforms or conforming physical spaces to ensure social distancing requirements, became the determining factor as to whether a franchise system would survive to see the end of the pandemic.

More than ever, franchisors learned the value of a well drafted franchise agreement in establishing the franchisor's ability to quickly modify system standards. At a minimum, every franchise agreement should include a specific requirement for the franchisee to comply with system standards at their own expense. For example:

> Compliance with Standards. You acknowledge and agree that your obligations set forth in this Agreement and the Operations Manual are reasonable and necessary for the operation of the Franchised Business and to maintain uniformity throughout the System. You must adhere to the standards and specifications set forth in this Agreement and the Operations Manual and any revisions or amendments to same (including, without limitation, standards and specifications for the offer, sale, shipping, and delivery of Products and any other goods or services authorized for sale through your Franchised Business, as well as standards for inventory, merchandise and displays, equipment, fixtures, and signage). You must use signs, furnishings, ingredients, food and beverage items, supplies, fixtures, equipment, vehicles and vehicle wraps, and inventory that comply with our then-current standards and specifications, which we establish from time to time. We have the right to change our standards and specifications in our discretion. You acknowledge that you may incur increased costs to comply with such changes at your expense.

Such provisions have been consistently upheld by courts.

In Bores v. Domino's Pizza, LLC, 530 F.3d 671 (8th Cir. 2008), the franchisee filed suit against Domino's asserting claims for breach of contract, fraud, negligent misrepresentation, breach of the implied covenant of good faith and fair dealing, promissory estoppels, and violation of the Minnesota Franchise Act, regarding Domino's requirement of purchasing and installing a custom-designed integrated computer system. Despite some ambiguous language, the Court held that Domino's was authorized by the express terms of the franchise agreement to require franchisees to purchase and install the customized computer system. At issue was the section in the franchise agreement that provided in relevant part "we will provide you with specifications for… computer

hardware and software… You may purchase these items meeting our specifications from any source." The franchisee contended that the agreement only allowed Domino's to mandate a comparable computer system, not a specific computer system, and that it could buy the hardware and software from any source and the District Court agreed. The 8th Circuit, however, found this reading of the provision to be too narrow and that the language "from any source" is limited to available sources and that the definition of any" includes "one, some, every or all." Id. at 676.

In a similar vein, the Court in La Quinta Corp. v. Heartland Properties, LLC, 603 F.3d 327 (6th Cir. 2010) found that the franchisor's implementation of a new computerized reservation system with its attendant costs was entirely permitted under the unambiguous terms of the franchise agreement, as the franchise agreement expressly gave the franchisor the right to add, amend, and/or delete system standards, including the reservation system, and required the franchisee to participate in and bear the costs of doing so.

Moreover, Courts have also upheld franchisors' right to compel large scale changes including entire re-designs to the model, through a reservation of rights clause. In TLH International v. Au Bon Pain Franchising Corp., 1986 WL 13405 (W.D.Mass. November 13, 1986), an area developer asserted misrepresentation claims against the franchisor on account of the franchisor's description of the franchise as a "small bakery/café atmosphere specifically designed to avoid the larger restaurant concept of Vie de France". The Court sided with the franchisor as to its right to make subsequent systemwide modifications to a larger sit-down style restaurant, noting that the development agreement provided that the system "may be changed, and improved, and further developed by Franchisor from time to time", and concluded that the change to the model was not inconsistent with this clause. Id. at *5.

Likewise, in Economou v. Physicians Weight Loss Centers of America, 756 F.Supp. 1024 (N.D.Oh. 1991) the franchisee argued that the franchisor's change to its diet program caused its business to fail. The Court found that the franchise agreement, which stated that "Franchisor reserves the right to modify or change the System", specifically allowed the franchisor to make such changes.

Similarly, in Johnson v. Arby's, Inc., BFG ¶12,018 (E.D.Tenn., March 15, 2000), a developer objected to the franchisor's requirement that all new buildings conform to the franchisor's new design. The developer asserted claims against the franchisor asserting breach of contract and breach of the implied covenant of good faith and fair dealing. The Court however granted Arby's summary judgment, finding that the development agreement expressly authorized Arby's to vary its building design based on the following language in the agreement:

> Arby's reserves the right in its sole discretion to vary its specifications, standards and operating practices and requirements among Licensees, including, without limitation, those relating to building, equipment, signage, operations and

> Licensed Products. … Licensee understands and acknowledges that such variations may lead to different costs or obligations among Licensees.

The Court also pointed to the developer's obligation to comply with the operations manual, as revised from time to time, as demonstrating that Arby's had the authority under the agreement to require the new building design and that "performance of a contract according to its terms cannot be characterized as bad faith."

IV. **Preparing for the Next Crisis**

It remains to be seen whether the covid 19 pandemic was a once in a lifetime event or the first of many global interruptions. For this reason, franchisors should heed the lessons learned over the past 14 months and implement best practices across the board. Franchisors should ensure that the franchise agreement contains provisions discussed in Section III above allowing the franchisor to modify system standards, whether on a temporary or permanent basis.

Additionally, Franchisors should take steps to ensure that the force majeure clause contained in the franchise agreement includes necessary language to protect the franchisor. What was considered unimportant boilerplate rose to the forefront in 2020.

A *force majeure* clause is defined as "a contractual provision allocating the risk of loss if performance becomes impossible or impracticable, especially as a result of an event or effect that the parties could not have anticipated or controlled."[10] These clauses address both natural or man-made events which, upon their occurrence, prevent a party from fulfilling its contractual obligations.[11] Generally, terms of a force majeure clause are subject to the normal rules courts apply when construing contracts, with courts considering: (1) whether the event qualifies as force majeure under the contract, (2) whether the risk of nonperformance was foreseeable and able to be mitigated and (3) whether performance is truly impossible.[12]

Force majeure clauses are typically narrowly construed, and "will generally only excuse a party's nonperformance if the event that caused the party's nonperformance is specifically identified."[13] Therefore, a party seeking to excuse performance based upon an unseen event must ensure that the event is listed, or otherwise falls under a catch-all provision. By way example, in Akorn, Inc. v. Fresenius Kabi AG, which was decided in

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[10] Black's Law Dictionary*, 718 (9th ed. 2009)*

[11] "Like commercial impracticability, a *force majeure* clause in a contract excuses nonperformance when circumstances beyond the control of the parties prevent performance." Harriscom Svenska, AB v. Harris Corp., 3 F.3d 576, 580 (2d Cir. 1993).

[12] See Reade v. Stoneybrook Realty, LLC*,* 63 AD3d 433, 434.

[13] In re Cablevision Consumer Litigation, 864 F.Supp.2d 258, 264 (E.D.N.Y., 2012); ARHC NVWELFL01, LLC v. Chatsworth at Wellington Green, LLC, No. 18-80712, 2019 WL 4694146, at *3 (S.D. Fla. Feb. 5, 2019)

2018, the force majeure clause listed "pandemic" as one of the defined force majeure events that excused performance (2018 WL 4719347, at *51 (Del. Ch. Oct. 1, 2018), aff'd, 198 A.3d 724 (Del. 2018)).[14]

Cases involving force majeure clauses during Covid are work their way through the courts, with varying outcomes. In Palm Springs Mile Assocs., Ltd. v. Kirkland's Stores, Inc., the tenant defendant filed a motion to dismiss based on the force majeure clause in a commercial lease, arguing that county regulations governing the shutdown of non-essential activities and business operations suspend its obligation to pay rent.[15] The district court, however, found that the party failed to properly link its nonpayment of rent to the government regulations. The party had erroneously argued that the force majeure clause did not require any showing that the county's regulations were linked to the nonpayment. The court held opposite and said the party must show how the restrictions on non-essential activities and business operations directly affected their ability to pay rent.[16]

In Future St. Ltd. v. Big Belly Solar, LLC, the District Court of Massachusetts considered a claim for declaratory judgment in which the plaintiff argued that its obligation to make minimum purchase requirements under a purchase agreement was excused on account of the COVID-19 pandemic.[17] Plaintiff relied upon the force majeure clause which stated in part:

> [n]either party shall be deemed in default pursuant to this Agreement so long as its failure to perform any of its obligations hereunder is occasioned solely by fire, labor disturbance, acts of civil or military authorities, acts of God, or any similar cause beyond such party's control.

In denying the plaintiff's claim for declaratory judgment, the court, assuming arguendo that the pandemic and effects constitute a force majeure under the agreement, held that plaintiff failed to demonstrate that its failure to perform its obligations under the agreement was caused by the pandemic. The court noted that certain of plaintiff's obligation to pay defendant preceded the pandemic and plaintiff continued to pay certain expenses during the winter 2020 even as plaintiff had previously accepted prior shipments of defendant's products without required payment. [18]

V. **The Present and Beyond**.

Despite the damage incurred, the franchise model appears to be on stable ground and already on the way to recovery. The passage of the $1.9 trillion American Rescue Plan

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[14] See also AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, et al., 2020 WL 7024929 (Del. Ch. Nov. 30, 2020).

[15] No. 20-21724-CIV, 2020 WL 5411353, at *2 (S.D. Fla. Sept. 9, 2020).

[16] Id.

[17] No. 20-CV-11020-DJC, 2020 WL 4431764, at *6 (D. Mass. July 31, 2020).

[18] Id.

Act will accelerate the franchise industry's comeback. The Act provides for the creation of the Restaurant Revitalization Fund, a $28.6 billion grant program tailor for the hard-hit restaurant and bar industry. The Restaurant Revitalization Fund (the "RRF") provides grants equal to the difference between the applicant's 2020 and 2019 revenue, with an additional deduction for any amounts received under the PPP loan program. The RRF is available to restaurants, food stands, food trucks, food carts, bars, and brewpubs on the condition that the applicant is a non-public entity and owns or operates 20 or fewer locations, regardless of the mark used, as of March 13, 2020.[19] Grants received under the RRF are exempt from federal income tax, and expenses paid with the funds are deductible and can be used towards:

- Payroll costs.
- Payments of principal or interest on any mortgage obligation (which shall not include any prepayment of principal on a mortgage obligation).
- Rent payments, including rent under a lease agreement (which shall not include any prepayment of rent).
- Utilities.
- Maintenance expenses, including—
    - construction to accommodate outdoor seating; and
    - walls, floors, deck surfaces, furniture, fixtures, and equipment.
- Supplies, including protective equipment and cleaning materials.
- Food and beverage expenses that are within the scope of the normal business practice of the eligible entity before the covered period.
- Covered supplier costs, as defined in section 7A(a) of the Small Business Act
- Operational expenses.
- Paid sick leave.
- Any other expenses that the Administrator determines to be essential to maintaining the eligible entity.

It should be noted that eligible entities that receive a grant under the RRF but fail to use all grant funds or permanently ceases operations on or before the last day of the covered period is required to return the unused funds to the Treasury.

[19] See Section 5003 of the American Rescue Plan Act of 2021.