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In This Issue:

December 2010

A new court decision explains how purchasers of franchises can insulate themselves from employment claims arising from the predecessor's operations.

Blindsided? Franchise Successor Liability in the Hospitality Industry

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Many companies active in the hospitality business operate as franchisees. Patrons and employees may not recognize or care about the distinction between the franchisor and the franchisee, or between one franchisee and a successor. However, to the owners of the individual business, that distinction can be critical, particularly on issues of liability to customers or workers. A recent decision from the Western District of Tennessee highlights these issues and discusses how purchasers of a franchise can help insulate themselves from employee lawsuits arising from their predecessor's operations.

The decision, *Equal Employment Opportunity Commission v. 786 South L.L.C. and Tripoli II, Inc.*, No. 07-02621 (Nov. 8, 2010), involved an IHOP franchise that was purchased in late 2007, by Tripoli II Inc. from another franchisee known as 786 South L.L.C. Unbeknownst to Tripoli, the EEOC had filed a lawsuit raising claims of race and sex discrimination against 786 South, alleging that the general manager had repeatedly requested sex, inappropriately touched an employee and used ethnic slurs directed toward minority employees. When Tripoli completed its purchase, the EEOC added it as a defendant to the case under the successor liability theory.

Successor Liability for Franchise Purchaser

The Sixth Circuit Court of Appeals (which includes Tennessee) applies a three-pronged balancing test, also adopted by the Second, Eighth and Ninth Circuit Courts of Appeal, when deciding when to impose liability on a successor. This balancing test involves weighing: (1) the interests of the defendant-employer; (2) the interests of the plaintiff-employee; and (3) the goals of federal policy. The court has identified nine factors that should be considered when applying the balancing test, while recognizing that all nine factors will not always collectively be applicable to every case. Only a few of the nine factors were under consideration in this case.

Notice and Due Diligence

Two of the factors that were under consideration were notice and due diligence. Tripoli argued that it did not have actual notice of the suit and, further, that it had no duty to inquire about pending lawsuits. It based this contention on a provision in the franchise contract between Tripoli and IHOP which required disclosure of any threatened suits or proceeding suits prior to closing of the sale of the franchise. IHOP was not a defendant in the EEOC case and, therefore, was not in a position to notify Tripoli of the pending lawsuit. Nonetheless, Tripoli argued that IHOP's corporate office was obligated to inform Tripoli of potential or pending lawsuits prior to closing, and that since it did not do so, Tripoli had no duty to inquire.

The EEOC argued that a due diligence clause in the contract gave Tripoli the right to investigate the operations of 786 South and that Tripoli should have searched the court's electronic filing system for pending lawsuits against the company as part of its due diligence.

The Sixth Circuit Court of Appeals concluded that 786 South could not show that it gave Tripoli actual notice. Further, the EEOC was unable to produce any evidence that Tripoli had actual notice of the suit. As for the due diligence argument, the court stated that the seller of the franchise is in the best position to prevent any "dilemmas" and, therefore, has an affirmative duty to disclose pending actions, claims or administrative charges.

Continuity of Business Operations

Applying the balancing test to the facts in this case, the court focused on four factors in assessing Tripoli's possible liability, namely: (1) whether the successor uses the same or substantially the same workforce; (2) whether the successor uses the same or substantially the same supervisory personnel; (3) whether the same jobs exist under substantially the same conditions; and (4) the predecessor's ability to provide relief.

One might expect that these factors would typically tend to weigh in favor of finding successor liability since to the general public, and to most employees, the restaurant operated identically both before and after the sale. Although the evidence showed substantial continuity in non-management personnel, Tripoli was able to demonstrate that it took specific steps to replace those supervisors who were involved in the harassment, and that working conditions greatly improved after its purchase of the franchise. These factors helped break the chain of continuity.

As to the fourth factor, the EEOC failed to provide evidence regarding the predecessor 786 South's assets or ability to provide relief to the alleged victims, and the court found that this lack of evidence weighed against successor liability. There was brief testimony as to the limited assets of 786 South and its inability to provide relief. The court confirmed a Seventh Circuit Court of Appeals decision, which stated that while an injured employee should not be made worse off by a change in business, he should not be made better off either. Consequently, if the aggrieved IHOP employees would not have recovered from 786 South, they should not reap a windfall because the successor company might have greater financial resources and an enhanced ability to pay a damages award.

Balancing the Equities

Applying the above factors to the three-prong test, the court determined that Tripoli should not be held liable as a successor. In support of this finding, the court relied on the fact that Tripoli did not benefit from the alleged discriminatory employment practices of 786 South, that Tripoli lacked notice of the suit, and that Tripoli took affirmative steps to change the business practices of the restaurant, which had the effect of correcting any mistreatment of employees that had allegedly occurred under 786 South. Finally, there was no evidence that the sale of the franchise was an effort to thwart corporate responsibility.

How Can Franchisees Avoid Liability?

The decision identified two kinds of steps acquiring franchisees should take to avoid being embroiled in lawsuits filed against predecessors, particularly if the new franchise owner is going to continue the same business with similar personnel after the sale.

First, although the court placed a significant burden on the seller to notify the buyer of any potential and/or pending lawsuits, and to identify and disclose any information that may create a "dilemma" in the future for the buyer, a purchaser cannot count on this implicit duty.

Purchasers of franchises must make specific inquiries on this subject and should insist on an explicit representation in the purchase agreement as to the existence of any EEOC or state administrative charges, lawsuits, or asserted claims that might form the basis for such a claim. The parties can then determine whether to arrange for indemnification, setting aside some of the purchase price as a reserve against loss, or whatever other arrangement they can devise. Such a representation also protects the purchaser by giving it the basis for a breach of contract claim if an undisclosed claim ripens into a legal action.

Second, the new employer should, to the extent possible, set up its systems and paperwork as if it is starting a business from scratch, effectively treating the employees of the franchise as new hires. In this case, the new owners issued orientation packets, with employee acknowledgment required, which specifically outlined the new franchise owner's anti-discrimination and anti-harassment policies as well as the reporting method for complaints. Other steps might include providing anti-discrimination and harassment training for all employees, just as if a new business were being opened. By making a clean break from the prior company's documentation, and by eliminating the personnel allegedly responsible for the claimed harassing conduct, the new franchisee was able to establish that there was not sufficient continuity between the two franchisees so as to support a successor liability claim.

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