LESSONS ABOUT FRANCHISE RISK FROM YUM BRANDS AND SCHLOTZSKY'S

by
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This Article presents YUM! Brands, Inc. disclosure information and valuable insight into the risks of starting a business that shares intellectual property with another party. YUM is the parent of entities such as KFC, Pizza Hut, and Taco Bell, with locations around the world. YUM is particularly useful for our analysis because of its mature operating concepts.

Sandwich shop franchisor and operator Schlotzsky's, Inc. presents a different aspect of shareholder and franchisee risk. The facts leading up to Schlotzsky's bankruptcy filing represent what can go wrong with undercapitalized franchise operations and illustrate that franchising is inherently risky for anyone.

This Article seeks to answer questions facing all seeking to use a franchise concept: "What are the major risks perceived by those engaged in the universe of franchise businesses? What potential risks, if they become reality, may cause substantial increases in operating costs or threaten the very survival of the enterprise?"

This Article provides a roadmap for understanding franchise risk and an opportunity to understand and reflect upon the multi-million-dollar research, investment, and documentation of perceived system risks. Relevant annual report disclosures from YUM, along with other YUM documents, are discussed. Descriptive language from YUM's regulatory filings with the Securities and Exchange Commission is utilized to show what the management personnel of this franchise powerhouse perceive to be its major categories of risk exposure.

The primary point of this Article is to repackage the risk disclosure language from these enterprises so that franchise entrepreneurs, their lawyers, and other readers may benefit. Our goal is to have a meaningful and scholarly impact on readers who are now, or will be, creating jobs through their efforts in growing businesses. They will proceed into the chaos of the capitalistic marketplace with valuable lessons in franchise risks.

This Article has five Sections. First, we provide a background and overview of franchising. Second, we give a primer on franchise law. Third, we examine YUM, and focus on its risk disclosure language. Fourth, we describe the history and circumstances leading up to the 2004 bankruptcy of Schlotzsky's. Lastly, we conclude with our

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thoughts on the lesson gained from disclosure documents and our bankruptcy investigation.

I. OVERVIEW

Franchising is an important form of entrepreneurial activity. For many individuals, it is the first step into an exciting world of business and entrepreneurship. Not many franchisees are well versed in business law or operating a business.[1] Thus, it is important that the legal community strives to educate the general public about what to expect. Additionally, if a franchisee obtains passive investors, that franchisee owes a duty of care and loyalty to those passive investors, otherwise known as members, limited partners, or shareholders.[2]

This Article presents disclosure information available from YUM! Brands, Inc. (hereinafter "YUM" or the "Company"). This large franchisor describes perceived risks to its shareholders, but in that effort presents valuable insight into the risks of starting a business that shares intellectual property with another party. YUM is the parent of various operating entities such as KFC (formerly known as Kentucky Fried Chicken), Pizza Hut, and Taco Bell.[3] These are some of the current franchising network giants.[4] They have ubiquitous locations nationally, and often even internationally. In other words, whatever YUM is doing, it is probably doing well. Its example may be a better way to learn: studying a successful franchised business in the same or similar field.

YUM is particularly useful for the purposes of this discussion because it is an example of mature operating concepts[5] and because 62% of its 48,124 total units are international.[6] By providing a discussion of YUM's domestic and international efforts, this Article can examine the possible risks to shareholders regarding overseas expansion.

Sandwich shop franchisor and operator Schlotzsky's, Inc. is a privately held franchise chain of restaurants specializing in sandwiches, and presents an entirely

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1 Robert W. Emerson & Uri Benoliel, *Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws*, 76 ALB. L. REV. 193, 195–96 (2013).

2 In the event that the franchisee organizes as an LLC (which is more likely to occur), the passive investors would be known as members rather than shareholders (for a corporation) or partners (for a general or limited liability partnership). A limited partnership is also available, but the least likely of the formerly mentioned business entities.

3 YUM! Brands, Inc., Annual Report (Form 10-K) 3 (Feb. 22, 2018) [hereinafter YUM 2018 Annual Report].

4 *Cf.* Heidi Chung, *Yum Brands Earnings Disappoint, but KFC, Taco Bell and Pizza Hut Sales Beat*, YAHOO! FIN. (Feb. 7, 2019), https://finance.yahoo.com/news/kfc-parent-yum-brands-reports-strong-global-sales-121322208.html (noting that YUM's franchises have succeeded, despite its own lackluster performance).

5 There are advantages and disadvantages to joining a mature franchise system. Some benefits are brand recognition, an existing customer base, and a helping hand to get started. Michael Seid, *Pros and Cons of Joining a Mature Franchise System*, BALANCE SMALL BUS., (June 25, 2019), https://www.thebalancesmb.com/joining-a-mature-franchise-system-1350239. Some disadvantages are a loss of independence, overdependence on the franchise system, unrealistic income expectations by franchisees, other franchisees underperforming, and over restrictive franchise agreements. *Id.* An example of a mature franchise system is Dunkin' Donuts. Robert W. Emerson, *Franchise Encroachment*, 47 AM. BUS. L.J. 191, 281 n.431 (2010).

6 *See* YUM! Brands, Inc., Annual Report (Form 10-K) 3 (Feb. 21, 2019) [hereinafter YUM 2019 Annual Report].

different aspect of shareholder and franchisee risk. Schlotzsky's entered bankruptcy proceedings during 2004.[7] We hasten to add that our 2003–2004 example bears no relationship to the current entity operating restaurants of a similar name. In other words, the franchise world is not all sunshine and rainbows, despite the beautiful portrait that franchisors may paint for prospective franchisees. Franchising is inherently risky for anyone, regardless of the person's business experience or sophistication.[8] An understanding of the fact pattern leading up to Schlotzsky's bankruptcy filing represents a useful example of what can go wrong with undercapitalized franchise operations.[9] A company is undercapitalized if "reasonably prudent persons with a general business background would deem the company undercapitalized."[10] *In re Mobile Steel* set out two tests to help determine if a company is undercapitalized: (1) if a skilled financial analyst thinks that the capitalization is inadequate to support a business of the size and nature of the company at the time the company was capitalized, and (2) when advances were made, capitalization is inadequate if an informed outside source would not have lent a similar amount of money to the company.[11]

This Article seeks to answer questions facing all entrepreneurs seeking to use a franchise concept: "What are the major risks perceived by those engaged in the universe of franchise businesses? What potential risks, if they become reality, may cause substantial increases in operating costs or threaten the very survival of the enterprise?"[12] By understanding these potential risks, a franchisee can do its best to operate the business and fulfill that duty to its shareholders.[13]

This Article provides a roadmap for understanding franchise risk.[14] As business law scholars have noted, "To survive, all successful entrepreneurs of necessity have become skillful at optimizing efficiency at every opportunity."[15] For any

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7 *Schlotzsky's Files for Bankruptcy Protection*, NBC NEWS (Aug. 3, 2004, 1:55 PM), http://www.nbcnews.com/id/5592124/ns/business-us_business/t/schlotzskys-files-bankruptcy-protection/#.XFoyC89Kjys.

8 *See* Jason Daley, *What Is the Real Survival Rate of Franchised Businesses?*, ENTREPRENEUR (Sept. 13, 2013) (noting that the 90% success rate of franchisees is unfounded).

9 Jonathan Selden, *Schlotzsky's Creditors Want Wooley Brothers Claims Thrown Out*, AUSTIN BUS. J. (Dec. 30, 2005, 2:35 PM), https://www.bizjournals.com/austin/stories/2005/12/26/daily32.html (describing the effect of undercapitalization on the company's outstanding loans).

10 Markus C. Stadler, *Treatment of Shareholder Loans to Undercapitalized Corporations in Bankruptcy Proceedings*, 17 J.L. & COM. 1, 17 (1997).

11 *Id.* (citing *In re* Mobile Steel Co., 563 F.2d 692, 703 (5th Cir. 1997)).

12 *See* Lawrence J. Trautman, *E-Commerce, Cyber, and Electronic Payment System Risks: Lessons from PayPal*, 16 U.C. DAVIS BUS. L.J. 261, 263 (2016).

13 The duties are generally placed into one of two baskets: duty of loyalty and duty of care. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1262 (2008).

14 For the younger reader, consider them "SparkNotes" similar to the ones used to avoid reading those absurdly long books in middle through high school. This Paper by no means eliminates the value of speaking with someone experienced in the field or an attorney. It provides quick, easily digestible points that you can bring with you to the discussion or consider prior to selecting an attorney.

15 Lawrence J. Trautman et al., *Some Key Things U.S. Entrepreneurs Need to Know About the Law and Lawyers*, 46 TEX. J. BUS. L. 155, 157 (2016).

enterprise thinking about or conducting domestic or global franchise operations, the "cost of accounting and legal fees and management time devoted to the discovery, examination and documentation of the perceived enterprise risk" are considerable.[16]

This Article goes beyond the franchisor's compelled disclosures by offering additional insight into the risks that a franchisor would not cover.[17] At no out-of-pocket cost to the reader, this Article provides an opportunity to understand and reflect upon the multi-million-dollar research, investment, and documentation of perceived systems risk from one of the world's largest franchise enterprises.[18]

Words are powerful and have meaning. As a basis for discussion and analysis about franchise risk, relevant annual report disclosures from YUM! Brands, Inc., along with other YUM documents, is used as a potentially powerful teaching device. Descriptive language excerpted directly from YUM's regulatory filings with the Securities and Exchange Commission (SEC) is utilized to show what the management personnel of this franchise powerhouse perceive to be its major categories of risk exposure.[19] The SEC filings are primarily used by shareholders and potential investors in publicly-traded issuers.[20] These disclosures are different from those required of franchisors by state law in the offering of franchises.[21] Weaving these materials into a logical presentation and providing supplemental sources for those who desire a deeper look (usually in our footnotes) is the authors' challenge. Hopefully, even the most seasoned franchise executives and attorneys benefit by examining YUM's struggle to optimize its business performance while navigating through a complicated maze of regulatory compliance concerns and issues involving jurisdictions throughout the world. The authors also hope that the material is discussed sufficiently for an inexperienced franchisee specifically or reader generally to learn about the topic.

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16 *See* Trautman, *supra* note 12, at 263.

17 Generally, the authors provide the common law approaches to franchise law. Particular jurisdictions may have adopted different rules or stricter or looser standards than those discussed in this Article. Only a very foolish franchisee enters such an important, long-term business relationship without consulting experts (e.g., in business, accounting, and law) that have pertinent information and experience in franchising. It remains vital to speak with a franchise attorney before entering a franchise agreement. *See* Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether to Hire Counsel*, 51 SAN DIEGO L. REV. 709, 719–21 (2014) (with comments and a survey of franchise lawyers, noting how prospective franchisees' misconceptions often reinforce their predisposition to not hire a franchise attorney).

18 The major subject matter for this analysis was compiled by YUM, at great expense to YUM, for legal purposes, including to present to shareholders (and thereupon publicly available for no cost).

19 *Fast Answers: Annual Report*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answers-annrephtm.html (last visited Mar. 2, 2020). For some readers, this Article may appear to lack the customary structure, look, and feel of the typical law or business school academic journal article. In an earlier draft of one of the author's eBay article (Trautman, *supra* note 12, at 263), more than one commentator asked whether it is possible to just paraphrase some of the heavy quotations of relevant eBay and PayPal disclosure language. However, the language—not merely paraphrasing—often is the point.

20 *See How to Read a 10-K*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answersreada10khtm.html (last visited Mar. 6, 2020).

21 *See* YUM 2018 Annual Report, *supra* note 3, at 6–7.

YUM incurs considerable management and legal expense to examine, analyze, and describe its perceived risks of conducting business.[22] A close examination of the disclosures' language will prove of value to those readers interested in the rapidly changing dynamics of (1) entrepreneurship, (2) franchise operations, or (3) franchise law. The massive United States disclosure documents (often hundreds of pages long when financial statements are included) in the case of YUM's regulatory filings with the SEC on Form 10-K,[23] provide an excellent insight for anyone interested in the business and legal environment of franchise operations.

The primary point of this Article is to repackage the risk disclosure language from these enterprises (without our heavy paraphrasing) so that franchise entrepreneurs, their lawyers, and other interested readers may benefit from the considerable thought and expense devoted by those closest to the situation (under penalty of disclosure liability) to telling their story. Our goal is to have a meaningful and scholarly impact on readers who are either now, or soon will be, creating jobs through their efforts in growing businesses. They will proceed into the chaos of the capitalistic marketplace with valuable lessons in franchise risks in a highly readable manner at no out-of-pocket cost.

This Article proceeds in five Sections. First, we provide background and overview of franchising. Second, a primer on franchise law is provided. Third, we examine YUM, a mature franchisor of tens of thousands of restaurants operating under the KFC, Taco Bell, and Pizza Hut brands, and focus on its risk disclosure language. Fourth, we describe the history and circumstances leading up to the 2004 bankruptcy of Schlotzsky's, Inc., a franchisor of over 500 restaurants at the time. In the last Section, we conclude with our thoughts on the lessons gained from disclosure documents and the bankruptcy investigation.

This Article contributes to the literature about entrepreneurship and franchising by: (1) examining the risk disclosure language provided by one of the world's largest and most experienced franchisors, YUM; and (2) describing the history and fact pattern leading up to the 2004 bankruptcy of Schlotzsky's, Inc., a franchisor having in excess of 500 units at the time.

II. FRANCHISED ENTERPRISES

A. Definitions

The following definition of franchising appears to be applicable worldwide:

> [Franchises are] a business form essentially consisting of an organization (the franchisor) with a market-tested business package centered on a product or service, entering into a continuing contractual relationship with franchisees, typically self-financed and independently owner-managed small firms, operating under the franchisor's trade name to produce and/or market goods or services according to a format specified by the franchisor.[24]

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22 *See id.* at 2.

23 *Id.*

24 James Curran & John Stanworth, *Franchising in the Modern Economy—Towards a Theoretical Understanding*, 2 INT'L SMALL BUS. J. 8, 11 (1983).

As a threshold matter, several additional definitions are useful:

Franchise: the sole right granted by the owner of a trademark or tradename to engage in business or to sell a good or service in a certain area.[25]

Franchisor: the grantor of a franchise.[26]

Franchisee: the receiver of a franchise.[27]

Intellectual Property: property that is composed of ideas. Refers to inventions, art, literature, icons, logos, and tangible and creative works.[28]

B. *History and How Franchises Work*

In simpler terms, a franchise is a contractual relationship where one party, the franchisor, provides business tips and tricks to another party, the franchisee.[29] In exchange, the franchisee provides the franchisor with a royalty fee.[30] The franchise agreement binds the two parties for a pre-determined amount of time, which may be extended according to the terms of the agreement. The amount of time and the terms of the relationship can vary dramatically between franchise agreements.[31] While a lack of uniformity may cause a concern in the minds of readers, it is actually extremely useful because it allows individuals to seek the franchise relationship that best satisfies their needs.

Additionally, for those seeking uniformity, there are federal and state laws that govern the franchise relationship. For example, the Federal Trade Commission provides rules on what sort of information must be present in franchise disclosure documents, otherwise known as FDDs.[32] Another example in the state of Illinois are registration requirements, as well as special procedural rules for franchises.[33] This Article will not discuss the procedural requirements or substantive requirements of a franchise relationship. As noted, it will discuss the external factors that a franchisee or franchisor should consider prior to developing a franchise relationship.

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25 *Franchise*, BLACK'S LAW DICTIONARY (11th ed. 2019).

26 *Franchisor*, BLACK'S LAW DICTIONARY (11th ed. 2019).

27 *Franchisee*, BLACK'S LAW DICTIONARY (11th ed. 2019).

28 *What is Intellectual Property?*, WORLD INTELL. PROP. ORG., https://www.wipo.int/about-ip/en/ (last visited Mar. 2, 2020).

29 *See* George Ward, *Franchising in an Entrepreneurial Age*, MICH. B.J., Jan. 2017, at 42.

30 *Id.*; *see also*, Brito et al., *Vicarious Liability in Developing Areas: Damned If You Do and Damned If You Don't!*, A.B.A. 39TH ANN. F. ON FRANCHISING 1 (Nov. 2–4, 2016), https://www.americanbar.org/content/dam/aba/events/franchising/2016/w9_course_materials.pdf ("Distilled to its essence, the franchisor-franchisee relationship 'involves the licensing of intellectual property, usually in the form of the franchisor's trademark.'" (citing Rainey v. Langen, 998 A.2d 342, 348 (Me. 2010))).

31 One can seek a product franchise or business format franchise, among other types. *See* Ward, *supra* note 29, at 42.

32 16 C.F.R. § 436.5 (2019).

33 14 ILL. CODE R. 200.400, .600 (LexisNexis 2020). There are also laws in place that regulate the relationship of car dealership franchises. *See* GA. CODE ANN. § 10-1-664(a) (2019); 815 ILL. COMP. STAT. 710/4 (2018); 63 PA. STAT. AND CONS. STAT. ANN. § 818.312 (West 2020). For a summary of state franchise laws, see *State Specific Franchise Laws for Franchisors*, INTERNICOLA L. FIRM, https://www.franchiselawsolutions.com/franchising/state-specific-laws.html (last visited June 30, 2020).

It is important to note that franchisees are not employees of the franchisor.[34] Franchisees are treated as independent contractors.[35] While this may seem like a small distinction, the consequences are quite the opposite. In a traditional employee-employer relationship, the employer may be held liable for the damages of injured third parties.[36] However, in the independent contractor relationship, the injured third party may only go after the franchisee, or whoever caused the injury.[37]

Individuals who are injured at a franchise location may thus be restricted to recovering from the franchisees themselves. While the franchisee may have enough funds to pay for the injury, sometimes the injured party may require more than the franchisee can provide. It is at this point that the benefit of going after the "deeper pockets" occurs.[38] Franchisors tend to have a stronger ability to pay for various damages than franchisees.

That franchisees are independent contractors is not an absolute rule. There are some instances where the franchise relationship may appear so similar to an employment relationship that a court will allow vicarious liability on the franchisor.[39] This requires a franchisor to balance the need to protect the trademark and brand image with the need to avoid excessive control. This balancing act will allow the franchisor to avoid vicarious liability for injuries caused by a franchisee.[40]

A franchise relationship clearly has benefits as well as costs. The franchisor is paid a license fee at the beginning of the agreement and consistently earns royalties off the franchisee's success.[41] A franchisee will benefit from a franchise relationship too because the franchisor will usually have an established reputation, established image, proven management, good work practices, and access to national advertising.[42] With a franchise, there is the independence, similar to a small business owner, but with the support of a big business network.[43]

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34 Bricker v. R & A Pizza, Inc., 804 F. Supp. 2d 615, 621 (S.D. Ohio 2011).

35 DAVID A. BEYER, VICARIOUS LIABILITY 5 (2006), https://www.franchise.org/sites/default/files/ek-pdfs/html_page/VICARIOUS-LIABILITY-_David-Beyer__0.pdf.

36 This is done through the common law doctrine of *respondeat superior* and vicarious liability. *See id.* at 1.

37 *See id.* at 5.

38 *Id.* at 1.

39 Patterson v. Domino's Pizza, LLC, 333 P.3d 723, 725–26 (Cal. 2014) (citing autonomy as a deciding factor in the employee versus independent contractor analysis).

40 Robert W. Emerson, *Franchisee Independence: Still Awaiting Customer Recognition*, 15 N.Y.U. J.L. & BUS. 287, 291–92 (2019) [hereinafter Emerson, *Franchisee Independence*]; David J. Kaufmann et al., *A Franchisor Is Not the Employer of Its Franchisees or Their Employees*, 34 FRANCHISE L.J. 439, 471 (2015) (citing the major factors a court will consider).

41 STAN LUXENBERG, ROADSIDE EMPIRES: HOW THE CHAINS FRANCHISED AMERICA 37 (1985).

42 *Advantages and Disadvantages of Buying a Franchise*, QUEENSLAND GOV'T (Jul. 18, 2017), https://www.business.qld.gov.au/starting-business/buying-business/buying-franchise/advantages-disadvantages.

43 *Id.*

But why do franchises work? The business concept has been around since the 1800s and has been relevant in the entrepreneurial world ever since.[44] It exploded in popularity in the 1930s with the creation of the first modern restaurant franchise.[45] Now the development of an increasingly mobile society has created an even heavier reliance on predictability.[46] Consumers who are traveling several hours a day for work are not interested in taking risks with quality. They are interested in having predictable quality in goods or services, which is a large appeal of franchises.[47] On the business end, by providing the same product at various locations, franchisors are able to create bulk-purchasing agreements.[48]

C. *The Franchise Business Structure*

Franchises are traditionally broken into two categories: a traditional relationship or a business-format franchise.[49] The traditional franchise focuses on the product or service being sold or performed.[50] Common examples include McDonald's and Krispy Kreme Donuts,[51] but there are literally hundreds of franchised brands even for just one industry, such as Quick-Service Restaurants (including YUM's KFC, Taco Bell, and Pizza Hut brands). The business-format approach focuses on how the product or service is being delivered.[52] For example, gasoline station franchises such as Shell would constitute a business-format approach.[53] Both franchise types involve the licensing of intellectual property. The gasoline franchisor does not necessarily create a new or unique product, while, in many contexts, a QSR franchisor may create a new type of food.

Another difference between the traditional business formats and franchises is the payment of royalties. Franchisors require franchisees to pay royalties, which are

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44 Joel Libava, *How Franchising Began*, U.S. SMALL BUS. ADMIN.: INDUSTRY WORD (Sept. 4, 2013), https://web.archive.org/web/20141016200317/https://www.sba.gov/blogs/how-franchising-began. *But see* William L. Killion, *The History of Franchising*, *in* FRANCHISING: CASES, MATERIALS & PROBLEMS 1, 24 (Alexander M. Meiklejohn ed., 2013) (noting that it was not until the 1970s that franchising "became a highly regulated method of doing business").

45 *Howard D. Johnson*, U.N.H. ROSENBERG INT'L FRANCHISE CTR., https://www.unh.edu/rosenbergcenter/howard-d-johnson (last visited Mar. 2, 2020).

46 ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 1 (2005). *But see* Douglas A. Wolf & Charles F. Longino, Jr., *Our "Increasingly Mobile Society"? The Curious Persistence of a False Belief*, 45 GERONTOLOGIST 5 (2005) (advocating against the existence of a mobile society).

47 *What Are the Advantages and Disadvantages of Owning a Franchise?*, INT'L FRANCHISE ASS'N, https://www.franchise.org/faqs/basics/what-are-the-advantages-and-disadvantages (last visited Mar. 9, 2020).

48 *Id.*

49 Michael Seid, *Franchise Relationship Structures*, BALANCE SMALL BUS. (Feb. 10, 2019), https://www.thebalancesmb.com/franchise-relationship-structures-1350436.

50 *See id.* ("In traditional franchising the manufactured product is center to the franchise").

51 Eric Biber et al., *Regulating Business Innovation as Policy Disruption: From the Model T to Airbnb*, 70 VAND. L. REV. 1561, 1597 (2017) (referring to McDonald's as a "classic" franchise).

52 Seid, *supra* note 49 ("in business format franchising, the system of delivering the product or service takes center stage").

53 Biber et al., *supra* note 51, at 1599.

usually calculated as a percentage of gross sales.[54] Franchises are distinguishable from other business arrangements in that the franchise "must be sufficiently profitable to generate profits for the franchisee and to permit it to pay royalties and other fees to the franchisor."[55]

D. *Advantages to Franchising*[56]

Many franchise businesses offer owners a turnkey solution for rapid business entry. In return, the franchisor receives unit growth by virtue of de novo[57] growth in operations and revenues, often substantially or mostly financed by the franchisee.[58] It is fairly common for franchisors to operate their own stores.[59] The number of franchisor-owned locations is traditionally small compared to those that are franchisee-owned.[60] However, monitoring costs hamper the amount of growth in franchisor-owned-stores.[61] By franchising, the franchisor may continue expanding the brand and avoid the traditional employer liability that growing vertically integrated (non-franchised) chains face.

The franchisee also receives the benefit of a concept that has been refined over time. Many franchises have existed for long periods of time and their success is partially attributable to a tried-and-true business method.[62] The franchisor is

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54 1 W. MICHAEL GARNER, FRANCHISE AND DISTRIBUTION LAW AND PRACTICE § 2:4 (2019).

55 *Id.* at § 2:3.

56 For a discussion on advantages and disadvantages of franchising, see KEVIN B. MURPHY, THE FRANCHISE INVESTOR'S HANDBOOK: A COMPLETE GUIDE TO ALL ASPECTS OF BUYING, SELLING OR INVESTING IN A FRANCHISE 185 (2006). Some of the topics may overlap, but the Franchise Handbook is meant to serve as an additional resource for the interested and curious reader.

57 De Novo, meaning "from the new." The de novo growth is the growth of the new franchisee. *De Novo*, LEGAL INFO. INST. (July 2017), https://www.law.cornell.edu/wex/de_novo.

58 Some franchisors offer financing options to franchisees. Other options include a traditional bank loan, a loan from the Small Business Administration, crowdfunding, or seeking investors. Jared Hecht, *The 6 Best Financing Options for Franchising a Business*, ENTREPRENEUR (May 16, 2018), https://www.entrepreneur.com/article/312476.

59 John Maxfield, *What Percentage of McDonald's Restaurants Are Owned by Franchisees?*, MOTLEY FOOL (Oct. 5, 2018, 10:34 AM), https://www.fool.com/investing/general/2016/04/03/what-percentage-of-mcdonalds-restaurants-are-owned.aspx (18% of McDonald's restaurants are franchisor-owned).

60 Robert W. Emerson, *Franchise Goodwill: Take a Sad Song and Make It Better*, 46 U. MICH. J.L. REFORM 349, 405 n.358 (2013).

61 *See* Steven C. Michael, *Investments to Create Bargaining Power: The Case of Franchising*, 21 STRATEGIC MGMT. J. 497, 498 (2000). Monitoring costs are costs associated with a board of directors, or a franchisor, taking action to monitor and restrict the actions of managers, or franchisees. Jim Wilkinson, *Agency Costs*, STRATEGIC CFO (July 23, 2013), https://strategiccfo.com/agency-costs/.

62 *See* Lindsay Friedman, *You Won't Believe How Old Some of these Franchises Are*, ENTREPRENEUR (April 8, 2016), https://www.entrepreneur.com/slideshow/273738; *What Are the Advantages and Disadvantages of Owning a Franchise?*, *supra* note 47 (noting benefits of "associating with proven products and methods.").

constantly striving to improve the system to remain competitive.[63] The franchisee benefits from obtaining a more effective system without having to expend funds into research and development.

Another advantage is that franchisees likely enjoy customer brand recognition and existing quality control methods in place for conducting the critical key business disciplines: accounting, finance, marketing, and operations.[64]

Goodwill is an invaluable asset for business owners.[65] The franchisee receives any pre-existing goodwill that is present at the time he or she signs the franchise agreement and opens up his or her business. Reversely, the franchisor is able to generate additional goodwill with each franchise added. Since goodwill is considered to be a capital asset, the franchise becomes more valuable with each well-performing member.

Franchisees also gain the benefit of the franchisor policing other franchisees.[66] For example, if a franchisee is not performing well or not adhering to the standards of the franchise, it is the franchisor's responsibility to take action against them. The burden is removed from the franchisee, and the franchisee can focus entirely on generating revenue and profit. The franchisor bears this sometimes-heavy burden, but as noted above, it receives the benefit of goodwill and free advertising to potential franchisees.

In return for this turnkey package of business, the franchisee will usually pay initial (up-front) fees, plus a royalty, often based on revenues.[67] Services such as advertising, marketing, research and development may be deemed highly useful, but not a necessity (hence, "luxuries") that franchisees receive as a benefit of having a franchisor. YUM spends approximately 600 million dollars annually in advertising to develop its brands, offers development opportunities for both single brand and multi-brand units, and provides training and professional development for managers and employees of the franchisee.[68]

E. *Franchisee Disadvantages*

Both a benefit and disadvantage to a franchisee is the required consistency of operations across operating units. This rigidly-enforced consistency means that a

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63 Friedman, *supra* note 62 (highlighting franchisors that have survived and expanded for many years).

64 *What Are the Advantages and Disadvantages of Owning a Franchise?*, *supra* note 47.

65 Goodwill is defined as a business's reputation and other intangible assets that are considered when appraising the business. *See Goodwill*, BLACK'S LAW DICTIONARY (11th ed. 2019). When a trademark is assigned, the goodwill follows the assignment. *Id.* This is a major benefit to franchising. In other words, goodwill causes a customer to visit your location because they had a pleasant experience at a location with your same trademark or tradename.

66 Craig Tractenberg et al., *The Franchisor's Duty to Police the Franchise System*, 36 FRANCHISE L.J. 87, 89–92 (2016) (stating that the duty to police the franchise system stems from Lanham Act and case law).

67 *Id.* at 87. *See also* Allan Dick, *How do Franchisors Make Money?*, SOTOS LLP (Feb. 27, 2017), https://sotosllp.com/how-do-franchisors-make-money/.

68 *YUM! Brands, Inc.*, INT'L FRANCHISE ASS'N, https://www.franchise.org/yum-brands-inc-franchise (last visited March 9, 2020); *People: We Unlock Potential*, YUM!, http://citizenship.yum.com/people/people-dashboard.asp (last visited May 22, 2020).

customer may expect essentially the same product or service offering at any franchise location. This intangible asset or value recognized by customers results in often substantial goodwill value to the franchise enterprise.

Monitoring a franchisee can become a complicated web of legal strands. As noted above, a franchisee is not an employee of a franchisor. Thus, if a franchise fails to perform, the franchisor cannot simply fire the individual. Instead, the franchisor must rely on the terms of the contract.[69] This is not always as easy as it sounds. First, if the franchise agreement does not mention any specific procedures or remedies, the franchisor may be required to proceed through the traditional court route.[70] This involves costly and time-consuming actions. The harm of proceeding in this fashion also includes the fact that a franchisee may still be behaving improperly.[71] There are alternatives that a franchise agreement may include. Some examples are mediation or arbitration.

A franchisee is not usually in a place to bargain or negotiate certain provisions in a franchise agreement.[72] These contracts are called adhesion contracts, standard form contracts, or boilerplate contracts.[73] These contracts are usually drafted by a person with stronger bargaining power and signed by a person with less bargaining power.[74] The party with the weaker bargaining power usually does not have the ability to negotiate or modify the contract.[75] This puts a franchisee in a "take it or leave it" position. Additionally, courts view these contracts as "arms-length" agreements and thus show a reluctance to rewrite the terms.[76] Therefore, a franchisee is not likely to win a legal dispute against a franchisor with an unconscionable or "unfair terms" argument.

The legislatures of various jurisdictions have noted the power discrepancy in some industries and have taken action to correct some of the imbalance.[77] One particular issue that lawmakers noticed was the issue of contract renewal, particularly with respect to business-format franchises. They thus passed legislation to

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69 Michael, *supra* note 61, at 498.

70 It is common for a franchise agreement to allow a franchisor to terminate the agreement prior to the predetermined end date. This may still require going through a court system. *Id.* at 499; *see also* Edward M. Mullins & Douglas J. Giuliano, *Leftover Fries, a Short Stack and a Pair of Shoelaces*, 25 CORP. COUNS. Q., no. 4, 2009, art. 6 (describing the importance of a well drafted contract).

71 It is true that a franchisor may seek a preliminary injunction while proceedings are pending, but that takes time as well.

72 Westfield Centre Serv., Inc. v. Cities Serv. Oil Co., 432 A.2d 48, 58 (N.J. 1981) (noting the existence of power disparity between a franchisor and a franchisee).

73 *Adhesion Contract (Contract of Adhesion)*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/adhesion_contract_%28contract_of_adhesion%29 (last visited Mar. 9, 2020).

74 *Id.*

75 *Id.*

76 *See, e.g.*, Thomas J. Collin & Matthew D. Ridings, *Franchising*, in 12 BUSINESS AND COMMERCIAL LITIGATION IN FEDERAL COURTS § 129:32 n.53, (Robert L. Haig, ed., 2019).

77 Biber et al., *supra* note 51, at 1599–1600.

require certain disclosures to franchisees and a requirement to act in good faith when dealing with franchisees.[78]

A franchise relationship provides a tested business product and method. This serves as a double-edged sword. For example, a franchisee is required to maintain the image of the brand.[79] Therefore, if there are any changes to how a restaurant or location is to look, the franchisee is responsible for effecting that change.

Lastly, the issue of royalty payments may serve as a deterrent for a franchise. Most franchise agreements provide for the royalty as a percentage of the franchisee's adjusted gross sales.[80] The actual royalty structure is outlined in the franchise agreement and can vary depending on the franchisor or the industry. It is also a practice for a franchisor to impose a minimum royalty fee.[81] This can be especially burdensome for franchisees at the beginning of a franchise relationship, when they already have so many upfront expenses and only the prospects of future revenue. Additionally, if a franchise does not perform well, perhaps due to problems in its particular market (e.g., its geographical area), the royalty fee can be the "nail in the coffin" for a franchisee.[82]

III. FRANCHISE LAW: A PRIMER

The International Franchise Association (IFA) lists over 1,400 franchisors among its membership.[83] In 1985, the International Institute for the Unification of Private Law (UNIDROIT) proposed uniform rules to govern the franchising concept to its member states.[84] UNIDROIT is an independent intergovernmental organization with 63 member states, including the United States, and was instituted to "study needs and methods for modernizing, harmonizing, and coordinating private and, in particular, commercial law as between States and groups of States."[85] After

78 *Id.* at 1600. The legislation is at both the state and federal level. Unfortunately, the legislation passed at the state level is narrowly tailored for certain industries.

79 *Advantages, Challenges of Franchising*, INT'L FRANCHISE ASS'N (Apr. 15, 2019), https://www.franchise.org/advantages-challenges-of-franchising (citing "Working Within the System" as a challenge with franchising).

80 Michael Seid, *How to Determine Your Franchise Royalty Fee Structure*, BALANCE SMALL BUS. (May 11, 2019), https://www.thebalancesmb.com/how-to-determine-your-royalty-fee-structure-4097867; *see also* BLAIR & LAFONTAINE, *supra* note 46, at 62 (noting that sales revenue is also often used to determine the royalty amount); *Franchise Companies Mostly Small Businesses, IFA Foundation Study Finds*, FRANCHISING WORLD, Sept./Oct. 2000, at 59 (noting that 82% of surveyed franchisors calculated royalties as a percentage of sales).

81 BLAIR & LAFONTAINE, *supra* note 46, at 62 (citing a self-performed study in which 40 out of 123 surveyed franchisors required a minimum amount in royalties).

82 Robert W. Emerson, *Franchising Constructive Termination: Quirk, Quagmire or a French Solution?*, 18 U. PA. J. BUS. L. 163, 201–02 (2015). There is a risk that if the franchisee is forced to close after the "nail in the coffin," the franchisee's "enterprise, facility improvements, and training will be lost, and often, irrecoverable and nontransferable." *Id.* at 202.

83 *International Franchise Association Membership*, INT'L FRANCHISE ASS'N, https://www.franchise.org/membership (last visited May 22, 2020).

84 Robert W. Emerson, *An International Model for Vicarious Liability in Franchising*, 50 VAND. J. TRANSNAT'L L. 245, 260–61 (2017).

85 *Id.* at 260.

the interest in the franchise model increased, UNIDROIT established the Study Group on Franchising, which developed both the Model Franchise Disclosure Law[86] and the Guide to International Master Franchise Arrangements ("the Guide").[87]

Annex Three of the Guide provides specific rules for franchisors and franchisees separated into two categories: General contract laws and franchise regulation laws.[88] The Guide advises the franchisor to consider an agency relationship or a distribution agreement when drafting the franchisor-franchisee agreement.[89]

IV. YUM BRANDS

In line with understanding franchise risk and management, YUM provides an excellent roadmap of risks that prospective franchisees face when investing in a franchise. Because YUM is a mature franchising concept, operating several well-known international brands, YUM presents a uniquely seasoned and valuable example of an operator's perceived risks of franchising.

A. The Company

YUM was incorporated under the laws of the state of North Carolina in 1997.[90] YUM discloses three operating segments as of December 31, 2017: "The KFC Division which includes the worldwide operations of the KFC concept . . . . The Pizza Hut Division which includes the worldwide operations of the Pizza Hut concept . . . . [and] The Taco Bell Division which includes the worldwide operations of the Taco Bell concept."[91] At the end of 2017, YUM employed approximately 60,000 employees in either the Company or subsidiaries, with "the majority of employees . . . paid on an hourly basis."[92] The parent entity, YUM, "does not directly own or operate any restaurants"; rather, ownership or operation is conducted through subsidiaries.[93]

86 This document was created in 2002 and provides the specific information franchisors must disclose to prospective franchisees. *Id.* at 263.

87 This document was published in 1998 and republished in 2007. It provides a model for how a franchise agreement should be structured, including but not limited to negotiations, drafting of the agreement, and the legal implications on both parties. *Id.* at 261, 264.

88 *Id.* at 269.

89 *See id.* at 269–70.

90 YUM 2018 Annual Report, *supra* note 3, at 3.

91 *Id.*

92 *Id.* at 7.

93 *Id.* at 3. Generally, this business structure is beneficial to the parent company because, under the protection of the doctrine of limited liability, the parent company will not be liable for tortious acts of the subsidiary. Gwynne Skinner, *Rethinking Limited Liability of Parent Corporations for Foreign Subsidiaries' Violations of International Human Rights Law*, 72 WASH. & LEE L. REV. 1769, 1773 (2015). However, parent companies have been found liable in certain circumstances where the tort occurred as a result of the parent company's direct role, the subsidiary acted specifically as an agent carrying out a duty of the parent company, or an employee proved the parent company had expressed or implied "primary responsibility" for the safety of others. *Id.* at 1831 n.239.

The rest of the Article will provide portions of the 10-K and explain what it states as well as provide additional information to give the reader a clearer and broader picture. The excerpts may be altered from the original writings located in YUM's 10-K filing.[94]

B. *Description of Business*

YUM reports assets in more than 135 territories and countries, consisting of over 45,000 restaurants, and provides a detailed general description of its business as follows:

> The Company's three concepts of KFC, Pizza Hut and Taco Bell (the "Concepts"), develop, operate, or franchise a worldwide system of restaurants which prepare, package and sell a menu of competitively priced food items. Units are operated by the Concepts or by independent franchisees or licensees under the terms of franchise or license agreements, which typically require an initial non-refundable fee upon an individual store opening and the payment of sales-based fees for use of our Concepts' brands. The terms "franchise" or "franchisee" . . . are meant to describe third parties that operate units under either franchise or license agreements. Franchisees can range in size from individuals owning just one restaurant to large publicly traded companies.[95]

In simpler terms, YUM owns and licenses out the intellectual property for three major franchise operations. The franchises operate on the global market with locations throughout the world.[96]

Most franchise agreements require the franchisee or a licensee to provide a non-refundable deposit for each store that it opens.[97] After that initial fee, the franchisee or licensee is required to continue providing YUM payments in the form of royalties. These are basically a use-fee that is determined by a percentage of a business's sales.[98]

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94 A 10-K is a report that is required by the SEC to be filed annually, for all publicly traded companies, about the company's financial performance. Will Kenton, *10-K*, INVESTOPEDIA (Jun. 1, 2019), https://www.investopedia.com/terms/1/10-k.asp. The company's "history, organizational structure, financial statements, earnings per share, subsidiaries, [and] executive compensation" are some of the items required in a 10-K. *Id.*

95 *See* YUM 2018 Annual Report, *supra* note 3, at 3.

96 The website for YUM notes that it operates in more than 145 countries and territories. *Company*, YUM!, https://www.yum.com/wps/portal/yumbrands/Yumbrands/company/ (last visited Mar. 9, 2020). To take just one example of the great extent to which the company operates worldwide, consider Oceania. The Company notes that in Australia and New Zealand, KFC is one of the region's "most distinctive and unique brands." Press Release, *Tony Lowings Promoted to KFC Division CEO, Effective January 1, 2019*, YUM! (Sept. 28, 2018, 9:00 AM), https://www.yum.com/wps/portal/yumbrands/Yumbrands/news/press-releases/tony+lowings+promoted+to+kfc+division+ceo%2C+effective+january+1%2C+2019.

97 FED. TRADE COMM'N, A CONSUMER'S GUIDE TO BUYING A FRANCHISE 8 (2015).

98 Royalties are essentially a ubiquitous use-fee in franchising. Robert W. Emerson, *Franchise Contract Interpretation: A Two-Standard Approach*, 2013 MICH. ST. L. REV. 641, 689 (2013) (reporting that 99% of all surveyed franchise contracts had provisions requiring the franchisee to pay a percentage of gross sales revenue as a royalty, with 5% being the median amount).

The actual term, "franchisee," is deceptively simple. A franchisee can include an individual or a pair of individuals that engage in the endeavor. Most likely, the franchisees are covered by the wall of limited liability in order to protect their personal assets.[99] However, a franchisee can also include a large corporation with plenty of shareholders.[100] This idea only adds to the flexibility that so many individuals or companies find attractive about the franchise business model.

C. *Restaurant Concepts*

YUM discloses a detailed description about its restaurant "Concepts" within its annual report as follows:

> Most restaurants in each Concept offer consumers the ability to dine in and/or carry out food. In addition, Taco Bell and KFC offer a drive-thru option in many stores. Pizza Hut offers a drive-thru option on a much more limited basis. Pizza Hut typically offers delivery service, while, on a more limited but expanding basis, KFC and Taco Bell allow for consumers to have the Concepts' food delivered either through store-level or third-party delivery services. In February 2018, we entered into an agreement with GrubHub, Inc., ("Grubhub") the leading online and mobile takeout food-ordering company in the U.S. Under the agreement, Grubhub will provide support in the U.S. for the KFC and Taco Bell branded online delivery channels, along with access to Grubhub's online ordering platform, logistics and last-mile support for delivery orders, and point-of-sale integration to streamline operations.
>
> Each Concept has proprietary menu items and emphasizes the preparation of food with high quality ingredients, as well as unique recipes and special seasonings to provide appealing, tasty and convenient food at competitive prices.[101]

YUM offers a variety of restaurant Concepts. They vary in their range of access including online ordering, drive-through capabilities, or a delivery service. Each franchise idea has different limitations with the aforementioned options, and it is important to consider the benefits and costs of each to the franchisee. It is unclear if the franchisor covers any of the costs such as the cost of maintaining a website.

In addition to the base Concepts, YUM provides franchisees behind-the-scenes support. One recent example is that YUM entered into an agreement with Grubhub, which provides a platform for online ordering.[102] KFC, Taco Bell, and Pizza Hut each have a unique taste and feel to them. YUM has experimented with different flavors and techniques and provided franchisees with what it believes will

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99 It is extremely common for individuals to form a business entity that signs the franchise agreement or operates the business. Franchises are attractive to beginning business owners because they do not have to reinvent the wheel. By creating a business entity, franchisees can limit the risk to their personal lives while still engaging in the business. The major benefit is that in the event of an injury on the franchise's premise, the personal assets of the franchisee are protected. However, a franchisor may still require some sort of guarantee on the franchisee's part to ensure payment of various fees. *See also* Trautman et al., *supra* note 15, at 175.

100 *See, e.g.*, *infra* note 193 and accompanying text (discussing franchisee YUM China).

101 YUM 2018 Annual Report, *supra* note 3, at 4.

102 *Id.*

be most successful. This makes logical sense because its success is heavily bound to the success of its franchisees. Without successful franchisees, no one would want to enter into a franchise agreement with YUM.

This portion of the Article may not be necessarily valuable for the day-to-day operations of a franchise. However, it may be important when determining with which franchise you would like to contract. The size of YUM and its various franchises may evidence its success, similar to how joining "corporate America" is believed to mean success as well.[103] However, being so widespread can have disadvantages as well.

YUM has its hands in various honeypots, which means it is exposed to a wider variety of risks. Its KFC franchise engages mainly in poultry, which carries risk.[104] Taco Bell engages in both poultry and beef, which carries additional risk. Taco Bell and KFC deal in similar food ingredients, but Pizza Hut is introducing additional concerns with the potential liability that comes with delivery drivers.[105]

While this widespread risk can have its drawbacks, the diversification of risk has benefits. If one Concept fails to perform, YUM can support the failing Concept with the succeeding Concepts. It can divert capital from other Concepts to develop a new strategy to rescue the failing franchise. This is likely something that smaller franchises cannot do. Additionally, it shows that YUM is a growing brand. It is interested in growing its Concepts and this can be extremely exciting for a potential franchisee. If one franchise is successful, a franchisee may be inclined to return to YUM to execute additional franchise agreements.

D. *Franchise Operations*

YUM disclosed a detailed description about its franchise operations within its annual report as follows:

> The franchise programs of the Company are designed to promote consistency and quality, and the Company is selective in granting franchises. The Company utilizes both store-level franchise and master franchise programs to grow its businesses. Under store-level franchise agreements, franchisees supply capital—initially by paying a franchise fee to YUM, by purchasing or leasing the land, building, equipment, signs, seating, inventories and supplies and, over the longer term, by reinvesting in the business. In certain refranchising

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103 *But see* Isaac Chotiner, *Bad Job: Why Corporate America Is So Much More Awful than It Used to Be*, SLATE (Sept. 29, 2017, 11:57 AM), https://slate.com/news-and-politics/2017/09/why-companies-and-ceos-treat-their-workers-like-garbage.html (describing how shareholders benefit at the expense of employees in Corporate America).

104 L.D. Sims, *Risks Associated with Poultry Production Systems*, *in* POULTRY IN THE 21ST CENTURY: AVIAN INFLUENZA & BEYOND 355–56 (Olaf Thieme & Dafydd Pilling eds., 2008), http://www.fao.org/AG/againfo/home/events/bangkok2007/docs/part2/2_1.pdf; *Public Health Officials Say KFC in Mongolia Linked to Food Poisoning Cases*, FOOD SAFETY NEWS (Feb. 20, 2019), https://www.foodsafetynews.com/2019/02/public-health-officials-say-kfc-in-mongolia-linked-to-food-poisoning-cases/.

105 *Restaurant Risk Management: The 6 Biggest Delivery Risks*, HEFFERNAN INS. BROKERS (Jul. 10, 2018), https://www.heffins.com/news-events/blog/restaurant-risk-management-6-biggest-delivery-risks (the six biggest concerns with delivery drivers are driving, auto liability, slips and falls, theft, wage and hour lawsuits, and bad publicity).

> transactions the Company may retain ownership of land and building and lease them to the franchisee. Franchisees contribute to the Company's revenues by paying non-refundable upfront fees at inception of the franchise agreement and on an ongoing basis through the payment of royalties based on a percentage of sales (usually 4%–6%). Under master franchise arrangements, the Company enters into agreements that allow master franchisees to operate restaurants as well as sub-franchise within certain geographic territories. Master franchisees are responsible for overseeing development within their territories and collect initial fees and royalties from sub-franchisees. Master franchisees generally pay upfront fees and ongoing royalties at a reduced rate to the Company. Our largest master franchisee, Yum China, pays a 3% license fee on system sales of our Concepts in mainland China to the Company.
>
> The Company believes that it is important to maintain strong and open relationships with its franchisees and their representatives. To this end, the Company invests a significant amount of time working with the franchisee community and their representative organizations on key aspects of the business, including products, equipment, operational improvements and standards and management techniques.[106]

Master franchising is a valuable tool for franchisors to rapidly expand their business.[107] It involves a franchisor that contracts with another individual or company to provide services to franchisees in a certain region.[108] The master franchisee can occupy a city, state, or group of states.[109] The master franchisee pays a large initial fee and retains control with respect to the franchisor's intellectual property for a certain area.[110] The benefit to the master franchisee is that it will receive compensation from individual franchisees that wish to operate within its area of control.[111] On the franchisor's end, a master franchisee is beneficial because the franchisor is able to shift the monitoring costs to that individual or entity.[112] Additionally, it allows a franchisor to expand internationally without having to

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106 *See* YUM 2018 Annual Report, *supra* note 3, at 4.

107 Peter D. Holt & Amir Kremar, The Basics of International Master Franchising (Feb. 10, 2008), https://www.franchise.org/sites/default/files/ek-pdfs/html_page/Sun-Intl-Summit-Track-1-Basics-Intl-Master-Fran_0.pdf. (noting that "80% of U.S. franchisor expansion is through master franchising").

108 Jeff Elgin, *What Is a Master Franchisee?*, ENTREPRENEUR (Sept. 7, 2004), https://www.entrepreneur.com/article/72380.

109 BRB Printing, Inc. v. Buchanan, 892 F. Supp. 190, 191 (E.D. Mich. 1995) ("Participation in the master franchise program gave Maibach master franchisee responsibility for all . . . franchises within a defined geographic region); Jay Bharat Developers, Inc. v. Minidis, 84 Cal. Rptr. 3d 267, 270 (Cal. Ct. App. 2008) (stating that a master franchise agreement allowed the appellants to sell franchises within a certain territory); Elgin, *supra* note 108.

110 Elgin, *supra* note 108.

111 JULIE BENNETT & CHERYL BABCOCK, FRANCHISE TIMES: GUIDE TO SELECTING, BUYING & OWNING A FRANCHISE 283 (2008) (referring to the concept as "subfranchising").

112 *See* Scott A. Shane, *Making New Franchise Systems Work*, 19 STRATEGIC MGMT. J. 697, 700 (1998).

quickly learn an area's culture.[113] By giving a master franchisee some room to exert creative control, an American franchise can thrive in a culture that is vastly different, such as China.[114]

One example of master franchising occurred in *Gotham Print, Inc. v. American Speedy Printing Centers, Inc.*[115] The case involved a master franchise agreement between the plaintiff and the defendant.[116] The agreement provided that the signer would find others to operate as "middlemen" and within a certain geographic area, those middlemen would "develop new franchises" and "support existing franchises."[117] Gotham Print, Inc. was interested in acquiring all of New York City as well as surrounding areas in New Jersey and Connecticut.[118] The purchase price for the agreement was $1,800,000.[119]

Another example occurred in *McKinnis v. Fitness Together Franchise Corp.*[120] The plaintiff, McKinnis, entered into two separate master franchise agreements.[121] One provided that McKinnis would be granted control of Washington, D.C.[122] The second granted to McKinnis a territory corresponding to the entire state of Maryland.[123]

The agreements differ depending on things such as the growth of the franchise and long-term goals of the franchisor. Master franchise agreements allow for rapid expansion, but also relinquish a certain amount of control. If the franchise becomes extremely valuable, it may be in the franchisor's interest to diversify franchisees and not grant one individual extensive control.

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113 A culture can entirely change how a franchise markets itself. In Asian markets, corporate branding and endorsements are more effective than branding the product, which is more effective in the United States. MARIEKE DE MOOIJ, GLOBAL MARKETING AND ADVERTISING: UNDERSTANDING CULTURAL PARADOXES 292 (1998). A master franchisee would be aware of what is effective and thus be more successful than a franchisor trying to enter that area. Furthermore, advertising between various western countries can vary as well. *See id.* at 273–83.

114 ROBERT W. EMERSON, BUSINESS LAW 36–37, 66 (6th ed. 2015) (describing different approaches to government and legal procedures).

115 Gotham Print, Inc. v. Am. Speedy Printing Ctrs., Inc., 863 F. Supp. 447 (E.D. Mich. 1994).

116 *Id.* at 449.

117 *Id.* at 450.

118 *Id.*

119 *Id.* As with all cases, things did not go as planned. The case continues on to describe an issue with the master franchise agreement. The franchisor promised to fix the issues, but nothing was resolved. Eventually the franchisor declared bankruptcy and the appellants filed a claim for false representations and misleading financial projections. Specifically, Gotham Print alleged a securities fraud violation, a Racketeer Influenced and Corrupt Organizations claim, conspiracy to commit fraudulent misrepresentation, and fraudulent misrepresentation claims. *Id.* at 451. The claims, after a lengthy discussion, were dismissed. *Id.* at 462.

120 McKinnis v. Fitness Together Franchise Corp., No. 10-cv-02308-RPM, 2010 WL 5056666 (D. Colo. Dec. 6, 2010).

121 *Id.* at *1.

122 *Id.*

123 *Id.*

YUM has taken advantage of this system. One of its master franchisees, Telepizza Group, operates Pizza Hut franchises around the globe.[124] The Company also employs master franchises for its other major chains, Taco Bell[125] and KFC.[126] YUM also utilizes a rather creative master-franchising tactic in which it created a master franchise agreement with YUM! China and one of its subsidiaries.[127] On the surface, the creation of a franchise implies that there is a commercial relationship between the franchisor and franchisee.[128] However, it is important that a franchisor and franchisee's relationship goes beyond the implied commercial standards. A strong working relationship between a franchisor and franchisee creates benefits to both parties.[129] A franchisor may strengthen the relationship by setting up support systems and giving guidance to the franchisee.[130] In return, the franchisee may make more money and have a lower likelihood of failure, thus paying higher royalties and being a lower risk to the franchisor.[131] For both parties to succeed, they must successfully work together.

Goodwill is the only asset that competition cannot undersell or destroy.[132] The value of goodwill is assigned to a franchise.[133] Goodwill is often linked to a franchise's brand and reputation.[134] This creates loyalty amongst customers.[135] Goodwill is important to a business, not just when the business is looking to grow but also when a business is acquired or merged.[136] If a business is acquired, goodwill is often calculated on the balance sheet by taking the excess of the purchase price over the fair market value of the identifiable tangible and intangible net assets that are to be acquired.[137] However, it is debated whether the true value of goodwill can

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124 Press Release, *Pizza Hut and Telepizza Group Announce Landmark International Growth Alliance*, YUM! (May 16, 2018, 2:00 AM), https://www.yum.com/wps/portal/yumbrands/Yumbrands/news/press-releases/pizza+hut+and+telepizza+group+announce+landmark+international+growth+alliance (reporting that Telepizza has over 1,600 stores in over 20 countries).

125 Nancy Luna, *Taco Bell Master Franchise Deal to Add 400 Units Abroad*, NATION'S RESTAURANT NEWS (Jun. 28, 2018), https://www.nrn.com/quick-service/taco-bell-master-franchise-deal-add-400-units-abroad.

126 *Master Franchisee of KFC Pakistan Sells Business*, QSR WEB, https://www.qsrweb.com/news/master-franchisee-of-kfc-pakistan-sells-business/ (last visited Mar. 2, 2020).

127 YUM 2018 Annual Report, *supra* note 3, at 4.

128 Robert W. Emerson & Jason R. Parnell, *Franchise Hostages: Fast Food, God, and Politics*, 29 J.L. & POL. 353, 367 (2014).

129 Denene Brox, *Ties that Bind*, QSR MAG. (Sept. 2010), https://www.qsrmagazine.com/denise-lee-yohn-qsrs-marketing-guru/ties-bind.

130 *Id.*

131 *Id.*

132 Emerson, *supra* note 60, at 351.

133 *Id.* at 352.

134 *Id.* at 353.

135 *Id.* at 352.

136 Andrea M. Matwyshyn, *Imagining the Intangible*, 34 DEL. J. CORP. L. 965, 974 (2009).

137 *Id.*

actually be fully calculated.[138] The importance of goodwill can be seen both through the actions of the consumer and as an asset on the business's balance sheet.

The ultimate goal of a franchisor is to increase profits by keeping customers happy and coming back.[139] This is often done by improving products and providing better goods and services. For example, a franchise's customer service plays a large role in a franchisor's success.[140] However, an issue arises with fast-food franchises as there are high rates of turnover with the employees that actually interact with customers.[141] Franchises may find success by improving the customer service from their front-line employees.[142] For example, in 2015 Chick-Fil-A generated more revenue per restaurant than any other fast-food chain in the United States.[143] Chick-Fil-A attributes its success to its front-line employees that are rigorously trained to have stellar customer service.[144] A franchisor's drive to improve its goods and services generates from its goal of improving business and increasing profits. This improvement may be linked to customer service, like Chick-Fil-A, or other services and goods.

E. Competition

Almost every successful business encounters stiff competition. Barriers to entry in the restaurant industry are relatively modest. YUM describes its competition as:

> The retail food industry . . . is made up of supermarkets, supercenters, warehouse stores, convenience stores, coffee shops, snack bars, delicatessens and restaurants (including the QSR segment), and is intensely competitive . . . . Competition from delivery aggregators and other food delivery services has also increased in recent years, particularly in urbanized areas. . . . Each of the Concepts competes with international, national and regional restaurant chains as well as locally-owned restaurants, not only for customers, but also for management and hourly personnel, suitable real estate sites and qualified franchisees. Given the various types and vast number of competitors, our Concepts do not constitute a significant portion of the retail food industry in terms of number of system units or system sales, either on a worldwide or individual country basis.[145]

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138 A.B.A. FORUM ON FRANCHISING, FUNDAMENTALS OF INTERNATIONAL FRANCHISING 62 (Richard M. Asbill & Steven M. Goldman eds., 2001).

139 Jeff Bevis, *How to Keep Customers Happy and Drive Continuous Improvement*, INT'L FRANCHISE ASS'N (Jun 27, 2016), https://www.franchise.org/franchise-information/marketing/how-keep-customers-happy-and-drive-continuous-improvement.

140 *Id.*

141 *Id.* A possible solution is higher pay or better working conditions. People starting franchises could benefit from this information.

142 *See, e.g.*, Kate Taylor, *Chick-fil-A Is Beating Every Competitor by Training Workers to Say 'Please' and 'Thank You'*, BUS. INSIDER (Oct. 3, 2016, 11:32 AM), https://www.businessinsider.com/chick-fil-a-is-the-most-polite-chain-2016-10.

143 *Id.*

144 *Id.*

145 *See* YUM 2018 Annual Report, *supra* note 3, at 6.

QSR refers to "Quick Service Restaurants." It is another way to refer to fast-food restaurants. To remain competitive, a fast-food franchise should continue making the service or production process faster without sacrificing efficiency.[146] For example, the growth of delivery services like Grubhub or Postmates should show franchisees and franchisors that consumers are interested in having food brought to them.[147] Another emerging trend is the desire for healthier food options.[148]

Some businesses are capitalizing on this by adopting slogans like "farm to table" or buzzwords like "organic."[149] People love the "farm to table" image that invokes family and friends gathered around enjoying locally grown food. Individuals are supporting local businesses and reducing carbon footprints caused by the long-distance transportation of food.[150] Additionally, the positive health benefits of organic food consumption are attracting individuals to move away from conventional farming.[151]

These two major movements may have a negative impact, particularly on franchise concepts similar to the ones YUM owns. In contrast, businesses are entering the marketplace to fill the void of franchises in the organic and healthy-eating

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146 *See* Joe Mach, *How to Prepare for the Quick-Service Restaurant of the Future*, QSR MAG. (Feb. 2018), https://www.qsrmagazine.com/outside-insights/how-prepare-quick-service-restaurant-future (noting that 42% of surveyed individuals would choose one restaurant as opposed to another because of online ordering).

147 *But see* Leo Sun, *Grubhub's Growth Hits a Brick Wall as Its Expenses Soar*, NASDAQ (Feb. 8, 2019, 8:15 AM), https://www.nasdaq.com/article/grubhubs-growth-hits-a-brick-wall-as-its-expenses-soar-cm1096392.

148 Nancy Gagliardi, *Consumers Want Healthy Foods—And Will Pay More For Them*, FORBES (Feb. 18, 2015, 11:30 AM), https://www.forbes.com/sites/nancygagliardi/2015/02/18/consumers-want-healthy-foods-and-will-pay-more-for-them/#5397bf7175c5; *The Fast Food Industry Growth Statistics that Should Shape Your Advertising Strategies*, SHOPKICK (Jan. 12, 2018), https://www.shopkick.com/partners/blog/the-fast-food-industry-growth-statistics-that-should-shape-your-advertising-strategies/.

149 Jennifer Robertson, *Produced with Care: A Look at the Growing Farm-to-Table Movement in Southern Illinois*, SOUTHERN (Feb. 15, 2019), https://thesouthern.com/lifestyles/magazine/produced-with-care-a-look-at-the-growing-farm-to/article_b40be989-4ec2-55d0-8f70-37d2cc3c4c8c.html (noting the growth of "farm to table" in Illinois).

150 *See* Wayne Wakeland et al., *Food Transportation Issues and Reducing Carbon Footprint*, *in* GREEN TECHNOLOGIES IN FOOD PRODUCTION AND PROCESSING 211, 228–33 (Joyce I. Boye & Yves Arcand eds., 2012).

151 USDA NAT'L AGRIC. STAT. SERV., CERTIFIED ORGANIC SURVEY 2016 SUMMARY (Sept. 2017), https://www.nass.usda.gov/Publications/Todays_Reports/reports/census17.pdf (reporting for the most recent year (2016) a continuing large increase in all three areas—sales of certified, organic commodities (up 23%), number of organic farms (up 11%), and amount of certified organic acreage (up 15%)); USDA ECON. RES. SERV., ORGANIC PRODUCTION (Sept. 30, 2019), https://www.ers.usda.gov/data-products/organic-production/documentation/ ("U.S. consumer demand for organically produced goods has grown continuously since USDA established national standards for organic production and processing in 2002"); USDA ECON. RES. SERV., ORGANIC AGRICULTURE (Oct. 9, 2019), https://www.ers.usda.gov/topics/natural-resources-environment/organic-agriculture/ ("Consumer demand for organically produced goods has shown double-digit growth during most years since the 1990s, providing market incentives for U.S. farmers across a broad range of products.").

movement.[152] For example, while higher gross sales may not equate to increased profits, one healthy-eating franchise's top 25% performers averaged gross sales of $846,556, which is approximately 70% of the average gross sales of the average KFC franchise.[153] This same franchise is relatively rapidly growing. In 2017, there were six franchise locations and by 2019, it increased to 75.[154]

A franchisee and franchisor must be aware of these trends. Whether the movements solicit a change in advertising and imagery, or perhaps an overhaul of the services or products, it is important for a franchise to stay up-to-date.[155]

Lastly, a franchise must remain aware of its competition. This can simply boil down to: if your competition is doing something that people like, make it yours. Businesses such as Walmart adopt their competitors' ideas and spin each idea to make it their own.[156] Brand loyalty will only persuade the average consumer to solicit one business over another for so long. Consumers love quick, cheap, and convenient options, and a franchise should market to those desires instead of relying entirely on brand loyalty or goodwill.[157]

One of KFC's main competitors is Chick-fil-A. It is important that a prospective franchisee examine the competition. While it is unlikely that Chick-fil-A will entirely supplant KFC, it is definitely more popular than the YUM brand.[158]

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152 Annie Pilon, *Move over McDonald's, 20 Healthy Food Franchises to Challenge the Burger Chains*, SMALL BUS. TRENDS (Jan. 24, 2020), https://smallbiztrends.com/2017/02/healthy-food-franchises.html; *see, e.g.*, Clean Juice, *USDA-Certified Organic Juice Bar Partners with FranchiseBlast Mobile Technology to Drive Brand Experience and Quality Processes*, FRANCHISING.COM (Feb. 20, 2019), https://www.franchising.com/news/20190221_usdacertified_organic_juice_bar_partners_with_fran.html.

153 *Compare Let's Talk About the Numbers*, CLEAN JUICE FRANCHISING, https://cleanjuicefranchising.com/the-numbers/ (last visited Mar. 5, 2020) (discussing 2018 figures), *with Sales per Unit of Kentucky Fried Chicken in the U.S. 2006–2018*, STATISTA (Aug. 7, 2019), https://www.statista.com/statistics/205784/kentucky-fried-chicken-sales-per-system-unit-since-2006/ (providing the 2017 figures).

154 *Clean Juice*, ENTREPRENEUR, https://www.entrepreneur.com/franchises/cleanjuice/334952 (last visited May 23, 2020). Smoothie King, a franchise with a similar style, increased its number of franchises by 149 between 2017 and 2019. *See Smoothie King*, ENTREPRENEUR, https://www.entrepreneur.com/franchises/smoothieking/282804 (last visited May 23, 2020). Note KFC added approximately 54 net new franchises between 2017 and 2019. *KFC US LLC*, ENTREPRENEUR, https://www.entrepreneur.com/franchises/kfcusllc/282495 (last visited May 23, 2020). However, KFC added 3,257 franchises outside the U.S. between 2017 and 2019. *Id.*

155 *See* MARCIA LAYTON TURNER, KMART'S TEN DEADLY SINS: HOW INCOMPETENCE TAINTED AN AMERICAN ICON 37 (2003) (citing a lack of customer awareness as one of Kmart's deadly sins).

156 *See id.* at 61.

157 Consider the famous growth of Amazon, the online web-retailer. *See* James Doubek, *Amazon Strikes a Deal with Apple, but Cuts Out Independent Sellers*, NAT'L PUB. RADIO (Dec. 23, 2018, 8:01 AM), https://www.npr.org/2018/12/23/679592480/amazon-strikes-a-deal-with-apple-but-cuts-out-independent-sellers; Robb Mandelbaum, *Is Amazon Good or Bad for Small Business?*, FORBES (Mar. 31, 2018, 6:00 PM), https://www.forbes.com/sites/robbmandelbaum/2018/03/31/is-amazon-good-or-bad-for-small-business-yes/#c2a12e844677 (noting that Amazon's success is attributable to "low prices and speedy home delivery").

158 Kate Taylor, *KFC Is Getting Killed by a Restaurant Half Its Size—And Now It's Making Huge Changes to Get Customers Back*, BUS. INSIDER (May 22, 2016, 11:28 AM), https://www.businessinsider.com/why-chick-fil-a-is-beating-kfc-2016-5.

However, unlike some past businesses that failed, KFC is aware of its competition and is working on competing against the Atlanta-originated chicken giant.[159] This is something that a franchisee should recognize as a positive trait in a franchisor.

F. *Risk Factors*

And now, discussion about: "*When things go pear-shaped*."[160]

The heart of our Article is to be found in the discussion offered by YUM of its perceived risks. Risks differ for any enterprise based upon factors such as: industry, geographical areas of operations, health and safety, available employee labor pool, required employee training, undercapitalization, and bankruptcy, just to name a few. Although YUM is engaged principally in the fast-food industry, the lessons available to the reader are applicable to many other industries as well.

1. *Food Safety and Food-borne Illness*

As might be expected, tainted or inferior food preparation is a major problem for businesses operating significant restaurant operations. Examples of disruptive quality failures negatively impacting restaurant brands in the past include: Jack in the Box (1993);[161] Burger King (1997);[162] KFC (1999);[163] Sizzler (2000);[164] Taco Bell (2006);[165] Wendy's (2006);[166] Jimmy John's (2008–2013);[167] and Chipotle (2015).[168] YUM provides the following description of how it perceives ongoing risk from food safety and food-borne illness:

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159 *Id.*

160 Annual Conference, International Society of Franchising, Vienna, Austria (June 7, 2019) (statement of Philip Smith, Partner, Thomson Geer, Sydney, Australia) (referring to franchisees, having bought a franchise without getting a franchise lawyer or franchise accountant help, then facing things going upside down (bad) and lamenting, "why didn't I get more expert advice?") (on file with authors).

161 *Jack in the Box's Worse Nightmare*, N.Y. TIMES (Feb. 6, 1993), https://www.nytimes.com/1993/02/06/business/company-news-jack-in-the-box-s-worst-nightmare.html.

162 Jim Kirk, *Burger King Works Quickly to Ease Concerns About Meat*, CHI. TRIB. (Aug. 26, 1997), https://www.chicagotribune.com/news/ct-xpm-1997-08-26-9708260319-story.html.

163 *Ohio Kentucky Fried Chicken Restaurants Coleslaw 1999*, MARLER CLARK LLP, http://www.outbreakdatabase.com/details/ohio-kentucky-fried-chicken-restaurants-coleslaw-1999/ (last visited Feb. 28, 2020).

164 Dan Flynn, *Wisconsin Sizzlers Vindicated in State Supreme Court*, FOOD SAFETY NEWS (July 12, 2012), https://www.foodsafetynews.com/2012/07/wisconsin-sizzler-vindicated-in-state-supreme-court/.

165 *Multistate Outbreak of* E. coli *O157 Infections Linked to Taco Bell (FINAL UPDATE)*, CTRS. FOR DISEASE CONTROL & PREVENTION (Dec. 14, 2006), https://www.cdc.gov/ecoli/2006/taco-bell-12-2006.html.

166 *June 2006 Wendy's E. coli O121:H19 Outbreak*, MARLER CLARK (June 6, 2007), https://www.ecoliblog.com/e-coli-outbreaks/june-2006-wendys-e-coli-o121h19-outbreak/.

167 Bill Marler, *Jimmy John's and Sprouts—Here We Go Again*, MARLER CLARK (Jan. 19, 2018), https://www.foodpoisonjournal.com/foodborne-illness-outbreaks/jimmy-johns-and-sprouts-here-we-go-again/.

168 Roberto A. Ferdman & Abha Bhattarai, *There's a Crisis at Chipotle*, WASH. POST (Dec. 9, 2015, 4:56 PM), https://www.washingtonpost.com/news/wonk/wp/2015/12/09/chipotle-food-outbreak-ecoli-reputation/?utm_term=.b068a4519c88; *see also* Caitlin Dewey, *A Chipotle Restaurant Is Closed After Yet Another Foodborne Illness Outbreak*, WASH. POST (July 18, 2017, 8:12

> Food-borne illnesses, such as E. coli, trichinosis, listeria and salmonella . . . may occur within our system from time to time. In addition, food safety issues such as food tampering, contamination and adulteration . . . may occur within our system from time to time. Any report or publicity linking us or one of our Concepts' restaurants . . . could adversely affect our Concepts' brands and reputations as well as our revenues and profits, and possibly lead to product liability claims, litigation and damages. If a customer . . . becomes ill as a result of food safety issues, restaurants in our system may be temporarily closed, which could . . . have a material adverse effect on our business, financial condition and results of operations.[169] In addition, instances or allegations of food-borne illness or food safety issues, real or perceived, involving our restaurants, restaurants of competitors, or suppliers or distributors (regardless of whether we use or have used those suppliers or distributors), or otherwise involving the types of food served at our restaurants, could result in negative publicity that could adversely affect our sales or the sales of our Concepts' franchisees. The occurrence of food-borne illnesses or food safety issues could also adversely affect the price and availability of affected ingredients, which could result in disruptions in our supply chain and/or lower margins for us and our Concepts' franchisees.[170]

One of the more substantial risks of franchising is the problem of food-borne illness. Across the entire food industry, issues related to food-borne illness cost approximately 55 billion dollars in the United States.[171] Outside of the franchise context it opens a restaurant up to legal liability, with the risk of a massive judgment increasing with each harmed individual. This can be mitigated if the franchise has liability insurance that covers different types of lawsuits, like food poisoning claims.[172]

In the franchise context, the risk has a unique, albeit unpleasant, twist. The franchisor determines exactly what sort of ingredients a franchisee may use in its operations. Additionally, a franchisor can provide a list of approved vendors.[173]

AM), https://www.washingtonpost.com/news/wonk/wp/2017/07/18/a-chipotle-restaurant-is-closed-after-yet-another-foodborne-illness-outbreak/?utm_term=.f5f86ecf09c0 (citing an issue at one franchise location).

169 YUM 2018 Annual Report, *supra* note 3, at 7. This situation brings about a disadvantage to franchisees. If one franchise has a scandal, all the franchises related to it are likely to be affected. A layperson is only concerned with the brand name and does not care if there are separate owners. *See* Emerson & Parnell, *supra* note 128, at 355–56.

170 YUM 2018 Annual Report, *supra* note 3, at 7.

171 Francine L. Shaw, *The Tremendous Cost of Foodborne Illnesses, and What to Do About It*, QSR MAG. (June 2018), https://www.qsrmagazine.com/outside-insights/tremendous-cost-foodborne-illnesses-and-what-do-about-it (providing various steps to reduce the risk of food contamination).

172 Marilyn Lindblad, *Types of Insurance Needed for a Fast Food Restaurant*, HOUS. CHRON, https://smallbusiness.chron.com/types-insurance-needed-fast-food-restaurant-10297.html (last visited May 23, 2020).

173 Howard Ullman, *Can a Franchisor Require Franchisees to Buy Supplies, Ingredients, or Products from It?*, MY DISTRIBUTION L. (Feb. 28, 2012), http://www.mydistributionlaw.com/2012/02/can-a-franchisor-require-franchisees-to-buy-supplies-ingredients-or-products-from-it/ (referring to the arrangement as "tying"). Such an arrangement can raise antitrust issues and give rise to franchisor liability. Robert W. Emerson, *Franchising and Consumers' Beliefs About "Tied" Products: The Death Knell for* Krehl?, 45 FLA. L. REV. 163, 165 (1993) (referring to 15 U.S.C. § 1

This is forcing various locations and franchises to reach into the same pool of potentially contaminated ingredients and causing an illness to spread more rapidly. According to one study, one outbreak can cost a franchise over two million dollars.[174] Outbreaks require franchises to quarantine employees and sanitize any restaurant suspected of carrying a food-borne illness.[175] One of the major sources of illness is referred to as the norovirus.[176] In fact, it is the leading cause of gastroenteritis in the United States.[177] Consumers may not experience symptoms for 48 hours after exposure.[178] This means that a franchise can sell contaminated food for two days before it is able to realize the damage and take action. For massive franchises, such as Taco Bell, two days of inaction could lead to exposure to approximately 11,400,000 customers throughout the United States.[179]

Another cause of public concern is avian or swine flu.[180] Since some franchises, YUM Concepts specifically, deal heavily with poultry and pork, a flu outbreak could cause concern despite a franchise taking every available precaution to guard against it.[181] Even if a franchisee's ingredients are not contaminated or the illness is not in fact food-borne, the fear of contamination can cause a franchisee to suffer.

Food-borne illnesses are dangerous to all franchisees, even if they are not affiliated with each other. If a nearby location is suspected of being contaminated, all franchisees in the nearby area may suffer.[182] Contamination could cause a disruption

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(1988)). *But see* Kate Wallace, *The Wonderful World of Tying*, *in* THE 101 PRACTICE SERIES: BREAKING DOWN THE BASICS, AM. BAR ASS'N YOUNG LAW. DIVISION (June 2012), available at https://www.jonesday.com/en/insights/2012/06/the-wonderful-world-of-tying-the-101-practice-series-breaking-down-the-basics-the-american-bar-association-young-lawyers-division (select "tying" next to Attachments) (recognizing a decline in the anti-tying arrangement sentiment).

174 Shaw, *supra* note 171.

175 *See* YUM 2018 Annual Report, *supra* note 3, at 8.

176 *See id.*

177 CTRS. FOR DISEASE CONTROL & PREVENTION, NOROVIRUS ILLNESS: KEY FACTS (2015), https://www.cdc.gov/norovirus/downloads/keyfacts.pdf ("Norovirus is the most common cause of acute gastroenteritis in the U.S. Each year, norovirus causes 19 to 21 million cases of acute gastroenteritis in the U.S."); CTRS. FOR DISEASE CONTROL & PREVENTION, PREVENTING NOROVIRUS OUTBREAKS: FOOD SERVICE HAS A KEY ROLE (2014), https://www.cdc.gov/vitalsigns/norovirus/index.html (noting that "[n]orovirus is the leading cause of disease outbreaks from contaminated food in the US.").

178 CTRS. FOR DISEASE CONTROL & PREVENTION, NOROVIRUS (2019), https://www.cdc.gov/norovirus/about/symptoms.html.

179 Taco Bell serves about 40,000,000 customers per week, which is approximately 5,700,000 per day. Each location could serve about 814 customers per day based on a total of 7,000 Taco Bell locations. *See Taco Bell,* YUM!, http://www.yum.com/company/our-brands/taco-bell/ (last visited Mar. 10, 2020). That is over 1,600 potentially infected consumers not even considering the possibility that one individual is purchasing for a group.

180 *E.g.*, *19 States Have High Flu Activity; 13 Children Have Died from Virus This Season*, ABC ACTION NEWS (Jan. 4, 2019, 9:54 AM), https://www.abcactionnews.com/lifestyle/health/19-states-have-high-flu-activity-13-children-have-died-from-virus-this-season.

181 *See An Imminent Pandemic*, ECONOMIST (April 30, 2009), https://www.economist.com/international/2009/04/30/an-imminent-pandemic (citing some of the effects of the swine influenza outbreak).

182 YUM 2018 Annual Report, *supra* note 3, at 7.

in a business's activities, a temporary closure of a restaurant, and impact the fast-food industry in general.[183]

2. Viruses or Other Diseases

Another variation of actual or perceived threats to customer health is found in YUM's risk from viruses (e.g., COVID-19) or other diseases. Accordingly, YUM describes this risk as follows:

> Our business could be materially and adversely affected by the outbreak of a widespread health epidemic, including various strains of avian flu or swine flu, such as H1N1. The occurrence of such an outbreak . . . . could also significantly impact our industry and cause a temporary closure of restaurants, which would severely disrupt our operations and have a material adverse effect on our business, financial condition and results of operations.
>
> Our operations could be disrupted if any of our employees or employees of our business partners were suspected of having the avian flu or swine flu, or other illnesses such as hepatitis A or norovirus, since this could require us or our business partners to quarantine some or all of such employees or disinfect our restaurant facilities. . . . Public concern over avian flu generally may cause fear about the consumption of chicken, eggs and other products derived from poultry, which could cause customers to consume less poultry and related products. Because poultry is a menu offering for our Concepts, this would likely result in lower revenues and profits for us and our Concepts' franchisees [and]. . . . could also adversely affect the price and availability of poultry. . . .
>
> Furthermore, other viruses may be transmitted through human contact, and the risk of contracting viruses could cause employees or guests to avoid gathering in public places, which could adversely affect restaurant guest traffic or the ability to adequately staff restaurants. We could also be adversely affected if government authorities impose mandatory closures, seek voluntary closures or impose restrictions on operations of restaurants. Even if such measures are not implemented and a virus or other disease does not spread significantly, the perceived risk of infection or health risk may affect our business.[184]

3. Reliance on Concepts' Franchisees

To a considerable extent, YUM believes that with materially all of its units being operated by franchisees, the Company is "increasingly tied to the success of Concepts' franchisees."[185] Accordingly, YUM discloses:

> A significant and growing portion of our restaurants are operated by our Concepts' franchisees. . . . [O]ur long-term system sales growth targets depend on an acceleration of our historical net system unit growth rate. Nearly all of this unit growth is expected to result from new unit openings by our Concepts' franchisees. If our Concepts' franchisees do not meet our expectations for new unit development, we may fall short of our system sales growth targets.
>
> We have limited control over how our Concepts' franchisees' businesses are run, and their inability to operate successfully could adversely affect our

[183] *See id.* at 8.

[184] *Id.*

[185] *Id.*

> operating results through decreased royalty payments. If our Concepts' franchisees incur too much debt, if their operating expenses or commodity prices increase or if economic or sales trends deteriorate such that they are unable to operate profitably or repay existing debt, it could result in their financial distress, including insolvency or bankruptcy. If a significant franchisee . . . becomes . . . financially distressed, our operating results could be impacted through reduced or delayed royalty payments and reduced new unit development. In addition, we are contingently liable on certain of our Concepts' franchisees' lease agreements, including lease agreements that we have guaranteed or assigned to franchisees in connection with the refranchising of certain Company-owned restaurants. Our operating results could be impacted by any increased rent obligations for such leased properties to the extent our Concepts' franchisees default on such lease agreements.
>
> Our success also depends on the willingness and ability of our Concepts' franchisees to implement major initiatives such as restaurant remodels or equipment or technology upgrades, which may require financial investment. Our Concepts may be unable to successfully implement strategies that we believe are necessary for further growth if their franchisees do not participate, which in turn may harm the growth prospects and financial condition of the Company. Additionally, the failure of our Concepts' franchisees to focus on the fundamentals of restaurant operations, such as quality service and cleanliness (even if such failures do not rise to the level of breaching the related franchise documents), could have a negative impact on our business.[186]

YUM's franchise strategy is upwardly contributing to the company's overall growth. Based on a Press Release in February of 2019, YUM reported an increase of 24% of its full year GAAP Earnings Per Share.[187] Worldwide sales increased by 6%, including three franchises—Taco Bell with 9%, KFC with 7%, and Pizza Hut with a 2% increase.[188] The success of the franchise business model is becoming more and more attractive to companies and shareholders. YUM is committed to increasing its franchise pool and using its unique business model to become more efficient in strengthening its brands.[189]

4. *Transformation Efforts for Future Global Expansion*

YUM discloses that risk exists in whether or not the Company is successful in implementing global expansion "transformation initiatives or fully realize[s] the anticipated benefits from the transformation."[190] The Company states:

> We are in the process of implementing our strategic transformation plans to drive global expansion of our KFC, Pizza Hut and Taco Bell brands. Among other things, this transformation includes a plan to become at least 98%

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186 *Id.*

187 Press Release, Keith Siegner, Vice President, Yum! Brands, Yum! Brands Reports Fourth-Quarter GAAP Operating Profit Decline of (39)%; Fourth-Quarter Core Operating Profit Growth of +5%; On Track with Strategic Transformation to Accelerate Growth (Feb. 7, 2019) (on file with the authors).

188 *Id.*

189 *Id.*

190 YUM 2019 Annual Report, *supra* note 6, at 9.

> franchised by the end of 2018 and to significantly reduce annual capital expenditures and our general and administrative costs, each by the end of 2019. We cannot assure you that we will be able to successfully implement our transformation initiatives. Further, our ability to achieve the anticipated benefits of this transformation, including the anticipated levels of cost savings and efficiency, within expected timeframes is subject to many estimates and assumptions . . . which are beyond our control. There is no assurance that we will successfully implement, or fully realize the anticipated positive impact of, our transformation initiatives, or execute successfully on our transformation strategy . . . . In addition, there can be no assurance that our efforts, if properly executed, will result in our desired outcome of improved financial performance.[191]

Currently, the Company has achieved the goal of becoming 98% franchisee-owned and continues to expand its capabilities in order to improve franchise unit economics and accelerate growth.[192]

5. Significant Exposure to Chinese Market

A spin-off of YUM's important China business into a publicly-traded, independent company was achieved on October 31, 2016, "under the name of Yum China Holdings, Inc. ("Yum China"). On the Distribution Date, [YUM] distributed to each of [its] shareholders . . . one share of Yum China common stock for each share of our Common Stock held."[193] Furthermore, YUM stated:

> [W]e entered into a Master License Agreement with Yum China pursuant to which Yum China is the exclusive licensee of the KFC, Pizza Hut and Taco Bell Concepts and their related marks and other intellectual property rights for restaurant services in China. . . . Yum China became, and continues to be, our largest franchisee. As a result, our overall financial results are significantly affected by Yum China's results. Yum China's business is exposed to risks in China, which include, among others, changes in economic conditions (including consumer spending, unemployment levels and wage and commodity inflation), consumer preferences, and the regulatory environment, as well as increased media scrutiny of our Concepts and industry, fluctuations in foreign exchange rates and increased competition. Further, any significant or prolonged deterioration in U.S.–China relations could adversely affect our Concepts in China if Chinese consumers reduce the frequency of their visits to Yum China's restaurants. Chinese law regulates Yum China's business conducted within China. Our royalty income from the Yum China business is therefore subject to numerous uncertainties based on the policies of the Chinese government, as they may change from time to time.
>
> Our relationship with Yum China is governed by a Master License Agreement, which may be terminated upon the occurrence of certain events, such as the insolvency or bankruptcy of Yum China. In addition, if we are unable to enforce our intellectual property or contract rights in China, if Yum China is unable or unwilling to satisfy its obligations under the Master License

191 YUM 2018 Annual Report, *supra* note 3 at 8–9.

192 *See* YUM 2019 Annual Report, *supra* note 6, at 8.

193 YUM 2018 Annual Report, *supra* note 3, at 3.

> Agreement, or if the Master License Agreement is otherwise terminated, it could result in an interruption in the operation of our brands that have been exclusively licensed to Yum China for use in China. Such interruption could cause a delay in, or loss of, royalty income to us, which would negatively impact our financial results.[194]

6. International Operations

Conducting business in international markets is inherently risky.[195] YUM identifies the very nature of international operations as having unique risks that have the potential to negatively affect results:

> A significant portion of our Concepts' restaurants are operated in countries and territories outside of the U.S., including in emerging markets, and we intend to continue expansion of our international operations. As a result, our business is increasingly exposed to risks inherent in international operations. These risks, which can vary substantially by country, include political instability, corruption, anti-American sentiment and social and ethnic unrest, as well as changes in economic conditions (including consumer spending, unemployment levels and wage and commodity inflation), the regulatory environment, income and non-income based tax rates and laws, sanctions, foreign exchange control regimes, consumer preferences and the laws and policies that govern foreign investment in countries where our restaurants are operated. In addition, our franchisees do business in jurisdictions that may be subject to trade or economic sanction regimes and such sanctions could be expanded. Any failure to comply with such sanction regimes or other similar laws or regulations could result in the assessment of damages, the imposition of penalties, suspension of business licenses, or a cessation of operations at our franchisees' businesses, as well as damage to our and our Concepts' brands' images and reputations, all of which could harm our profitability.[196]

Nations may place economic sanctions on international franchises, creating a risk to the franchise's ability to conduct business internationally. These sanctions may be correlated to political tension or other bureaucratic obstacles.[197] For example, the United States placed heavy sanctions on Cuba, not just on Cuban goods and services but on all international dealings, due to political disputes.[198] More specific to franchises, the European Union has recently placed large tariffs and economic sanctions on the United States brand Harley Davidson Motorcycles, causing Harley to drop in sales and earnings.[199] Although Harley Davidson Motorcycle dealerships are not franchises, they are independently owned and operated, so the

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194 *Id.* at 9.

195 *See* RICHARD SCHAFFER ET AL., INTERNATIONAL BUSINESS LAW AND ITS ENVIRONMENT 145 (9th ed. 2014).

196 YUM 2018 Annual Report, *supra* note 3, at 9.

197 Robert Courtney, *When Doing Business in Countries That, Um, Don't Like Us, Here's What You Need to Know*, ENTREPRENEUR (Jan. 24, 2018), http://www.entrepreneur.com/article/307918.

198 *See Cuba Sanctions*, U.S. DEP'T OF THE TREASURY, https://www.treasury.gov/resource-center/sanctions/Programs/pages/cuba.aspx (last visited Mar. 10, 2020).

199 Anneken Tappe, *Trade War Pain Gets Real: Harley Davidson Cites EU and China Tariffs for Weak Earnings*, CNN (April 23, 2019, 5:13 PM), https://www.cnn.com/2019/04/23/investing/harley-davidson-tariffs-earnings/index.html.

dealership is like a franchise in that it uses the trade name for a price.[200] Foreign relations and economic sanctions create unpredictability for franchises located internationally.[201] However, the benefits of breaking into a new growing market may outweigh these risks.

7. Foreign Currency Risks and Exchange Controls

The Company recognizes that financial results may be adversely affected by foreign exchange controls and risks associated with fluctuations in foreign currency exchange rates:

> Our results of operations and the value of our foreign assets are affected by fluctuations in currency exchange rates, which may adversely affect reported earnings. More specifically, an increase in the value of the U.S. dollar relative to other currencies, such as the Chinese Renminbi ("RMB"), Australian Dollar, the British Pound and the Euro, as well as currencies in certain other markets, such as the Malaysian Ringgit and Russian Ruble, could have an adverse effect on our reported earnings. There can be no assurance as to the future effect of any such changes on our results of operations, financial condition or cash flows. In addition, the Chinese government restricts the convertibility of RMB into foreign currencies and, in certain cases, the remittance of currency out of China. Yum China's income is almost exclusively derived from the earnings of its Chinese subsidiaries, with substantially all revenues of its Chinese subsidiaries denominated in RMB. Any significant fluctuation in the value of the RMB could materially impact the U.S. dollar value of royalty payments made to us by Yum China, which could result in lower revenues. In addition[,] restrictions on the conversion of RMB to U.S. dollars or further restrictions on the remittance of currency out of China could result in delays in the remittance of Yum China's license fee, which could impact our liquidity.[202]

8. Protection and Security of Personal Information

Cyberattacks remain a major threat to every business enterprise,[203] and a frus-

200 HARLEY-DAVIDSON UK, FAQS, https://www.harley-davidson.com/gb/en/about-us/company/becoming-a-dealer/faqs.html (last visited May 23, 2020).

201 *See Harley-Davidson Is an Early Casualty of Trade War*, BLOOMBERG (June 27, 2018, 10:27 AM), https://www.bloomberg.com/opinion/articles/2018-06-27/harley-davidson-is-an-early-casualty-of-trump-s-trade-war.

202 YUM 2018 Annual Report, *supra* note 3, at 9.

203 *See* David D. Schein & Lawrence J. Trautman, *The Dark Web and Employer Liability*, 18 COLO. TECH. L.J. 49, 59 (2020); Lawrence J. Trautman & Mason J. Molesky, *A Primer for Blockchain*, 88 UMKC L. REV. 239 (2019); Lawrence J. Trautman & Peter C. Ormerod, *Industrial Cyber Vulnerabilities: Lessons from Stuxnet and the Internet of Things*, 72 U. MIAMI L. REV. 761, 763 (2018); Lawrence J. Trautman, *Managing Cyberthreat*, 33 SANTA CLARA HIGH TECH. L.J. 230, 232 (2017); Lawrence J. Trautman, *Congressional Cybersecurity Oversight: Who's Who and How It Works*, 5 J.L. & CYBER WARFARE 147, 149 (2016); Lawrence J. Trautman, *Cybersecurity: What About U.S. Policy?*, 2015 U. ILL. J.L. TECH. & POL'Y 341, 344 (2015); Lawrence J. Trautman & George P. Michaely Jr., *The SEC and the Internet: Regulating the Web of Deceit*, 68 CONSUMER FIN. L.Q. REP. 262, 262 (2014); Lawrence J. Trautman, *How Law Operates in a Wired Global Society: Cyber and E-Commerce Risk* (Korea Legis. Res. Inst. (KLRI) Legal Scholar Roundtable 2017),

trating challenge for all corporate boards of directors.[204] Major breaches have taken place at Target,[205] Yahoo,[206] Equifax,[207] and Marriott,[208] just to name a few. Municipalities,[209] educational institutions,[210] and public utilities[211] remain at constant risk. Disclosure of customers' and users' private information has been a highly publicized issue for such media giants as Google[212] and Facebook.[213] Surely, data privacy will be a highly contested matter for numerous franchised entities, just as it is for other businesses having personal data associated with their employees, customers, or others.[214]

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https://ssrn.com/abstract=3033776; Lawrence J. Trautman et al., Governance of the Internet of Things (IoT) 2 (Jan. 27, 2020) (unpublished manuscript) (on file with author).

204 Lawrence J. Trautman & Janet Ford, *Nonprofit Governance: The Basics*, 52 AKRON L. REV. 971, 1029 (2018); Lawrence J. Trautman, *Who Sits on Texas Corporate Boards? Texas Corporate Directors: Who They Are & What They Do*, 16 HOUS. BUS. & TAX L.J. 44, 94 (2016); Lawrence J. Trautman, *Who Qualifies as an Audit Committee Financial Expert Under SEC Regulations and NYSE Rules?*, 11 DEPAUL BUS. & COM. L.J. 205, 233 (2013); Lawrence J. Trautman, *The Matrix: The Board's Responsibility for Director Selection and Recruitment*, 11 FLA. ST. U. BUS. REV. 75, 113 (2012) [hereinafter Trautman, *Matrix*]; Lawrence J. Trautman & Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*, 28 JOHN MARSHALL J. COMPUTER & INFO. L. 313, 321 (2011).

205 *See* Rachel Abrams, *Target to Pay $18.5 Million to 47 States in Security Breach Settlement*, N.Y. TIMES (May 23, 2017), https://www.nytimes.com/2017/05/23/business/target-security-breach-settlement.html.

206 Lawrence J. Trautman & Peter C. Ormerod, *Corporate Directors' and Officers' Cybersecurity Standard of Care: The Yahoo Data Breach*, 66 AM. U. L. REV. 1231, 1231 (2017).

207 *Equifax Data Breach Settlement*, FED. TRADE COMM'N (Jan. 2020), https://www.ftc.gov/equifax-data-breach.

208 *See* David Uberti, *Marriott Reveals Breach that Exposed Data of up to 5.2 Million Customers*, WALL STREET J. (Mar. 31, 2020, 4:29 PM), https://www.wsj.com/articles/marriott-reveals-breach-that-exposed-data-of-up-to-5-2-million-customers-11585686590.

209 Lawrence J. Trautman & Peter C. Ormerod, *WannaCry, Ransomware, and the Emerging Threat to Corporations*, 86 TENN. L. REV. 503, 535 (2019).

210 *Id.* at 535.

211 *See* Lawrence J. Trautman, *Is Cyberattack the Next Pearl Harbor?*, 18 N.C. J.L. & TECH. 233, 247 (2016).

212 *See* Lawrence J. Trautman, *How Google Perceives Customer Privacy, Cyber, E-commerce, Political and Regulatory Compliance Risks*, 10 WM. & MARY BUS. L. REV. 1, 38 (2018).

213 *See* Lawrence J. Trautman, *Governance of the Facebook Privacy Crisis*, 20 PITT. J. TECH. L. & POL'Y 43, 109–16 (2020).

214 This is an ongoing matter of grave concern for franchisors and franchisees internationally as well as in the United States. Helen Goff Foster, *The Privacy Franchise: U.S. States Go European with Data Protection Rules*, 22 FRANCHISE LAW. 13, 16 (2019) (discussing, in particular, the California Consumer Privacy Act, Cal. Civ. Code §§ 1798.100–.199, enacted in 2018 and coming fully into effect at the start of 2020); David L. Cahn & Jordan M. Halle, *At Your Service? Customer Account Ownership and Its Impact on Non-Competes, Control Determinations for Vicarious Liability, and Franchise Goodwill*, 39 FRANCHISE L.J. 39, 41 (2019) ("Under the European Union General Data Protection Regulation, if a company collects personal data for a particular purpose (e.g., in connection with the service contracts), that personal data can be used for another purpose only if the new purpose is compatible with the original purpose."); Susan Tegt, *The California Consumer Privacy Act and Franchising*, LARKIN HOFFMAN FRANCHISING: BLOG (Jan. 17, 2020), https://franchising.larkinhoffman.com/blog/the-california-consumer-privacy-act-and-franchising/.

9. National Labor Relations Board Regulations

YUM describes its potential risk due to a certain adverse determination from the National Labor Relations Board (NLRB) as follows:

> The National Labor Relations Board's (the "NLRB") standard for determining when two or more otherwise unrelated employers may be found to be a joint employer of the same employees under the National Labor Relations Act is uncertain and subject to change. In addition, the general counsel's office of the NLRB has issued complaints naming McDonald's Corporation as a joint employer of workers at its franchisees for alleged violations of the U.S. Fair Labor Standards Act. The NLRB's joint employer liability standard could cause us . . . to be liable or held responsible for unfair labor practices, violations of wage and hour laws, and other violations and could also require our Concepts to conduct collective bargaining negotiations regarding employees of our Concepts' franchisees. Further, there is no assurance that we or our Concepts will not receive similar complaints as McDonald's Corporation in the future, which could result in legal proceedings based on the actions of our Concepts' franchisees. In such events, our operating expenses may increase as a result of required modifications to our business practices, increased litigation, governmental investigations or proceedings, administrative enforcement actions, fines and civil liability.[215]

A court may find a franchisor liable for the actions of its franchisee under the theory of respondeat superior.[216] The court can find the franchisor liable if (1) "the franchisor gave the franchisee explicit authority to undertake a harmful action[,]" (2) "the franchisee exercised authority not explicitly granted by the franchisor, but based on explicit authority encompassing the harmful action[,]" or (3) "the franchisor expressed no direct authority to the franchisee, but third parties reasonably believed the franchisee was acting for the benefit of the franchisor."[217]

One day the franchise business may be unionized. The NLRB opened the door to this in the Browning-Ferris case.[218] Service Employees International Union (SEIU) wants to unionize the franchise industry.[219] This may not be good for the franchise business because unionizing could come with extra costs, derail job growth, and increase prices for consumers.[220]

10. Increase in Food Prices

As is the case for any participant in the restaurant business, "an increase in food prices may have an adverse impact on [YUM's] and our Concepts' franchisees' profit margins."[221] The Company provides the following description of this risk:

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215 YUM 2018 Annual Report, *supra* note 3, at 12.

216 Emerson, *Franchisee Independence*, *supra* note 40, at 291.

217 *Id.* at 291–92.

218 Hayden Ludwig, *NLRB Colludes with Big Labor to Unionize Franchises*, CAP. RES. CTR. (Sept. 11, 2017), https://capitalresearch.org/article/nlrb-colludes-with-big-labor-to-unionize-franchises/.

219 *See id.*

220 *Id.*

221 *See* YUM 2018 Annual Report, *supra* note 3, at 12.

> Our and our Concepts' franchisees' businesses depend on reliable sources of large quantities of raw materials such as proteins (including poultry, pork, beef and seafood), cheese, oil, flour and vegetables (including potatoes and lettuce). Raw materials purchased for use in our Concepts' restaurants are subject to price volatility caused by any fluctuation in aggregate supply and demand, or other external conditions, such as weather conditions or natural events or disasters that affect expected harvests of such raw materials. As a result, the historical prices of raw materials used in the operation of our Concepts' restaurants have fluctuated. We cannot assure you that we or our Concepts' franchisees will continue to be able to purchase raw materials at reasonable prices, or that the cost of raw materials will remain stable in the future. In addition, a significant increase in gasoline prices could result in the imposition of fuel surcharges by our distributors.
>
> Because we and our Concepts' franchisees provide competitively priced food, we may not have the ability to pass through to our customers the full amount of any commodity price increases. If we and our Concepts' franchisees are unable to manage the cost of raw materials or to increase the prices of products proportionately, our and our franchisees' profit margins may be adversely impacted.[222]

The agriculture industry is volatile. It also brings polarized desires to the forefront. Consumers benefit from low prices, but the producers of food benefit from high prices.[223] As a consumer, every franchisor and franchisee want food prices to be low. However, that is not always possible.

One particular concern for franchises is food cost inflation.[224] In January 2020, the cost of food increased by 1.8%.[225] In the average United States city, the cost of things such as beef and pork is consistently increasing.[226] On the other hand, the cost of poultry in January 2020 is lower than what it was in the previous year.[227] The food volatility will affect each industry differently. For example, Pizza Hut, which depends on tomatoes for its pizza sauce, will experience a lower cost of tomatoes.[228] This is a change because the cost has been increasing steadily since 2013.[229]

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222 *Id.*

223 Eugenio Díaz-Bonilla, *Volatile Volatility: Conceptual and Measurement Issues Related to Price Trends and Volatility*, *in* FOOD PRICE VOLATILITY AND ITS IMPLICATIONS FOR FOOD SECURITY AND POLICY 36 (Matthias Kalkuhl et al., eds., 2016).

224 *Id.* at 38.

225 *United States Food Inflation*, TRADING ECON. (Mar. 2020), https://tradingeconomics.com/united-states/food-inflation.

226 *Average Retail Food and Energy Prices, U.S. and Midwest Region*, U.S. BUREAU OF LAB. & STAT., https://www.bls.gov/regions/midatlantic/data/averageretailfoodandenergyprices_usandmidwest_table.htm (last visited Mar. 2, 2020).

227 *Id.*

228 In January of 2018, the cost of tomatoes was $2.336. It lowered to $2.227 in January of 2019. *Id.*; *see also Cheese Pizza Nutrition Facts*, NUTRITIONIX, https://m.nutritionix.com/pizza-hut/cheese-medium-original-pan-slice/?show (last visited Mar. 4, 2020).

229 *CPI Average Price Data for Field Grown Tomatoes*, U.S. BUREAU OF LAB. & STAT. (Mar. 2, 2020), https://data.bls.gov/timeseries/APU0000712311?amp%253bdata_tool=XGtable&output_view=data&include_graphs=true.

Agriculture needs anywhere from 1.5 to 2 million hired workers and at least 50–70% of farm laborers in the United States today are unauthorized to legally work.[230] The impacts of an enforcement-only approach to immigration would be detrimental to the agricultural industry.[231] If agriculture were to lose access to all undocumented workers, agricultural output would fall by $30 to $60 billion.[232] The enforcement-only option would increase food prices by 5–6%.[233]

Immigration also plays an integral role in farming and food prices.[234] The United States food system relies heavily on immigrant farm workers; an estimated 60–80% of farm workers are immigrants.[235] In the agricultural industry, concerns have been raised as to whether changes in immigration laws have or will impact farming. Through immigration programs like the H-2A visa, farmers are able to hire immigrant workers.[236] However, this visa process has recently been slowed with bureaucratic processes, causing most farmers to need legal aid or wait for long periods of time.[237] As a result of this process, the farming industry has experienced a labor shortage.[238] Due to this labor shortage, food prices are predicted to rise.[239]

Aside from immigration policy changes, an increase in food prices may also be correlated to higher gas prices/transportation costs.[240] Generally, the further food has to travel, the higher its prices will be.[241] Moreover, franchise agreements will include a list of approved suppliers and a channel to submit a request for a franchisee to change its supplier.[242] However, franchisors that wish to have more oversight may have stricter guidelines for the franchise's approved suppliers.

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230 *Economic Impact of Immigration*, AM. FARM BUREAU FED'N, https://www.fb.org/issues/immigration-reform/agriculture-labor-reform/economic-impact-of-immigration (last visited Mar. 2, 2020).

231 *Id.*

232 *Id.*

233 *Id.*

234 Jessica Kurn, *Immigration and the Food System*, FARM AID (Aug. 24, 2018), https://www.farmaid.org/blog/fact-sheet/immigration-and-the-food-system/.

235 *Id.*

236 *H-2A Temporary Agricultural Workers*, U.S. CITIZEN & IMMIGR. SERV. (Jan. 16, 2020), https://www.uscis.gov/working-united-states/temporary-workers/h-2a-temporary-agricultural-workers (stating qualifications for H-2A visa classification and the required paperwork).

237 *Economic Impact of Immigration*, *supra* note 230.

238 *Id.*

239 *Id.*

240 Kimberly Amadeo, *Why Food Prices Are Rising, Recent Trends, and 2019 Forecast*, BALANCE (Dec. 13, 2019), https://www.thebalance.com/why-are-food-prices-rising-causes-of-food-price-inflation-3306099.

241 Richard Volpe et al., *How Transportation Costs Affect Fresh Fruit and Vegetable Prices*, U.S. DEP'T OF AGRIC. (Nov. 2013), https://www.ers.usda.gov/webdocs/publications/45165/41076_err160-summary.pdf?v=41614.

242 *E.g.*, Rocky Mountain Chocolate Factory Franchise Agreement 16 (2005), https://www.sec.gov/Archives/edgar/data/785815/000095013405013229/d26962exv10w4.htm (example that includes agreement of approved vendors and method to change supplier).

An important part of franchising is uniformity.[243] Customers expect a similar experience to the one they had at other franchise locations.[244] Franchisors like for their franchisees to use prescribed food and supplies from certain companies.[245] When franchisees deviate from the prescribed food and supplies, it can tarnish the brand name, lead to consumer confusion, lead to a loss of control by the franchisor, make the franchisor lose money with the use of outside vendors, and make it harder for the franchisor to assure quality and safety.[246]

11. Dilution in Brand

YUM discloses its risk of potential vulnerability to brand dilution as follows:

> Although we monitor and regulate franchisee activities through our Concepts' franchise agreements, franchisees or other third parties may refer to or make statements about our Concepts' brands that do not make proper use of our trademarks or required designations, that improperly alter trademarks or branding, or that are critical of our Concepts' brands or place our Concepts' brands in a context that may tarnish their reputation. This may result in dilution of, or harm to, our intellectual property or the value of our Concepts' brands.
>
> Franchisee noncompliance with the terms and conditions of our franchise agreements may reduce the overall goodwill of our Concepts' brands, whether through the failure to meet health and safety standards, engage in quality control or maintain product consistency, or through the participation in improper or objectionable business practices. Moreover, unauthorized third parties, including our Concepts' current and former franchisees, may use our intellectual property to trade on the goodwill of our Concepts' brands, resulting in consumer confusion or dilution. Any reduction of our Concepts' brands' goodwill, consumer confusion, or dilution is likely to impact sales, and could materially and adversely impact our business and results of operations.[247]

Courts do not take the infringement of trademarks in the franchise context lightly. In *Petro Franchise Systems, LLC v. All American Properties, Inc.*,[248] a franchisee continued to use the franchisor's protected mark after defaulting on its franchise agreement.[249] The United States District Court for the Western District of Texas granted preliminary injunctive relief to the franchisor.[250]

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243 F. Joseph Dunn et al., *Why Can't I Buy This Instead? The Issue of Unauthorized Products and Suppliers in Franchise Systems*, 1 (Int'l Franchise Ass'n, May 2016).

244 *Id.*

245 *Id.*

246 *Id.* at 1–4.

247 YUM 2018 Annual Report, *supra* note 3, at 12.

248 Petro Franchise Sys., LLC v. All Am. Props., Inc., 607 F. Supp. 2d 781, 781 (W.D. Tex. 2009).

249 *Id.* at 800–801; *see also* Hosp. Int'l v. Mahtani, No. 2:97CV87, 1998 U.S. Dist. LEXIS 16445, at **92–93 (M.D.N.C. Aug. 3, 1998) (holding that the franchisor was entitled to compensatory damages and prejudgment interests and costs for its claim against its franchisee for trademark infringement).

250 The Court used the Lanham Act, 15 U.S.C. §§ 1114, 1125(a) to protect the franchise in its trademark infringement claim. Petro Franchise Sys., LLC., 607 F. Supp. 2d at 801; *Preliminary*

It is absolutely vital for a franchisor to monitor the franchisees and ensure that they are operating in accordance with the franchise agreement and the overall brand.[251] Franchisors are required by the Lanham Act to assert a degree of control over the franchisor's trademark, or the franchisor can lose the trademark.[252] An example of a franchisor that failed to do so is Kmart, which ended up irreparably harming the franchise.[253] Individuals that experience an unpleasant service or product will no longer rely on said service or product.[254]

Additionally, franchisors may desire to have a larger percentage of corporate ownership if the value of their brand is relatively high.[255] This is because of what is commonly known as free-riding. Free-riding is enjoying the benefits of another's work without engaging in the costs or effort.[256] It gives the free-rider an unfair advantage because it takes advantage of what one party creates without having to pay any of the costs in gathering the information or developing that information for a useful purpose. In the franchise context, it occurs when one franchise location enjoys the goodwill and brand value of a franchise without paying the costs of adhering to the franchise standards.[257]

To avoid free-riding, franchisors are encouraged to take a more involved position in the franchise or increase the frequency with which they observe the behavior of franchisees.[258] Furthermore, a franchisor should use its best tool for anti-free-riding measures, the power of termination.[259] On the franchisee's end, a franchisee should encourage the franchisor to monitor or act against free-riding franchisees. A franchisee does not benefit at all from free-riding and can only be harmed. Additionally, it is a franchisee's brand as well. Depending on the length of the franchise agreement and the paid investments, a franchisee is often committed for the long-haul.

Along the lines of brand protection, it is important that a franchisor focuses on maintaining what it is. By all means, a franchisor should strive to improve its product or perhaps target additional demographics. However, it should not lose

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Injunction, LEGAL INFO. INST., https://www.law.cornell.edu/wex/preliminary_injunction (last visited May 23, 2019) (noting that a preliminary injunction is an order by the court, before or during trial, which helps preserve the status quo before a final judgment).

251 Brian B. Schnell & Ronald K. Gardner, Jr., *Battle Over the Franchisor Business Judgment Rule and the Path to Peace*, 35 FRANCHISE L.J. 167, 168 (2015).

252 Tractenberg et al., *supra* note 66, at 89 n.11.

253 TURNER, *supra* note 155, at 13 (citing a lack of quality in its stores as a reason for its failure).

254 Emerson & Parnell, *supra* note 128, at 355–56.

255 BLAIR & LAFONTAINE, *supra* note 46, at 115.

256 *See, e.g.*, Agora Fin., LLC v. Samler, 725 F. Supp. 2d 491, 499 (D. Md. 2010) (referring to free-riding in the context of news articles).

257 Free-riding is the "feeding on the goodwill of the special well-known trademark." NG-LOY LOON, LAW OF INTELLECTUAL PROPERTY OF SINGAPORE 288 (Thomson Sweet & Maxwell Asia rev. ed. 2008); *see also* DANIEL R. BERESKIN & RONALD J. LEHRMAN, INTERNATIONAL TRADEMARK DILUTION § 18:4 (2019).

258 BLAIR & LAFONTAINE, *supra* note 46, at 115.

259 Doug Berry, *Using the Franchise Agreement to Discourage Free-Riding*, ZORBLOG, (July 7, 2014), https://www.zorbloglaw.com/2014/07/using-the-franchise-agreement-to-discourage-free-riding/.

track of the ideas its customers associate with it. Brand dilution can occur either at the franchisee or the franchisor level, and both are equally deadly to the overall success of a franchise.[260]

For example, if one develops a low-cost franchise, that same franchise should be extremely careful if attempting to provide high-quality goods. Kmart was known as a "low-cost, commodity goods provider."[261] When the store was referred to in modern media, parodies included, it was referring to the things that made Kmart unique.[262] When the company began to experience difficulties, mainly from the emergence of competing low-cost stores,[263] Kmart failed to respond effectively.[264]

In franchising, sometimes the easy answer to competition may not be the effective, long-term response. For example, some franchisors have refused to remove provisions related to poaching.[265] Cases are pending against companies like H&R Block, Jiffy Lube, and several other fast-food restaurants.[266] The DOJ takes the "position that naked no-poach agreements are per se unlawful."[267] It is unknown at this time whether the courts will agree with the DOJ's position. More broadly, as a business development matter, trying to keep one franchisee from hiring good workers at another franchisee within the franchise system via broad, contractual prohibitions may only lead to the best workers simply leaving the franchise system altogether.

12. Corporate Reputation

Corporate reputation may be an intangible asset; however, a negative impact to reputation has a very real cost to shareholders and employees—and impacts the ability to attract new employees.[268] YUM discusses its reputation risk as follows:

> Our success depends in large part upon our ability and our Concepts' franchisees' ability to maintain and enhance the value of our brands and our customers' loyalty to our brands. Brand value is based in part on consumer perceptions on a variety of subjective qualities. Business incidents, whether isolated or recurring, and whether originating from us, franchisees, competitors, suppliers or distributors, can significantly reduce brand value and

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260 TURNER, *supra* note 155, at 14 (stating Kmart's marketing efforts have "diluted and confused the core essence of the Kmart brand").

261 *Id.*

262 Charisse Jones, *Attention Kmart Shoppers: ABC's Jimmy Kimmel Live Has a Deal for You*, USA TODAY (Nov. 8, 2017, 5:15 PM), https://www.usatoday.com/story/money/2017/11/08/attention-kmart-shoppers-jimmy-kimmel-has-deal-you/840884001/ (describing a late-night comedy sketch concerning the "Bluelight Specials" offered by Kmart).

263 Paul Leinwand & Cesare Mainardi, *Why Can't Kmart Be Successful While Target and Walmart Thrive?*, HARV. BUS. REV. (Dec. 15, 2010), https://hbr.org/2010/12/why-cant-kmart-be-successful-w (comparing the tactics of Kmart, Walmart, and Target).

264 TURNER, *supra* note 155, at 61.

265 Boris Bershteyn et al., *No-Poach Update: DOJ Seeks to Rein In Franchise Suits*, MONDAQ (Feb. 15, 2019), https://www.mondaq.com/uk/Anti-trustCompetition-Law/781448/No-Poach-Update-DOJ-Seeks-To-Rein-In-Franchise-Suits.

266 *Id.*

267 *Id.*

268 *See generally* Marianne Jennings & Lawrence J. Trautman, *Ethical Culture and Legal Liability: The GM Switch Crisis and Lessons in Governance*, 22 B.U. J. SCI. & TECH. L. 187 (2016).

> consumer trust, particularly if the incidents … result in litigation. For example, our Concepts' brands could be damaged by claims or perceptions about the quality or safety of our products or the quality or reputation of our suppliers, distributors or franchisees, regardless of whether such claims or perceptions are true. Similarly, entities in our supply chain may engage in conduct, including alleged human rights abuses or environmental wrongdoing, and any such conduct could damage our or our Concepts' brands' reputations. Any such incidents (even if resulting from actions of a competitor or franchisee) could cause a decline directly or indirectly in consumer confidence in, or the perception of, our Concepts' brands and/or our products and reduce consumer demand for our products, which would likely result in lower revenues and profits. Additionally, our corporate reputation could suffer from a real or perceived failure of corporate governance or misconduct by a Company officer, or an employee or representative of us or a franchisee.[269]

13. Litigation

The Company describes this topic by observing that litigation "could adversely affect us by increasing our expenses, diverting management attention or subjecting us to significant monetary damages and other remedies."[270] In addition:

> We are regularly involved in legal proceedings, which include consumer, employment, real estate related, tort, intellectual property, breach of contract, securities, derivative and other litigation. See the discussion of legal proceedings in Note 20 to the Consolidated Financial Statements included in Item 8 of this Form 10-K [herein omitted]. Plaintiffs in these types of lawsuits often seek recovery of very large or indeterminate amounts, and the magnitude of the potential loss relating to such lawsuits may not be accurately estimated. Regardless of whether any such claims have merit, or whether we are ultimately held liable or settle, such litigation may be expensive to defend and may divert resources and management attention away from our operations and negatively impact reported earnings. With respect to insured claims, a judgment for monetary damages in excess of any insurance coverage could adversely affect our financial condition or results of operations. Any adverse publicity resulting from these allegations may also adversely affect our reputation, which in turn could adversely affect our results of operations.
>
> In addition, the restaurant industry around the world has been subject to claims that relate to the nutritional content of food products, as well as claims that the menus and practices of restaurant chains have led to customer health issues, including weight gain and other adverse effects. These concerns could lead to an increase in the regulation of the content or marketing of our products. We may also be subject to such claims in the future and, even if we are not, publicity about these matters (particularly directed at the quick service and fast-casual segments of the retail food industry) may harm our reputation and adversely affect our business, financial condition and results of operations.[271]

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269 YUM 2018 Annual Report, *supra* note 3, at 12–13.

270 *Id.* at 13.

271 *Id.*

In *Hospitality Int'l v. Mahtani*, a franchisee violated 15 U.S.C. § 1125 by using franchisors' registered service mark after being terminated, causing a likelihood of confusion as the mark's use indicated a continued affiliation to the public.[272] The court awarded 25% of franchisee's known gross sales as profits and then trebled those damages.[273] Damages were comprised of the initial franchise fee, monthly royalty, reservation sales center, and advertising fees; franchise sales expenses were also awarded and trebled due to franchisee's willful and intentional violation.[274]

14. Governmental Regulations

A major challenge for any enterprise—especially those operating in international markets—is the understanding of, and compliance with, various governmental regulations. YUM states that "changes in, or noncompliance with, governmental regulations may adversely affect our business operations, growth prospects or financial condition."[275] In addition YUM states:

> Our Concepts and their franchisees are subject to numerous laws and regulations around the world. These laws change regularly and are increasingly complex. For example, we are subject to:
>
> - The Americans with Disabilities Act in the U.S. and similar state laws that give civil rights protections to individuals with disabilities in the context of employment, public accommodations and other areas.
> - The U.S. Fair Labor Standards Act, which governs matters such as minimum wages, overtime and other working conditions, as well as family leave mandates and a variety of similar state laws that govern these and other employment law matters.
> - Laws and regulations in government-mandated health care benefits such as the Patient Protection and Affordable Care Act.
> - Laws and regulations relating to nutritional content, nutritional labeling, product safety, product marketing and menu labeling.
> - Laws relating to state and local licensing.
> - Laws relating to the relationship between franchisors and franchisees.
> - Laws and regulations relating to health, sanitation, food, workplace safety, child labor, including laws prohibiting the use of certain "hazardous equipment" by employees younger than the age of 18 years of age, and fire safety and prevention.
> - Laws and regulations relating to union organizing rights and activities.

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272 Hosp. Int'l v. Mahtani, No. 2:97CV87, 1998 U.S. Dist. LEXIS 16445, at *22–23 (M.D.N.C. Aug. 3, 1998).

273 *Id.* at *45.

274 *Id.* at *78.

275 YUM 2018 Annual Report, *supra* note 3, at 13.

- Laws relating to information security, privacy (including the European Union's GDPR, which will become effective in May 2018), cashless payments, and consumer protection.
- Laws relating to currency conversion or exchange.
- Laws relating to international trade and sanctions.
- Tax laws and regulations.
- Anti-bribery and anti-corruption laws.
- Environmental laws and regulations.
- Federal and state immigration laws and regulations in the U.S.

> . . . The compliance costs associated with these laws and regulations could be substantial. Any failure . . . to comply with these laws or regulations could adversely affect our reputation, international expansion efforts, growth prospects and financial results or result in, among other things, litigation, revocation of required licenses, internal investigations, governmental investigations or proceedings, administrative enforcement actions, fines and civil and criminal liability. Publicity relating to any such noncompliance could also harm our reputation and adversely affect our revenues.[276]

15. Anti-Bribery and Anti-Corruption Laws

Elsewhere, Trautman and Kimbell have observed: "Much has been written during recent years about the problem of pervasive global bribery and corruption."[277] YUM provides the following description of how its "[f]ailure to comply

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276 *Id.* at 13–14.

277 Lawrence J. Trautman & Joanna Kimbell, *Bribery and Corruption: The COSO Framework, FCPA, and U.K. Bribery Act*, 30 FLA. J. INT'L L. 191, 194 (2018) (citing Bruce W. Bean, *The Perfect Crime? FIFA and the Absence of Accountability in Switzerland*, 32 U. MD. J. INT'L L. 68 (2017)); *see* Rachel Brewster, *Enforcing the FCPA: International Resonance and Domestic Strategy*, 103 VA. L. REV. 1611, 1613 (2017); Nishant Dass et al., *Geographic Clustering of Corruption in the U.S.* (PARIS DEC. 2017 FIN. MEETING EUROFIDAI–AFFI, 2019), https://ssrn.com/abstract=2981317; Eugen Dimant & Guglielmo Tosato, *Causes and Effects of Corruption: What Has Past Decade's Empirical Research Taught Us? A Survey*, 32 J. ECON. SURVS. 335, 335 (2018); David Hess, *Business, Corruption, and Human Rights: Towards a New Responsibility for Corporations to Combat Corruption*, 2017 WIS. L. REV. 641, 642 (2017); Yujin Jeong & Jordan I. Siegel, *Threat of Falling High Status and Corporate Bribery: Evidence from the Revealed Accounting Records of Two South Korean Presidents*, 39 STRATEGIC MGMT. J. 1083, 1083 (2018); Robert W. McGee, *The Panama Papers: A Discussion of Some Ethical Issues*, 3 J. INS. & FIN. MGMT., no. 3, 2017, at 1–2; Sharon Oded, *Coughing Up Executives or Rolling the Dice?: Individual Accountability for Corporate Corruption*, 35 YALE L. & POL'Y REV. 49, 50 (2016); Jamie Bologna Pavlik, *Corruption: The Good, the Bad, and the Uncertain*, 22 REV. DEV. ECON. 311, 311 (2018); Andrew Brady Spalding, *Restoring Pre-Existing Compliance Through the FCPA Pilot Program*, 48 U. TOLEDO L. REV. 519, 520 (2017); Lawrence J. Trautman, *Grab 'Em By The Emoluments: The Crumbling Ethical Foundation of Donald Trump's Presidency*, 17 CONN. PUB. INT. L.J. 169, 219 (2018); Lawrence J. Trautman, *Following the Money: Lessons from the Panama Papers, Part 1: Tip of the Iceberg*, 121 PENN ST. L. REV. 807, 842 (2017); Lawrence J. Trautman, *American Entrepreneur in China: Potholes and Roadblocks on the Silk Road to Prosperity*, 12 WAKE FOREST J. BUS. & INTEL PROP. L. 427, 491–492 (2012); Lawrence J. Trautman & Kara Altenbaumer-Price, *The Foreign Corrupt Practices Act: Minefield for Directors*, 6 VA. L. & BUS. REV. 145, 146 (2011); Maria T. Caban-Garcia, *Antibribery Efforts in Brazil*, STRATEGIC FIN. (Mar. 1, 2017), https://sfmagazine.com/post-entry/march-2017-antibribery-efforts-in-brazil/; M. Shahe Emran et al., *Distributional Effects of Corruption when*

with anti-bribery or anti-corruption laws could adversely affect"[278] its business operations:

> The U.S. Foreign Corrupt Practices Act, the UK Bribery Act and other similar applicable laws prohibiting bribery of government officials and other corrupt practices are the subject of increasing emphasis and enforcement around the world. Although we have implemented policies and procedures designed to promote compliance with these laws, there can be no assurance that our employees, contractors, agents or other third parties will not take actions in violation of our policies or applicable law, particularly as we expand our operations in emerging markets and elsewhere. Any such violations or suspected violations could subject us to civil or criminal penalties, including substantial fines and significant investigation costs, and could also materially damage our reputation, brands, international expansion efforts and growth prospects, business and operating results. Publicity relating to any noncompliance or alleged noncompliance could also harm our reputation and adversely affect our revenues and results of operations.[279]

16. Tax Matters

Given the complexities associated with real estate construction and international operations, "[t]ax matters, including changes in tax rates or laws, disagreements with taxing authorities and imposition of new taxes could impact . . . operations and financial condition."[280] The YUM spin-off of operations in China raises issues of potential U.S. tax liability,[281] and China indirect transfer tax.[282] YUM describes its general tax situation as follows:

> We are subject to income taxes as well as non-income-based taxes, such as payroll, sales, use, value-added, net worth, property, withholding and franchise taxes in both the U.S. and various foreign jurisdictions. We are also subject to ongoing and/or regular reviews, examinations and audits by the U.S. Internal Revenue Service ("IRS") and other taxing authorities with respect to such income and non-income based taxes inside and outside of the U.S. In connection with the Organization for Economic Co-operation and Development's Base Erosion and Profit Shifting project, companies are now required to disclose more information to tax authorities on their global operations, which may lead to greater audit scrutiny of profits earned in various countries. Our accruals for tax liabilities are based on past experience, interpretations of applicable law, and judgments about potential actions by tax authorities, but because such accruals require significant judgment the ultimate resolution of any tax matters may result in payments greater than the amounts accrued. If the IRS or another taxing authority disagrees with our tax positions, we could face additional tax liabilities, including interest and penalties. Payment of additional amounts upon final settlement or

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Enforcement Is Biased: Theory and Evidence from Bribery in Schools in Bangladesh (Feb. 17, 2018) (unpublished manuscript).

278 YUM 2018 Annual Report, *supra* note 3, at 14.

279 *Id.*

280 *Id.*

281 *Id.*

282 *Id.* at 15.

> adjudication of any disputes could have a material impact on our results of operations and financial position.
>
> In addition, we are directly and indirectly affected by new tax laws and regulation and the interpretation of tax laws and regulations worldwide. Changes in laws, regulation or interpretation of existing laws and regulations in the U.S. and other jurisdictions where we are subject to taxation could increase our taxes and have an adverse effect on our results of operations and financial condition.
>
> On December 22, 2017, the U.S. government enacted comprehensive Federal tax legislation commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "Tax Act") which significantly modifies the U.S. corporate income tax system. Due to the timing of the enactment and the complexity involved in applying the provisions of the Tax Act, we have made reasonable estimates of its effects . . . . These provisional amounts include a one-time mandatory deemed repatriation tax on accumulated foreign earnings, the remeasurement of certain net deferred tax assets and liabilities and the establishment of a valuation allowance on our foreign tax credits. . . . The final impacts of the Tax Act may differ from current estimates and provisional amounts recorded, possibly materially, due to, among other things, changes in interpretations of the Tax Act, changes in accounting standards for income taxes or related accounting interpretations in response to the Tax Act, or updates or changes to estimates the Company has utilized to calculate the provisional impacts.[283]

17. Intellectual Property Protection

For a business enterprise such as YUM, service marks or other intellectual property is important. The Company describes how failure to successfully protect these assets could result in substantial harm:

> We regard our Yum®, KFC®, Pizza Hut® and Taco Bell® service marks, and other service marks and trademarks related to our restaurant businesses, as having significant value and being important to our marketing efforts. We rely on a combination of protections provided by contracts, copyrights, patents, trademarks, service marks and other common law rights, such as trade secret and unfair competition laws, to protect our restaurants and services from infringement. We have registered certain trademarks and service marks in the U.S. and foreign jurisdictions. However, from time to time we become aware of names and marks identical or confusingly similar to our service marks being used by other persons. Although our policy is to oppose any such infringement, further or unknown unauthorized uses or other misappropriation of our trademarks or service marks could diminish the value of our brands and adversely affect our business. In addition, effective intellectual property protection may not be available in every country in which our Concepts have, or intend to open or franchise, a restaurant. There can be no assurance that these protections will be adequate, and defending or enforcing our service marks and other intellectual property could result in the expenditure of significant resources. We may also face claims of infringement that could interfere with the use of the proprietary know-how, concepts, recipes, or trade secrets used in our business. Defending against such claims may be

[283] *Id.* at 14.

> costly, and we may be prohibited from using such proprietary information in the future or forced to pay damages, royalties, or other fees for using such proprietary information, any of which could negatively affect our business, reputation, financial condition, and results of operations.[284]

Cost alone is enough to show the benefit of using someone else's intellectual property. Rather than paying the upfront costs for a trademark, patent, or copyright, an individual can license the intellectual property and pay a royalty or fee to the original owner. Further, if the licensee is using a well-reputed brand, the licensee will have a jump start in profit solely based on using a popular name—which probably took the original owner years to build up.

18. Economic Conditions and Changes in Consumer Spending

As is the case for almost every business enterprise, YUM is aware of potential adverse risks from deteriorating economic conditions or changes in consumer discretionary spending. The Company provides the following description:

> Purchases at our Concepts' restaurants are discretionary for consumers and, therefore, our results of operations are susceptible to economic slowdowns and recessions. Our results of operations are dependent upon discretionary spending by consumers, which may be affected by general economic conditions globally or in one or more of the markets we serve. Some of the factors that impact discretionary consumer spending include unemployment rates, fluctuations in the level of disposable income, the price of gasoline, stock market performance and changes in the level of consumer confidence. These and other macroeconomic factors could have an adverse effect on our sales, profitability or development plans, which could harm our financial condition and operating results.[285]

19. Debt Load

YUM states that "[o]ur substantial indebtedness makes us more sensitive to adverse economic conditions, may limit our ability to plan for or respond to significant changes in our business, and requires a significant amount of cash to service our debt payment obligations that we may be unable to generate or obtain."[286] The Company further states:

> In connection with the announcement of our strategic transformation plans, we have increased our indebtedness from approximately $4 billion to approximately $10 billion. The proceeds from the debt were primarily used to return capital to shareholders through share repurchases and dividends. Subject to the limits contained in the agreements governing our indebtedness, we may be able to incur additional debt from time to time, which would intensify the risks related to our high level of indebtedness.
>
> Specifically, our high level of indebtedness could have important potential consequences, including, but not limited to:

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284 *Id.* at 15.

285 *Id.* at 16.

286 *Id.*

- increasing our vulnerability to, and reducing our flexibility to plan for and respond to, adverse economic and industry conditions and changes in our business and the competitive environment;
- requiring the dedication of a substantial portion of our cash flow from operations to the payment of principal of, and interest on, indebtedness, thereby reducing the availability of such cash flow to fund working capital, capital expenditures, acquisitions, dividends, share repurchases or other corporate purposes;
- increasing our vulnerability to a further downgrade of our credit rating, which could adversely affect our cost of funds, liquidity and access to capital markets;
- restricting us from making strategic acquisitions or causing us to make non-strategic divestitures;
- placing us at a disadvantage compared to other less leveraged competitors or competitors with comparable debt at more favorable interest rates;
- increasing our exposure to the risk of increased interest rates insofar as current and future borrowings are subject to variable rates of interest;
- making it more difficult for us to repay, refinance or satisfy our obligations with respect to our debt;
- limiting our ability to borrow additional funds in the future and increasing the cost of any such borrowing;
- imposing restrictive covenants on our operations, which, if not complied with, could result in an event of default, which in turn, if not cured or waived, could result in the acceleration of the applicable debt, and may result in the acceleration of any other debt to which a cross-acceleration or cross-default provision applies; and
- increasing our exposure to risks related to fluctuations in foreign currency as we earn profits in a variety of currencies around the world and our debt is denominated in U.S. dollars.

There is no assurance that we will generate cash flow from operations or that future debt or equity financings will be available to us to enable us to pay our indebtedness or to fund other liquidity needs. If our business does not generate sufficient cash flow from operation in the amounts projected or at all, or if future borrowings are not available to us in amounts sufficient to pay our indebtedness or to fund other liquidity needs, our financial condition and results of operations may be adversely affected. As a result, we may need to refinance all or a portion of our indebtedness on or before maturity. There is no assurance that we will be able to refinance any of our indebtedness on favorable terms, or at all. Any inability to generate sufficient cash flow or

> refinance our indebtedness on favorable terms could have a material adverse effect on our business and financial condition.[287]

Numerous franchise operators that were once household names have gone bankrupt and materially disappeared, such as: Tower Records,[288] Blockbuster Video, and Howard Johnson's, "once the country's largest restaurant chain."[289] Blockbuster, a 9,000-store chain only 15 years ago, was no longer conducting business operations by the end of 2011.[290] While we compare same-industry fast-food franchisors YUM and the former Schlotzsky's, like comparisons could be done for two franchise networks in other industries such as hospitality, gyms/exercise centers, or tutoring centers.

V. SCHLOTZSKY'S

We have decided to use the failed example of Schlotzsky's, Inc., ("Schlotzsky's" or the "Company"), formerly a franchisor and operator of "524 franchised restaurants and 37 Company-operated restaurants located in 37 states, the District of Columbia and six foreign countries"[291] to illustrate an example of an undercapitalized franchise operation in crisis. We hasten to add that our 2003–04 example bears no relationship to the current entity operating restaurants of a similar name. Despite Schlotzsky's reported revenues for 2003 of approximately $56.2 million,[292] eight months later (August 3, 2004), the Company entered bankruptcy.[293]

A. *The Company*

1. *Early History*

Journalist Amy Smith describes it this way: "[I]n the beginning, there was this sandwich as big as your head. It came with three meats, cheeses, lettuce, tomato, olives and herb dressing on a delicious and perfectly textured sourdough bun. You could down one of those and sleep like a baby the rest of the afternoon."[294] Introducing a single sandwich and shop to Austin in 1971, the "$2.95 Original was the first and only child of Schlotzsky's founders Don and Delores Dissman, who modeled the sandwich on the muffulettas they discovered in an Italian grocery store in the French Quarter of New Orleans."[295] Then, in 1981 brothers John C. Wooley, Jeffrey J. Wooley, and another partner acquired the 100-unit franchisor with $18

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287 *Id.* at 16–17.

288 Tiffany Hsu, *A 9,000-Store Chain Has Closed 8,999. How Does That Work?*, N.Y. TIMES, Mar. 7, 2019, at B3.

289 *See id.*

290 *See* Blockbuster, Inc., Annual Report (Form 10-K) 5 (July 12, 2012); *see also* Hsu, *supra* note 288, at B3.

291 *See* Schlotzsky's, Inc., Annual Report (Form 10-K) 2 (Dec. 31, 2003).

292 *Id.* at 2.

293 *See* Schlotzsky's, Inc., Quarterly Report (Form 10-Q) 5 (June 30, 2004).

294 *See* Amy Smith, *Original History: The Schlotzsky's History Begins with a Really Big Sandwich*, AUSTIN CHRON. (Oct. 8, 2004), https://www.austinchronicle.com/news/2004-10-08/232204/.

295 *Id.*

million in sales for $3 million.[296] "[F]or the next six years [the Wooley brothers and their partner] concentrated their efforts on improving the existing franchise system."[297] In its annual report for the period ending December 31, 1996, the Company reported:

> Between 1987 and 1990, management focused on expanding the Company's business by developing Company-owned stores, as well as franchising. During this period, 16 Company-owned and 67 franchised stores were opened. In 1990 and 1991, the Company closed or sold 20 of its Company-owned stores due to difficulties with operations, and beginning in the fourth quarter of 1991, management adopted the strategy of developing only franchised stores and relying on area developers to recruit and support franchisees. In late 1991 and 1992, the Company concentrated on building its network of area developers throughout the United States. The addition of area developers has resulted in an increasing rate of store openings during the last three years.[298]

Schlotzsky's disclosed that "from 1981 to 1991, management tested different strategies to expand the Company's business, including the development of Company-owned stores and expanded store menus."[299] During 1991, Schlotzsky's began a strategy for "becoming a leader in the specialty sandwich segment of the restaurant industry in the United States" by implementing:

> The key elements of this strategy [which] are to: offer an expanded menu of consistent, high quality foods featuring the Company's proprietary sourdough bread recipe, complemented by excellent customer service; utilize area developers to decentralize franchisee recruiting and support; develop a strong network of motivated owner-operator franchisees; implement a turnkey development program to secure superior sites and accelerate market penetration; develop new stores in high visibility, free-standing locations; and increase awareness of the Schlotzsky's brand through enhanced marketing and private label products.[300]

2. 1993 Entity Restructure and Formation

The history of the Schlotzsky's entities we are discussing here effectively dates back to early 1993 as described here:

> Schlotzsky's, Inc. (the "Company") was formed effective January 1, 1993, when Schlotzsky's Franchising Limited Partnership, Schlotzsky's-Houston, Ltd., Schlotzsky's-San Antonio, Ltd., Schlotzsky's Restaurant Management Corporation, and Schlotzsky's, Inc. (collectively, the "Predecessor Entities") were merged into the Company and its two wholly-owned subsidiaries, Schlotzsky's Restaurants, Inc. and Schlotzsky's Real Estate, Inc. (the "1993 Merger"). In June 1993, the Company raised $5 million through the sale of Class A Preferred Stock and used the proceeds to redeem the preferred stock

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296 *See The Life of a Sandwich: Schlotzsky's from Sandwich to Bankruptcy*, AUSTIN CHRON. (Oct. 8, 2004), https://www.austinchronicle.com/news/2004-10-08/232203/.

297 *See* Schlotzsky's, Inc., Annual Report (Form 10-K) 17 (Mar. 03, 1997).

298 *Id.*

299 *Id.* at 1.

300 *Id.*

> issued in the 1993 Merger to the investors in the Predecessor Entities other than John C. Wooley and Jeffrey J. Wooley. The Company's other subsidiaries, which are wholly-owned, are Schlotzsky's Brands, Inc., Schlotzsky's Equipment Corporation, DFW Restaurant Transfer Corporation, 56th and 6th, Inc., and 218 Beverage Corporation. The Company and its subsidiaries are Texas corporations, and references to the "Company" include its predecessors, and its and their subsidiaries, unless the context otherwise requires.[301]

3. 1995 Initial Public Offering

A landmark development for the Company took place in December 1995 with the Company's successful initial public offering of common stock. Schlotzsky's provided the following description:

> The Company's financial position remained strong in 1996 as a continuing result of its initial public offering in December 1995. Proceeds from the offering funded the operations of the Turnkey Program and allowed proceeds from those operations to be invested in money market accounts.
>
> The Company's financial position improved significantly as the result of its initial public offering of Common Stock on December 15, 1995. The Company sold 1,850,000 shares of the total 2,250,000 shares offered to the public at a per share price of $11. After expenses associated with the offering, the Company generated cash proceeds of $17,594,000. The Company applied $6,027,000 of the cash proceeds to retire outstanding obligations and $6,500,000 has been used to fund operations of the Turnkey Program. The remaining proceeds have been invested in money market accounts and will be used to fund operations, including the Turnkey Program.
>
> As a result of the Company's initial public offering, its working capital ratio has improved from 1.57 at December 31, 1994 to 6.98 at December 31, 1995 and 4.56 at December 31, 1996 while its debt to equity ratio has fallen from 9.3 at December 31, 1994 to .13 at December 31, 1995 and .11 at December 31, 1996.
>
> Prior to the initial public offering, the Company financed its business activities primarily with the proceeds of long-term debt, the sale of preferred stock and funds generated from operating activities.[302]

B. Description of Business

As of December 31, 2003, Schlotzsky's, Inc.'s business consisted of operating and acting as franchisor with "561 Schlotzsky's restaurants, of which 37 are Company-operated and 524 are franchised, located in 37 states, the District of Columbia and six foreign countries. Approximately 31.4% of the restaurants [were] located in Texas and 3.9% in foreign countries."[303]

As of December 31, 2003, Austin, Texas-based Schlotzsky's, Inc. reported that "through its wholly-owned subsidiaries, [it] is a franchisor and operator of restaurants in the fast casual sector under the Schlotzsky's® brand. Schlotzsky's®

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[301] *Id.*

[302] *Id.* at 23.

[303] *See* Schlotzsky's, Inc., Annual Report (Form 10-K) F-7 (Dec. 31, 2003).

restaurants offer a menu of distinctive, high quality foods featuring our proprietary breads, complemented by excellent customer service in a visually appealing setting."[304] The menu offering at that time included, "upscale made-to-order hot sandwiches and pizzas served on our proprietary buns and crusts, wraps, chips, salads, soups, fresh baked cookies and other desserts, and beverages."[305]

C. The Crisis

The Austin Chronicle reported that in years prior to 2004, "ballooning debt and deflating sales were taking their toll on the company and worrying the relatively new board—a slate of high-profile names that came with plenty of business and legal savvy, but no inside knowledge of the cut-throat nature of the fast-food industry."[306] Elsewhere, Trautman has observed, "[c]orporations are created by state-granted charters, their governance dictated by state law, with corporate directors responsible for managing the affairs of the corporation."[307] It is "every director's legal duty of care [that] requires a careful, diligent approach to the effective discharge of their [sic] individual duties and responsibilities."[308]

In financial terms, the Schlotzsky's board knew "that last year's [2003] loss of $11.7 million, followed by a first-quarter loss of $671,000, did not inspire a lot of confidence in [the then CEO's] ability to turn the company around."[309] The Company provides the following description of the crisis:

> On June 17, 2004, the Board of Directors terminated John C. Wooley from his position as President and Chief Executive Officer of the Company and Jeffrey J. Wooley from his position as Senior Vice President of the Company. They had served as senior management of the Company since 1981. That same day, David Samuel ("Sam") Coats was named President and Chief Executive Officer of the Company. Subsequently, John and Jeff Wooley were removed from various positions with the subsidiaries of the Company. On

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304 *Id.* at 2.

305 *Id.*

306 *See* Amy Smith, *Can Schlotzsky's Be Saved?*, AUSTIN CHRON. (Oct. 8, 2004), https://www.austinchronicle.com/news/2004-10-08/232202/. One might argue that not having inside knowledge of the cut-throat nature of the fast-food industry should be considered a breach in the director's duty of care, even if the director otherwise has plenty of business and legal savvy.

307 *See* Trautman, *Matrix*, supra note 204, at 78 (citing DEL. CODE ANN. tit. 8, § 141(a) (1991)) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."). While more than half of all publicly-owned United States corporations are chartered under the laws of the state of Delaware, corporate counsel and directors will want to closely examine the laws of relevant states when considering any particular matter. *See also* Bradley R. Aronstam, *The Interplay of* Blasius *and* Unocal*—A Compelling Problem Justifying the Call for Substantial Change*, 81 OR. L. REV. 429, 429 n.4 (2002) (explaining why corporations prefer Delaware as their choice for incorporation); Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 248 (1989) ("Delaware corporate law . . . governs the largest proportion of the largest business transactions in history").

308 *See* Lawrence J. Trautman, *The Board's Responsibility for Crisis Governance*, 13 HASTINGS BUS. L.J. 275, 282 (2017).

309 *See* Smith, *supra* note 306.

> June 24, 2004, the Board appointed Sam Coats to the Board of Directors and the Company announced that it had retained Trinity Capital, LLC ("Trinity"), a specialty investment banking firm focused on the multi-unit retail and food and beverage industries, to serve as financial advisor to the Company. Trinity had been retained by the Company in March 2004 on a limited basis to obtain waivers of certain covenants from specific lenders and to seek financing for the Company. The June 24 engagement expanded the scope of their engagement to include restructuring, corporate finance and other advisory services.
>
> On June 30, 2004, both John and Jeff Wooley voluntarily resigned from their positions as members of the Board of Directors of the Company. They both remained on the Board of Schlotzsky's N.A.M.F., Inc., ("NAMF") a Texas not-for-profit, non-member corporation that collects payments from Schlotzsky's franchisees to use for advertising and marketing purposes. The Board of the Company asked them to resign from NAMF but they have refused to do so to date.
>
> On July 6, 2004, the Company reduced its workforce and eliminated approximately 20 percent of corporate staff, or 19 positions, within Schlotzsky's, Inc. and Schlotzsky's Franchise Operations, LLC, a subsidiary of Schlotzsky's, Inc. Eight of the people terminated were at the vice president or director level. On August 2, 2004, the Company terminated nine additional employees. Beginning on July 9, 2004 and continuing through July 26, 2004, the Company closed 15 Company-operated restaurants located in various states. In October 2004, three additional Company-operated restaurants were closed; two were in Mississippi and one was in Texas. None of these stores had been profitable prior to the closing.
>
> On August 3, 2004, the Company filed for Chapter 11 . . . .[310]

D. *2004 Bankruptcy*

As a result of the Company finding itself insolvent, the Schlotzsky's board took action to preserve as much entity value as possible by seeking protection under the bankruptcy code, and described this action as follows:

> On August 3, 2004 (the "Petition Date"), Schlotzsky's, Inc. (the "Company") and its subsidiaries filed a voluntary petition for relief (the "Filing") under Chapter 11 of Title 11 of the United States Code in the United States Bankruptcy Court for the Western District of Texas (the "Bankruptcy Court"), San Antonio division. The cases have been assigned No. 04-54504. The Company is operating its business and managing its property as a debtor in possession of its assets and the Company's existing directors and officers continue to oversee operation of the Company's business as a debtor-in-possession.[311]

The Company provided the following additional description of events leading up to its decision to file for bankruptcy protection:

> The Schlotzsky's franchise system has been declining in store count since 2000 and has had negative same store sales since 2001, resulting in declining

310 *See* Schlotzsky's, Inc., Quarterly Report (Form 10-Q) 17–18 (June 30, 2004).

311 *Id.* at 5.

> royalty and license fees to the Company. Since 1999, the Company has repurchased certain area developer rights, and often these repurchase agreements had some component of seller financing, which resulted in a significant debt service burden to the Company. Additionally, the Company guaranteed over $25 million of franchisee lease and mortgage liabilities during the 1997-2000 time period as part of the Turnkey program, in which the Company developed restaurant sites and then sold them to franchisees. The Company, as a franchisor, also was subject to significant amounts of litigation over various matters by both the franchisees and area developers. While significant expenses related to litigation and guarantees had been incurred over the last four years, the Company anticipated that it would continue to incur material cash expenses related to litigation and guarantees in future periods.
>
> From approximately August 2002 to June 2004, the Company attempted to secure financing with favorable repayment terms that would allow it to retire the area developer obligations and provide additional operating capital, but was unable to secure such financing. The Company was able, starting in January 2003, to extend vendor payment terms and secure limited amounts of financing, but these financing facilities were repayable in full in less than two years, and called for amortizing payments beginning in mid-2004. Because of the cash required to repay the short-term financing, the area developer notes, and guarantee and litigation costs, as well as expenses incurred in attempting to secure additional financing, the Company was unable to pay its obligations in a timely and consistent manner and was incurring additional liabilities it was unable to pay as well. The Company and its subsidiaries filed a voluntary petition for relief under the Bankruptcy Code on August 3, 2004.[312]

E. *Economic Critical Mass Required*

A lesson to be learned from this brief case study is that it appears to be a difficult challenge for some franchisors to amass sufficient cash flows and revenues to support their necessary fixed cost structure of accounting, advertising, franchisee support, marketing, etc. Here, despite having over 500 franchised units and a revenue stream based predominantly on royalties computed from 4–6% of aggregate unit sales volume, the economics precluded success or survival.

VI. CONCLUSION

Franchising is an important strategy and tool for entrepreneurs and creates jobs and economic growth. This Article contributes to the literature about entrepreneurship and franchising by (1) examining the risk disclosure language provided by one of the world's largest and most experienced franchisors, YUM and (2) describing the history and fact pattern leading up to the 2004 bankruptcy of Schlotzsky's, Inc., a franchisor having in excess of 500 units at the time.

Schlotzsky's, Inc. had many problems including declining sales in some stores resulting in lower royalty and license fees, taking on significant debt, guaranteeing over $25 million of franchisee lease and mortgage liabilities as a part of the Turnkey

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312 *Id.*

program, being subject to litigation from franchisees and area developers, and being unable secure financing, which all led to the company filing for bankruptcy.[313]

While Schlotzsky's, Inc. was a sandwich shop, YUM has its hands in different pots. Concept diversification is useful for a franchise because if one product offering is not making enough money, then there are other concepts for the company to fall back on. YUM is changing its strategy as the times change, as now the company uses food delivery apps such as UberEats.

Constant adaptation to consumer sentiment will help franchisors and their franchisees succeed in the long run by protecting them from the inherent risks associated with either owning and operating a franchise network or being one of that network's franchisees.

313 *See id.* at 18–19.