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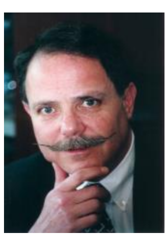
The Franchise Valuations Reporter

Featured Expert: Tom Pitegoff

In this issue we feature Tom Pitegoff's blog post examining the meaning of the term "exclusive territory" in the franchise context. Franchising is the focus of Tom's business law practice at the national law firm of LeclairRyan. Tom helps successful businesses launch franchise systems and foreign franchisors expand into the U.S. He is a member of the executive committee of the New York State Bar Association's Business Law Section and a former member of the governing board of the American Bar Association's Forum on Franchising. Tom can be reached at 212-634-5032 or tom.pitegoff@leclairryan.com.

Our Expertise



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- Damages, Valuations & Expert Testimony
- Finance, Accounting and Tax
- Cyber Security and E-discovery of Electronically Stored Information

What Is an Exclusive Territory?

Disclosure Under FTC Rule Seems Counter-Intuitive

As Tom Pitegoff observes in a recent blog post, the meaning of "exclusive" under the Federal Trade Commission's trade regulation rule on franchising (the FTC Rule) isn't the same as the plain-language meaning of the term. The full text of Tom's post may be found here.

Pitegoff builds his case by starting off with a review of what is required to be disclosed in Item 12 of the Franchise Disclosure Document (FDD) which deals with the extent of a franchisee's territorial rights. If the territory is not exclusive, the FTC Rule requires that Item 12 contain this statement:

> You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.

A franchisor that offers an "exclusive territory" may not establish either a company-owned or franchised outlet within the defined geographic area.

"Distinct Islands"

But there are exceptions to exclusivity. Pitegoff notes that "the definition became complicated on October 16, 2012, when the FTC Staff issued FAQ 37, modifying the definition of an exclusive territory. FAQ 37 addresses the case in which the franchisor reserves the right to open franchised or company outlets in 'non-traditional venues' like airports, arenas, hospitals, hotels, malls, military installations, national parks, schools, stadiums and theme parks." When retaining the right to open outlets in such non-traditional venues, the franchisor is prohibited from claiming that the territory offered is exclusive.

Pitegoff argues that practically speaking, even though these non-traditional outlets are located physically within the franchisee's territory, they function as "distinct islands" and do not actually compete with the franchisee for customers. "An airport, hospital, hotel, military installation, park, school, stadium or theme park is distinct from the surrounding geographic area. The people in those venues are there for a reason. They are a captive market for the outlets in those venues." Likewise, a person living outside of the theme park or airport "does not enter that venue in order to shop or eat at a particular franchised store or restaurant."

On the other hand, the FTC does allow franchisors to claim the territory is "exclusive" when it reserves the right to offer sales through the Internet or mail order, which the FTC considers to be "alternative channels of distribution." As many franchisees with so-called "exclusive" territories have learned, Internet and mail order sales actually do draw sales from customers within the franchisee's geographic territory.

Pitegoff concludes, "It's probably too late, but it might have been better to define a non-traditional venue as one that constitutes a captive geographic market that does not compete with the market in the surrounding areas. This would have allowed franchisors to disclose that the territory granted is exclusive notwithstanding a reservation of rights in non-traditional venues."

We offer a free initial consultation. If any readers have questions, you are welcome to email or phone us and we will provide our best answer as quickly as possible.

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Just Published

Be sure to check out this article - "Identify What's Missing From Your Cyber-Security Posture" - by Bruce Schaeffer and Henry Chan published in the June 2015 issue of *Franchising World*.

We Write the Book

Franchise Regulation and Damages, the only treatise that covers valuations of franchises, is updated 3 times a year.

For more details, to see a Table of Contents or to place an order, go to the Wolters Kluwer Law & Business web page here.

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Expert Testimony: What Is Independence?

Canadian Supreme Court Clarifies Two-Stage Test For Admissibility

A ruling in a recent case by the Canadian Supreme Court said that concerns about an expert's impartiality may be considered at the threshold admissibility stage but that threshold requirement is not onerous.[1] Once past the threshold test, any remaining concerns about an expert's independence or impartiality can be taken into account in the second stage where the court's concern is with the weight to be given the evidence. Although Canadian courts do not heed SCOTUS *Daubert* rules, they use pretty much the same criteria for expert admissibility.

The case arose when a group of shareholders hired a new accounting firm, Grant Thornton LLP, who discovered what appeared to be negligent work by the former accounting firm. [footnote case and Christopher Munroe] The shareholders brought an action for professional negligence and, to support their argument, engaged a Grant Thornton partner to prepare an expert report. Defendants challenged the admissibility of the expert's report on the basis that she was neither independent nor impartial. The trial judge found for defendants but his decision was overturned on appeal and the Canadian Supreme Court affirmed the Court of Appeal.

Canadian Supreme Court Justice Cromwell restated and clarified the two-stage test for challenges to the independence of expert opinion evidence. At the threshold admissibility stage, the expert must be found to be aware of the duty to be impartial, independent and unbiased and be willing to carry it out.

The Court was not willing to exclude the expert on the basis of:

- the appearance of bias
- a mere employment relationship between the expert and a party
- having an interest in or connection with the litigation or a party

The high court ruled that factors that could be sufficient for exclusion include evidence of the expert's direct financial interest in the outcome or a familial relationship with a party. Otherwise, as the Justice noted, "this threshold requirement is not particularly onerous and it will likely be quite rare that a proposed expert's evidence would be ruled inadmissible for failing to meet it."

He went on to say:

> Exclusion at the threshold stage of the analysis should occur only in very clear cases in which the proposed expert is unable or unwilling to provide the court with fair, objective and non-partisan evidence. Anything less than clear unwillingness or inability to do so should not lead to exclusion, but be taken into account in the overall weighing of costs and benefits of receiving the evidence.

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[1] *White Burgess Langille Inman v. Abbott and Haliburton Co*., 2015 SCC 23.

Damages: Consequential vs. Direct

Two Important Cases Reach Opposite Results

Frequently in franchise agreements there are limitations on damages provisions. Often a distinction is made between claims for direct damages vs claims for consequential damages. Two recent cases found contrary results.

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(1) *Atlantech Inc. v. American Penel Corp*., 743 F.3d 287 (1st Cir. 2014). This case held that evidence of lost profits that a dealer provided at trial in a breach of contract action constituted consequential rather than direct damages.

(2) *KSW Mechanical Services v. Johnson Controls, Inc.*, 2014 WL 50129 (E.D.N.Y. 2014) holding that although lost profits damages are normally consequential damages, they can be considered direct damages when only an award of damages equal to lost profits will put the nonbreaching party in the same position that he or she would have occupied had the contract been performed.

Valuations: Less Theory and Fewer Models

A Call For More Common Sense in Business Valuations

Pablo Fernandez is a professor in the department of financial management at the University of Navarra- IESE Business School in Spain (ranked No. 5 in the world for full-time MBAs by The Economist). A widely published author, his recent paper, "CAPM: An Absurd Model," created a stir in the business valuation community.

Recently Fernandez was interviewed by Michael Crain, a valuation practitioner who is in the AICPA Business Valuation Hall of Fame, on behalf of Business Valuation Update. To all those who are fiercely wedded to formulae and databases in valuation calculations the interesting part of the interview is:

> Crain: You've done a lot of empirical research collecting data using surveys rather than large-scale databases used by many finance professors. What motivated you in this methodological direction?
>
> Fernandez: I also use some databases. But I started primarily with the CAPM, which, when I was studying, it was the bible. It was "the" model- the main author won the Nobel prize in economics. And, for the first few years that I was teaching, I taught it in the same way I learned it. But then I started doing some consulting, and I realized that the model and the beta calculation was far removed from what I was taught when I was doing my Ph.D. So I started to review the model and its assumptions. **What I realized was that the CAPM is perhaps very good, but it has nothing to do with the real world and with our markets.**

Valuations: Healthcare Services

Duff & Phelps Notes Best and Worst Performing Sectors

As reported by the Business Valuation Wire, the S&P Healthcare Services Index decreased by 2.0% in the second quarter, underperforming the S&P 500 (a 0.1% increase over the same period), according to the June 2015 Healthcare Sector Update from Duff & Phelps. The best performing sectors were emergency services (up 18.8%) and special managed care (up 17.4%). The worst performing sectors were diagnostic imaging (down 23.1%) and healthcare REITs (down 8.6%).

The current median LTM revenue and LTM EBITDA multiples for the healthcare services industry overall are 1.76x and 13.1x, respectively. The sectors with the highest valuation multiples include: HCIT (3.7x LTM revenue, 19.5x LTM EBITDA), healthcare REITs (12.0x LTM revenue, 17.4x LTM EBITDA), consumer-directed health and wellness (3.4x LTM revenue, 20.8x LTM EBITDA), and other services (2.0x LTM revenue, 27.2x LTM

EBITDA).

Cybersecurity: Data Breach Study Released

Costs Continue To Rise

IBM and Ponemon Institute released their *2015 Cost of Data Breach Study: Global Analysis*. It showed that the average total cost of a data breach for the 350 companies participating in this research increased from 3.52 to $3.79 million and the average cost paid for each lost or stolen record containing sensitive and confidential information increased from $145 in 2014 to $154 in 2015.

Key findings:

Data breaches cost the most in the US and Germany and the least in Brazil and India. The average per capita cost of data breach is $217 in the US and $211 in Germany. The lowest cost is in Brazil ($78) and India ($56).

The cost of data breaches varies by industry. The average global cost of a data breach per lost or stolen record is $154. However, if a healthcare organization has a breach, the average cost could be as high as $363 and in education the average cost could be as high as $300. The lowest cost per lost or stolen record is in transportation ($121) and public sector ($68). The retail industry's average cost increased dramatically from $105 last year to $165 in this year's study.

Hackers and criminal insiders cause the most data breaches. Forty-seven percent of all breaches in this year's study were caused by malicious or criminal attacks. The average cost per record to resolve such an attack is $170. In contrast, system glitches cost $142 per record and human error or negligence is $134 per record.

Malicious or criminal attacks vary significantly by country. Fifty-seven percent of all breaches in the Arabian Cluster and 55 percent of all breaches in France are due to hackers and criminal insiders. Only 32 percent of all data breaches occurring in India are due to malicious attacks and in Brazil it is 30 percent. However, India and Brazil have the most data breaches due to system glitches. Breaches due to human error are highest in Canada.

Board involvement and the purchase of insurance can reduce the cost of a data breach. For the first time, the study looked at the positive consequences that can result when boards of directors take a more active role when an organization had a data breach. Board involvement reduces the cost by $5.50 per record. Insurance protection reduces the cost by $4.40 per record.

Business continuity management plays an important role in reducing the cost of a data breach. The research reveals that having business continuity management involved in the remediation of the breach can reduce the cost by an average of $7.10 per compromised record.

Other Findings:

- The loss of customers increases the cost of data breach.
- Notification costs remain low, but costs associated with lost business steadily increase.
- Certain countries are more likely to have a data breach.

- Time to identify and contain a data breach affects the cost.