

PUBLICATION

KFC Rules the Roost but Franchisees Govern the Coop

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In the traditional franchisor's point of view, brand ownership means control over all brand components, with input and advice from franchisees at the franchisor's discretion. This point of view held little sway with the Delaware Chancery Court, which recently ruled that the KFC National Council and Advertising Cooperative (NCAC) has the power to propose and approve the advertising plan for the KFC brand, while franchisor KFC Corporation (KFCC) has the power to hire, fire and direct the brand's national advertising agency and public relations firm.¹ The court acknowledged that business realities may make it impossible for the parties to continue operating in the manner the Certificate of Incorporation (the Certificate) requires, but the court strictly construed the language of the NCAC's heavily negotiated Certificate in a manner favorable to the franchisees based on principles of contract interpretation.

This case is instructive for franchisors that have or are considering sponsoring or creating an advertising cooperative or sharing control over brand advertising with a franchisee-dominated organization. Clarity in organic documents is crucial to avoiding a litigation-defined relationship.

In August 2009, the KFC brand was on the verge of "going dark" with no on-air national television advertising for a month-long period because the Committee governing the NCAC (the Committee) would not approve the KFCC-proposed commercial. The commercial focused on KFC's relatively new grilled chicken product, while the Committee (13 out of 17 of whom are franchisee representatives) wanted the focus to remain squarely on fried chicken. Three days before the September advertising window was set to begin, the NCAC, through the Committee's action, agreed to the commercial, avoiding a potential loss of millions of dollars in already-committed media purchases.

Shortly thereafter, a similar dispute arose when KFCC proposed the brand's advertising and marketing plan for 2010. The Committee wanted to amend the KFCC proposal and recommend a different plan over KFCC's objection. KFCC argued that it was the only party that could plan and propose advertising for the brand and that the NCAC's role was to approve KFCC's proposed plan or request a modified plan from KFCC, not to propose its own plan. This time, the parties could not agree, and the NCAC, through the Committee's action, filed *KFC National Council and Advertising Cooperative, Inc. v. KFC Corporation* in the Delaware Chancery Court on January 7, 2010.

The NCAC was organized in 1964 to maintain and utilize the advertising fees paid by each KFC franchisee. In 1997, KFCC and its franchisees concluded an eight-year class action lawsuit, part of the settlement of which was re-negotiating the NCAC Certificate. The parties later came to dispute what powers and duties each agreed to in the Certificate and their respective roles in the approval of the advertising plans and strategies.

The negotiated and revised Certificate limited the Committee's powers from what they were prior to 1997. It gave KFCC representation on the Committee, which KFCC previously did not have, but it allowed the franchisees to maintain a super-majority of Committee members. The Certificate enumerated the following powers and duties of KFCC: (1) the sole authority to hire and fire the national advertising agency and public relations firm and direct their work; (2) development of national advertising, public relations and media plans and strategies and submission of such plans for approval by the Committee; (3) recommendation of any changes in the advertising calendars and budgets, which changes can only be implemented by the approval of

the Committee; (4) development of all creative and production of all commercials; and (5) management of the purchase of media.

The Certificate also set forth the roles and duties of the Committee: (1) evaluation and approval of all advertising, publicity and promotional programs and establishment of related fiscal policies; (2) planning and approval of yearly advertising program, within the limits of an estimated budget developed by KFCC; and (3) review of performance of advertising agencies and PR firms; approval of strategic direction, calendars and budgets; approval of campaign strategy; approval of national advertising prior to airing; and approval of price points and promotions featured in national advertising.

The revised Certificate was not a model of clarity. Thus, the court's task was to parse the language and interpret the Certificate. The court determined that the Certificate was ambiguous, with the parties urging widely divergent interpretations. KFCC interpreted the Certificate to allow KFCC the sole authority to hire and fire the national advertising agency and to propose the advertising plan and strategy, while giving the Committee only an "up or down" vote on the proposed plan. NCAC argued that because the Certificate was silent as to whether the Committee could make proposals of its own, it had the power to do so. The court believed that both parties' interpretations were reasonable but decided that "if I were to have to decide this case by only referring to the language of the Certificate, I would rule for the franchisees."² However, because of the ambiguity, the court was forced to consider additional facts and law by admitting parol evidence.

The court next examined the typical rules of interpretation of corporate instruments and determined that those rules would not apply because the Certificate was the product of bi-lateral negotiation, unlike most corporate instruments where the stockholders have no role in negotiating the terms. The court dispensed with the Committee's argument that the Certificate should be construed in favor of the "equity holders," in this case the franchisees. However, the court noted that if the language and the parol evidence are ambiguous, then the burden "should be borne by the party seeking to have the corporation act in a manner contrary to majority rule."³

The court then turned to an examination of the extrinsic evidence, including the facts surrounding the negotiation of the Certificate and the course of dealing of the parties. The court considered the testimony of individuals involved in the settlement of the class action litigation, including then-KFCC President David Novak, who testified that KFCC wanted to create a win/win situation for franchisees and KFCC. He said that restructuring the NCAC was one of the goals of the settlement. The Committee had originally played the leading role in national advertising for the brand, and KFCC wanted to obtain more rights while not taking all power away from the Committee.

Evidence showed that KFCC offered to grant franchisees a 1.5-mile exclusive territory in exchange for obtaining the right to hire, fire and direct the national advertising agency. The related testimony and documents convinced the court that KFCC did not attempt to obtain the sole authority to make advertising plan proposals. Instead, the approval process would remain the same, and KFCC's only new right was to hire, fire and direct the national advertising agency.

According to the court, the history of the NCAC also weighed in the Committee's favor. Franchisee members of the Committee had previously submitted advertising proposals that the Committee voted on without KFCC's objection, and other advertising had been approved over the objection of the KFCC representatives on the Committee.

The court construed the Certificate to mean that "KFCC has primary responsibility to make recommendations to the NCAC for the Committee's approval but that the NCAC retains the authority to make recommendations of its own or modify KFCC's recommendations and then vote on those recommendations by majority rule."⁴

The court acknowledged, however, that this reading of the Certificate may not be the most practical or "sensible" solution because KFCC has more resources and capability to plan the advertising for the brand.⁵ Splitting the functions of directing the national advertising agency apart from approving the advertising plan has not functioned smoothly in the past and may not prove sustainable without continued disputes. However, strict adherence to rules of contract interpretation won the day, with the court stating that because "KFCC does not like the reality that it has long lived with is no excuse for a court to change it."⁶ Thus, if the ruling stands, the only method for improving the structure will be to renegotiate the Certificate.⁷

KFCC's consolation is that it still maintains control over what products are sold and, obviously, owns the brand itself and the associated trademarks to which the NCAC has a license. The NCAC is obligated to use the marks "in good taste and consistent with the then current Bylaws of the NCAC."⁸ As the court noted, if the Committee decided to air a campaign called "All Fat, All Fried, All the Time," KFCC could prevent the national advertising agency from airing such a campaign.⁹

Both sides claimed victory in the case, with the Committee's Vice Chair John R. Neal stating that "this ruling reaffirms KFC franchisees' rights to develop and approve advertising, publicity and promotion programs for the KFC system in the United States"¹⁰ and with KFCC's President Roger Eaton stating that "this lawsuit was always about retaining rights, not gaining rights, and we are pleased the court has affirmed that the franchisees do not have authority to run ads which KFC Corp. deems to be inconsistent with its brand image."¹¹

Certainly, the franchisees have every incentive to help the brand succeed, but the parties may have divergent visions of how to achieve that success, which makes this case and the power it allows the franchisees problematic for franchisors. This franchisor's introduction of grilled chicken onto its menu in response to perceived demand for healthier dining options ran into the franchisees' resistance to changing the successful fried chicken KFC brand identity. After all, fried is the brand's middle name. Because the franchisees have the power to approve or reject advertising plans, the franchisees may be able to make their differing vision manifest by refusing to approve or changing a grilled-chicken-focused advertising campaign. Because the franchisor still directs the advertising agency, though, it remains to be seen how this structure will play out absent cooperation between the parties.

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1. *KFC Nat'l Council and Advertising Coop, Inc. v. KFC Corp.*, 2011 WL 350415 (Del. Ch. January 31, 2011).

2. *Id.* at *12.

3. *Id.* at *15.

4. *Id.* at *28.

5. *Id.*

6. *Id.* at *29.

7. The court stated that "[U]ltimately, of course, if KFCC does not like its relationship with the franchisees it can reopen contract negotiations. However painful this is, it might be that current business realities make it impossible to continue applying band-aids to the Colonel's outdated business model." *Id.*

8. *Id.* at *28, citing the Agreement between KFCC and NCAC dated November 1, 2004.

9. *Id.* at *29.

10. NCAC Press Release, "KFC National Council and Advertising Cooperative Announcement: Court Rules for Franchisees in Dispute with KFC Corporation" at <http://www.restaurantnewsresource.com/article52004.html>, February 3, 2011.

11. KFCC Press Release, "KFC Retains Right to Control Brand Image and Advertising" at <http://www.restaurantnewsresource.com/article51912.html>, February 1, 2011.