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The Annotated Franchise Agreement

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Introduction[◊]

Franchise relationships are characterized by a franchisor granting a franchisee a temporary or time limited right to use the franchisor's system and trademarks to conduct business.[1] Franchise agreements are crucial in determining the relationship between a franchisor and a franchisee because they set out the rights and obligations of each party in detail. It is critical that prospective franchisors and franchisees understand the purpose and drafting issues behind each clause. There is no "cookie cutter" approach to drafting a franchise agreement, and counsel must consider a myriad of business goals, objectives, regulatory issues and judicial direction when drafting. However, there are key provisions commonly found in franchise agreements, regardless of the industry or business. This Annotated Franchise Agreement will detail the common and often complex terms and conditions found in franchise agreements by providing for each section: a sample provision (which appears in italics) and discussion on the provision's meaning and typical purpose, and, where appropriate, variations on the language, practical perspectives on the clause, and judicial considerations.[2] Of course, every industry, business and relationship has unique considerations, and each consideration may affect and alter the sample provisions, the variations of which are beyond the scope of this paper.

A franchise agreement should be drafted with precision and care. It should be clear (with concise and simple language), user friendly, and comprehensive. The sections should build logically on one another, should be placed under appropriate headings, and should be easily found by any person reading it. To make the agreement as comprehensible as possible, drafters might consider approaching the project as if they are writing a "story," so that users can see the big picture of the franchise relationship.[3] The typical franchise agreement is a long and complicated document which the franchisor drafts with the intention of establishing the contractual framework for the franchise relationship. If a franchise agreement is not logically built, and/or if provisions are not easy to find, then the agreement could, at best, become a source of confusion and frustration and, at worst, add to the time, cost and complication of disputes between a franchisor and franchisee.

Given the importance of a well structured franchise agreement, commentators have noted that several general approaches have emerged. Some drafters prefer to take a "Life-Cycle" approach and set out a sequential outline of what will happen in the franchisee/franchisor relationship.[4] Another approach is the "Highlight-the-Deal" approach where the key aspects of the relationship are covered first, followed by a sequential life-cycle approach for the remainder of the agreement.[5] Lastly, some may use a "Franchise Disclosure Agreement" approach, where the agreement follows the order of the information required by the Franchise Disclosure

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[◊] The authors would like to gratefully acknowledge Ms. Tali Eliav, Summer Law Student, Cassels Brock LLP, Toronto, for her invaluable contribution to this paper.

[1] W. Andrew Scott, *Business Labels: Identifying the Signs of a Franchisee Relationship*, 79 A.B.A.J. 86 (1993).

[2] The clauses in this agreement are simply sample clauses drawn from typical franchise agreements. They are not intended to be comprehensive, the "gold standard," or clauses recommended by the authors.

[3] Richard M. Asbill, Rupert M. Barkoff & Andrew C. Selden, *Franchise Agreements - New Approaches to Old Problems*, ABA Forum on Franchising 1, 4 (2002).

[4] *Id.* at 7-9.

[5] *Id.*

Document ("FDD"). This last approach often misses key provisions and is rarely used. Even though it is uncommon for drafters to follow the general structure of the FDD, they nevertheless should consider drafting in anticipation of franchise disclosure. This Annotated Franchise Agreement follows the life-cycle approach as it is used most frequently. Regardless of the approach, the goal is an effective franchise agreement that embodies the parties' respective rights and obligations and provides an opportunity to assist in the resolution of disputes.

Understanding the meaning and purpose of a clause in a franchise agreement is key to being able to provide quality advice to clients, whether they are franchisors or franchisees. Too many lawyers, and their franchisor clients, are "slaves to precedents," who will take one form of franchise agreement and believe it can be used in another, or any other, franchise system. Although often intended as a cost saving measure, this results in franchise systems with forms of agreement inappropriate to the type of franchise being offered. Those franchise systems can then spend more on marketing the franchise, as they try to explain to prospects the content of a form that is not appropriately tailored to the situation. But the real long-term cost may be much more significant -- more and costlier legal disputes result when interpretation of the contract wording becomes the focus. It should go without saying that inappropriate or incorrect provisions result in substantial problems. This Annotated Franchise Agreement is intended as a tool by which legal counsel can review each clause independently, in an effort to provide better advice, and better agreements, to their clients.

PARTIES TO THE AGREEMENT

A M O N G:

●[6] a corporation incorporated under the laws of ●, and operating as "●";

(hereinafter referred to as the "Franchisor")

OF THE FIRST PART

- and –

● a corporation incorporated under the laws of ●;

_____;

(hereinafter referred to as the "Franchisee")

OF THE SECOND PART

Discussion:

Franchise agreements should name the parties, describe the legal entity of each, and indicate how the parties will be referred to throughout the rest of the agreement. Often times, the prospective franchise owner will form a corporation or a limited liability company ("LLC") as the franchisee, for tax purposes or to minimize personal liability.[7] It is critical for the franchise agreement to name the correct legal entities. That may seem trite, but many litigation counsel can readily recall cases where a franchisor has sought to enforce a franchise agreement and the first concern is that the franchisee entity is improperly named or does not exist at all as a

[6] In this Annotated Franchise Agreement, "●" symbolizes a placeholder for specifics related to the agreement (*i.e.*, state identification, franchisor or franchisee entity name, trade name, etc.).

[7] *See, e.g.,* Charles S. Modell, *What Do Personal Guarantees Offer the Franchisor? Don't Do Business Without One*, 23-WTR Franchise L.J. 138 (2004). Despite the formation of a franchisee entity, franchisors typically require a personal guaranty of the performance of the franchise agreement by the individual owners and sometimes by others as well. This Annotated Franchise Agreement includes a guaranty as Exhibit A and discusses guaranties there.

legal entity under the name provided in the agreement. Arriving at the correct name may be less about drafting than counsel training clients to conduct appropriate searches to confirm the existence, legal name, and ownership details related to the franchisee entity. For instance, if the franchisee is an LLC, the franchisor should ensure that it knows who the members of the LLC are, just as they should know names of all of the shareholders (within reason), directors and officers of a corporation. With respect to LLCs, this is important for federal diversity jurisdiction, among other reasons, if a claim does later arise.

I. KEY TERMS

The key terms or "Definitions" section explains the terms that will be used throughout the agreement. The drafter should never assume that a term will be understood by the reader. The absence of one or two words in a definition could mean a substantially different agreement between the franchisor and the franchisee. As such, great care should be taken when defining these terms, and perhaps most especially the terms listed below.

A. The System

"System" - The business methods, designs, know how and arrangements for developing and operating ● businesses, which include the Trademarks, trade dress, building design and layouts, equipment, training, and certain operating and business standards and policies, all of which the Franchisor may improve, further develop or otherwise modify from time to time.

Discussion:

"The System" is the industry standard term used to define the bundle of intellectual property and other rights, such as know how, that are being licensed for use by the franchisee pursuant to the franchise agreement as part of the franchisor/franchisee relationship. It is important for the franchise agreement to define exactly what is included in the system so that the franchisor can adequately protect its intellectual property rights in the elements that make up the system. The sample clause includes some of the typical elements included in the definition of a retail format franchised business system. There may very well be a longer list, or if the business is one that is solely service oriented, references to premises and building design may not be necessary. Either in the body of the agreement, or in this definition, the franchise agreement should contemplate that the then current system will evolve and change over time, as that is a fundamental feature of most businesses, and that the franchisee must abide by and adhere to such changes. If something is missing from the definition, then the franchisor risks losing the right to adequately control the system, the franchisee's use of it, and perhaps even any intellectual property rights it may assert, thereby preventing the full capture of its value.

B. Gross Sales

"Gross Sales" means all revenue from the sale of all products sold and all other income of every kind related to the Franchised Business (including, without limitation, any proceeds from business interruption insurance and premiums), whether for cash or credit (and regardless of collection in the case of credit). Gross Sales will not include any sales taxes or other taxes collected from customers by the Franchisee and paid directly to the appropriate taxing authority.

Discussion:

It is important to explain gross sales or gross revenues in the franchise agreement because the ongoing amounts to be paid to the franchisor by the franchisee under the agreement will often be based on a percentage of gross sales, however defined.[8] Most commonly, the franchisee pays a continuing royalty based on a percentage of gross sales (*see* Section III: Initial Fees & Royalty). Additionally, advertising fees are often paid as a percentage of gross sales (*see* Section X: Advertising).[9] Given its importance, the franchisor will want to give a broad definition for gross sales so that it can ensure that the franchisee is not able to categorize income under a different label and thereby argue that payment is not due to the franchisor. Drafters might include a specific note including income from Internet sales, phone sales, or other forms of sale. It is also common for drafters to exclude sales taxes from the calculation of gross sales. In more unusual cases, there will be other exclusions from gross sales, but these need to be considered on a case by case basis. A franchisor may choose not to collect continuing royalties (for instance, on sales made at cost to employees) or a franchisor may be restricted from collecting continuing royalties on certain goods sold (for instance, liquor sales in certain jurisdictions).

C. Trademarks

"Trademarks" means collectively, those trademarks, service marks, trade names and other commercial symbols and related logos as set forth in Schedule "A" hereto, including the trade name "●", together with such other trade names, trademarks, service marks, symbols, logos, distinctive names, and elements, trade dress, logos, designs, insignia or other items which may be designated by the Franchisor from time to time.

Discussion:

Along with the system, the trademarks associated with the system are the franchisor's most valued asset.[10] As noted, the essence of what is being licensed under a franchise agreement is use of the system and trademarks. It is crucial that the franchisor carefully define the trademarks. For instance, if the franchisor's product or packaging has a distinctive physical appearance, then such a trade dress should be included in the definition.[11] Otherwise, the franchisor cannot capture the full value associated with this physical appearance. Therefore, franchisors should carefully review which aspects of their trademarks bring value to the franchise, and explicitly describe them in the definitions. Additionally, franchisors typically include a catch-all for future trademarks they may develop or use.

Another much less discussed intellectual property right associated with franchising is the copyright that subsists in the written or tangible expressions of the ideas that the franchisor produces for use in the system. Copyright is a form of intellectual property right that "provides the author of an original work of authorship with certain exclusive rights with respect to that

[8] Asbill, Barkoff & Selden, *supra* note 3 at 26.

[9] *Id.* at 26-27.

[10] Francis J. Duffin & Bryan S. Watson, *Best Practices in Protecting and Enforcing Trademarks, Copyrights, and Other Intellectual Property Rights,* 28-WTR Franchise L.J. 132 (2009).

[11] *Id.* at 135.

work."[12] Again, if the franchisor fails to identify its copyrights adequately, then it will not be able to capture the full value of those rights. Copyrights may be registered, but because registration is not required to assert rights, it is less commonly done. In the U.S., registered copyrighted materials must be deposited in the Library of Congress. Because most franchisors consider (and should consider, if appropriate) their manuals to constitute trade secrets, they typically do not want to deposit a copy for copyright purposes lest they lose trade secret protection. In some instances, a franchise agreement will be so comprehensive that it includes other unrelated intellectual property rights as part of the trademarks, such as the copyrights in the manuals and materials produced by or for the franchisor.

D. Manual

"Manual" means, collectively, all books, pamphlets, bulletins, memoranda, letters, notices, computer media (i.e. computer software, CD-Rom) or other publications, documents or electronic media prepared by or on behalf of the Franchisor for use by Franchisees generally or for the Franchisee in particular, setting forth information, advice, standards, requirements, operating procedures, recipes, instructions or policies relating to the operation of ● outlets, as the Franchisor may amend from time to time.

Discussion:

The manual is of critical importance in any franchise relationship. The manual sets out the system standards that the franchisee must abide by in operating the franchised business, and can include such items as the store operating procedures, recipes, and other policies.[13] Historically it would be delivered to the franchisee in binder "hard copy" form. Today, it is usually a mixture of hard copy and electronically delivered information, with more and more being delivered to the franchisee in electronic form (via e-mail, access to extranet, or the like). The definition of the manual needs to take into account the methods by which the information is delivered. The agreement must provide the franchisor with the right to revise the manual on an ongoing basis, and there must be provision made for the franchisee to accept and abide by all parts of the manual and any changes. Section IX, below, includes more detailed clauses regarding the operations manual.

E. Franchised Business

"Franchised Business" means the business operated by Franchisee under this agreement located at [specific address].

Discussion:

It is important to identify the specific business that the franchisee is going to operate. Once this identification is made, the rest of the franchise agreement can refer to the specific location merely through the defined term "Franchised Business."

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[12] *Id.*

[13] Heather Carson Perkins, Sarah J. Yatchak & Gordon M. Hadfield, *Franchisor Liability for Acts of the Franchisee*, 29-WTR Franchise L.J. 174, 180 (2010).

F. Control Person (or Principal Owner)

"Control Person" means an individual who has the authority to, and does in fact, actively direct the business affairs of the Franchisee in regard to the Franchised Business and is responsible for overseeing the general management of the day-to-day operations of the Franchised Business. Unless the Franchisee notifies the Franchisor otherwise in writing, a Control Person who does not have an ownership interest in the Franchisee shall be deemed to have authority to sign on behalf of the Franchisee on all contracts and commercial documents. If the name Franchisee is one or more individuals, each such individual shall be deemed to be a Control Person of the Franchisee.

Discussion:

Administratively, it is important to identify a franchisee control person, managing stockholder, or other key person operating the franchise in the definition section of the franchise agreement. The label "Control Person" is but one example, as this term varies greatly from one form of franchise agreement to another. The control person may very well be the same person as the principal owner or guarantor. Although a franchisee is most usually a business corporation or other legal entity (*i.e.*, a limited liability company), the franchisor is usually keenly interested to make sure that it is aware of the person in charge and managing the business on a day to day basis.

The control person also may be the key manager, but that is not necessarily the case. A franchisor will therefore need to consider early on whether it will permit a franchisee to use employee managers to run the franchised business, or insist that a control person fulfill this role. In some business it is critical to the franchisor that the owner also be an operator. In other situations it is not important at all. Where a franchisor permits multiple unit ownership by the same franchisee, it may of course be impossible.

II. GRANT

A. Grant of Rights

Subject to the provisions of this agreement and for the term hereinafter specified, the Franchisor hereby grants to the Franchisee a non-exclusive right to operate a Franchised Business at and only at the Premises and a non-exclusive license to use the System and Trademarks solely and exclusively in the operation thereof. Termination or expiration of this agreement shall constitute a termination or expiration of the rights and license granted herein to the Franchisee.

Discussion:

The grant of rights in a franchise agreement is often a short but fundamental provision. It states in unambiguous terms the scope of the rights licensed to the franchisee.[14] Typically, the grant of rights gives the franchisee temporary rights to use the trademarks and system (the business know how) during the term of the agreement.[15] This section should stipulate exactly

[14] Asbill, Barkoff & Selden, *supra* note 3 at 19.

[15] Andrew J. Sherman, Franchising & Licensing 107 (3d ed. 2004).

where the franchisee is authorized to conduct business, what the franchisee is authorized to do, and how exclusive those rights are going to be during the duration of the franchise agreement.

B. Exclusive or Non-Exclusive Territory

Example of Exclusive Territory:

So long as the Franchisee has not breached any of the terms and conditions of this agreement, the Franchisor shall refrain from operating or granting to anyone else a franchise to operate a ● outlet within the Territory.

Example of Non-Exclusive Territory:

The rights granted to the Franchisee are site specific, for use only at the location identified in this agreement, and provide no rights of exclusivity to the Franchisee. Accordingly, the Franchisee's rights do not include (i) an exclusive area or protected territory within which the Franchisor or its affiliates agree not to issue competing franchises or operate competing businesses, (ii) any right to sell products and items identified by the Trademarks at any location other than the Authorized Location or through any other channels or methods of distribution, including the Internet (or any other existing or future form of electronic commerce) and pre-packaged retail sales, (iii) any right to sell products and items identified by the Trademarks to any person or entity for resale or further distribution, or (iv) any right to exclude, control or impose conditions on the location or development of future stores at any time.

Discussion:

A franchise agreement's section relating to exclusivity (or non-exclusivity) of the franchisee's rights is a classic example of competing franchisor and franchisee objectives. It exemplifies the difficult balance that a franchisor must strike when considering the attractiveness of the franchise offering versus the need to reserve control and flexibility over the expansion of the brand (whether that is through additional outlets or other channels of distribution). The language of the franchise agreement must consider all of these objectives, and clearly state the franchisee's rights as they relate to territory, distribution and expansion. Just as important, the franchise agreement should spell out the rights a franchisee does *not* have related to these areas. Further, as discussed below, an unambiguous explanation of the *franchisor's* rights as they relate to territory, distribution and expansion is a necessary element to a well drafted territory section. A clearly drafted section regarding territory helps set expectations of the parties and may assist in dispute resolution.

If an exclusive territory is to be provided to the franchisee, the franchisor is best advised to consider the needs that it and the franchisee wish to see protected. It is very much a function of the type of business being operated. For instance, when provided in a retail restaurant franchise, territorial protection is most often afforded to a franchisee by providing a relatively straightforward geographic area, defined in the agreement with sufficient certainty, such that the franchisor agrees that it will not open physical units in the territory, nor franchise others to open units in the territory. However, in other situations, the territory needs to be considered and articulated in a different manner, such as exclusivity with respect to market segment, or by specifying that the franchisee will in fact only seek customers from within the territory. This last right (restriction) is most often seen in service franchises where the franchisee is expected to seek out customers at their addresses.

In other cases, the franchisor will give no such rights, and the franchisee will be given no guaranty that the franchisor or its affiliates will not directly compete. In other words, the franchisee gets no exclusivity on any territory and the franchise rights are truly "site only." Anyone, including the franchisor, can open a competing outlet nearby. More advanced and mature franchisors are more likely to have this kind of language in their franchise agreements.[16] Sophisticated franchisors can do this because there is enough value attached to their trademarks that the consumer demand for the franchises themselves, and the franchise's products or services, is high. Because the demand is high, locations in close proximity will likely still succeed. Franchisors generally want to add a number of franchise outlets in densely populated areas and keep exclusive areas small so that they can dominate the market and outpace their competitors.[17] Similarly, the brand popularity, track record or history is enough to incentivize demand by prospective franchisees, regardless of territorial exclusivity. On the other hand, newer or smaller franchisors might have to provide for some exclusivity of territory to attract franchisees.[18]

C. Reservation of Rights and Alternate Channels of Distribution

The Franchisor and all of its affiliates (and the Franchisor's respective successors and assigns, by purchase, merger, consolidation or otherwise) retain all of the Franchisor's rights with respect to the Trademarks, the System and the ● businesses anywhere in the world, and the right to engage in any business whatsoever, including the right to:

a. *issue competing franchises or operate competing businesses identified by the Trademarks for or at locations, as determined by the Franchisor or its affiliates, including in close proximity to the Franchised Business location;*

b. *distribute or sell products identified by the Trademarks, or any other trademarks, service marks, trade names and commercial symbols, through any distribution channels or methods, including the Internet (or any other existing or future form of electronic commerce) and pre-packaged retail sales, which periodically may be established or licensed by the Franchisor or its affiliates;*

c. *operate, and grant to others the right to operate establishments identified by trade names, trademarks, service marks or trade dress, other than the Trademarks, pursuant to such terms and conditions as the Franchisor deems appropriate which may include locations in close proximity to the Franchised Business location.*

Discussion:

[16] Joseph J. Fittante, Jr. & Dennis E. Wieczorek, *Advanced Drafting*, A.B.A. 27th Annual Forum on Franchising (2004) at 3-5.

[17] Joe Mathews, Don DeBolt & Deb Percival, Street Smart Franchising 189 (Entrepreneur Press 2006).

[18] Scott A. Shane, From Ice Cream to the Internet: Using Franchising to Drive the Growth and Profits of Your Company 133 (Pearson Education Inc. 2005).

The example clause above illustrates the need to identify clearly the franchisor's territory, expansion and distribution rights, even in the context of a franchise agreement that does not grant an exclusive area to the franchisee. Although it may cause consternation for the prospective franchisee and result in difficult discussions for those on the franchise development side of the business, it is critical to clearly "call out" the respective rights (or the limitation on such rights, as the case may be) related to territory.

If the franchisor grants some designated or exclusive territory to the franchisee, it must carefully consider and include in the franchise agreement the rights it reserves to itself, namely the parameters under which the franchisor *can* operate or franchise competing businesses. Vague language could lead to claims of encroachment. Claims of encroachment may occur when a franchisor opens a new location (whether as a corporate or franchise location) within certain proximity to the franchised business, and the new location lures customers from the original franchised business, or claims may occur when the franchisor conducts the sale of the franchise system's products and services through alternate channels of distribution.[19] Alternate channels are any methods used to offer products or services to the franchise system's consumer that are different than the method used by the franchises of the system. The issues surrounding alternate channels have become especially pronounced with the advent of the Internet, as online sales became a new channel of distribution that was not previously contemplated.[20] But there are many others, and the example above contemplates several.

To avoid claims to the extent possible, the agreement should speak to acceptable/unacceptable proximity. If this section is left ambiguous, it could lead to problems between the franchisor and franchisee about whether the franchisor breached the terms of this agreement by opening an outlet on the perimeter of the territory. It is not sufficient to reserve a "general right" above and beyond this agreement.[21] Parties also should be aware that particular state franchise statutes restrict franchisors' freedom with respect to locating new locations, in an effort to protect franchisees from encroachment, and those restrictions override contractual terms and reservations of rights.[22]

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[19] For a compilation and history of encroachment case law by legal theory, *see* Erika L. Amarante, Andraya C. Frith & Karen B. Satterlee, *Territory, Exclusivity and Encroachment – Thinking Ahead of the Curve and Dealing with the Fallout*, A.B.A. 32nd Annual Forum on Franchising W23 (2009) at 17-36. *See also* Ann Hurwitz & Brian B. Schnell, *Tough Issues: Drafting Challenges for Franchisors Operating in the New Economy*, A.B.A. 23rd Annual Forum on Franchising (2000) at 6.

[20] *See, e.g., Emporium Drug Mart, Inc. v. Drug Emporium, Inc.*, summarized in (CCH) Bus. Franchise Guide ¶ 11,966 (AAA Sept. 2, 2000) (arbitrators held franchisor's Internet sales encroached franchisee's contractual exclusivity); *see also Armstrong Bus. Services, Inc. v. H&R Block, Inc.*, No. WD 60348 (Circuit Ct. Jackson Co., MO Oct. 2003) (jury found franchisor's Internet program encroached franchisee's rights), discussed in Gary R. Duvall, *Using the Web More Effectively*, 24-WTR Franchise L.J. 173 (2005).

[21] Asbill, Barkoff & Selden, *supra* note 3 at 20-25.

[22] *See, e.g.,* Indiana Deceptive Franchise Practices Act, Ind. Code § 23-2-2.7-1(2) ("It is unlawful for any franchise agreement entered into between any franchisor and a franchisee who is either a resident of Indiana or a nonresident who will be operating a franchise in Indiana to contain any of the following provisions: (2) Allowing the franchisor to establish a franchisor-owned outlet engaged in a substantially identical business to that of the franchisee within the exclusive territory granted the franchisee by the franchise agreement; or, if no exclusive territory is designated, permitting the franchisor to compete unfairly with the franchisee within a reasonable area."); *id.*, § 23-2-2.7-2(4) (Unlawful for franchisor to "[e]stablish[] a franchisor-owned outlet engaged in a substantially identical business to that of the franchisee within the exclusive territory granted the franchisee by the franchise agreement or, if no exclusive territory is designated, competing unfairly with the franchisee within a reasonable area…"(exemptions omitted)); Iowa Franchise Act, Iowa Code § 523H.6 (imposing extensive encroachment restrictions); Washington Franchise

Although beyond the scope of this paper, some franchisors (particularly those with no grants of exclusivity in the franchise agreement) may supplement their system expansion standards with site clearance procedures, rights of first refusal, minimum performance quotas, impact policies, and so forth. Such additional considerations may be included in the franchise agreement, but they also may be beyond the scope of the franchise agreement and included instead in policy statements, system memos and the like.

III. INITIAL FEES & ROYALTY

A. Initial Franchise Fee

In consideration of the Franchisee receiving the opportunity to establish the Franchised Business, and conduct it at the Premises, the Franchisee shall pay to the Franchisor, upon the execution of this agreement, an initial, non-recurring, non-refundable franchise fee in the amount of Twenty Thousand Dollars ($20,000). The Initial Franchise Fee shall be deemed to be fully earned by the Franchisor upon the execution of this agreement by the Franchisor and in consideration of the grant by it to the Franchisee of the opportunity to establish the Franchised Business as herein provided. The Franchisee shall not be entitled to a refund of any part thereof, regardless of the date of expiration or termination of this agreement, except as specifically provided herein.

Discussion:

Almost every franchise relationship requires the franchisee to pay an upfront initial franchise fee to the franchisor. The initial franchise fee is the fee or price to be paid by the franchisee for the right to open a franchised outlet. Most often, there are industry specific market rates for this fee.

The initial franchise fee may relate to the franchise rights and services provided by the franchisor, but it is not meant to represent the full present value of the potential future profit flow from the franchised business (and franchisees typically would not have enough capital at the outset of the franchise relationship to pay that full amount in any event).[23] Thus, the franchisor and franchisee agree to a lower initial fee, with the franchisor to be further compensated in the future via additional fees and continuing royalties.

The amount of the initial franchise fee varies for several reasons aside from industry standards. The initial fee will tend to increase in proportion to the term of the franchise agreement. It is more expensive for franchisees to obtain long-term rights because they will derive more value from using the franchisor's trademarks and system over a longer period of time. Furthermore, the amount of the initial franchise fee may depend on the success and maturity of the franchise system. Established franchise systems are likely to charge a higher initial fee from their franchisees than newer franchise systems. A new franchise system can still

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Investment Protection Act, Wash Rev. Code § 19.100.180(2)(f) (encroachment restrictions); Wisconsin Fair Dealership Law, Wis. Code 135.03 & 135.04 (governing "changes in competitive circumstances").

[23] Roger D. Blair & Francine Lafontaine, *Understanding the Economics of Franchising and the Laws that Regulate it*, 26-FALL Franchise L.J. 55, 57 (2006).

be very attractive to a potential franchisee because a lower cost of entry for a franchisee will allow for a greater reward if the venture succeeds.[24]

Drafters often state that the initial franchise fee is non-refundable and deemed to be fully earned on execution of the franchise agreement. Franchisors do this in order to make it more difficult for a franchisee to claim that the franchisor's entitlement to the initial fee is dependent on some further services being provided to the franchisee or that the fee should be refunded for lack of consideration. In certain instances the franchisor may specify in the franchise agreement situations where it will allow a portion of the fee to be refunded. For instance, this may arise if the franchisee fails to pass the initial training course, or if the franchise does not actually materialize (*e.g.,* the franchisee cannot find an acceptable site or is unable to open the location).[25] However, even in these situations, it is likely that the franchisor will keep a portion of the initial franchise fee.

B. Continuing Royalty

In return for the on-going rights and privileges granted to the Franchisee hereunder, the Franchisee shall pay to the Franchisor, throughout the term of this agreement, a royalty of six (6%) percent of Gross Sales for each week (Monday to Sunday). All royalties are payable in arrears on or before the Tuesday of each week for the Gross Sales generated by the Franchisee during the immediately preceding week.

Discussion:

As mentioned above, franchisees are not expected to pay the full present value of future profit flow at the moment they enter the franchise relationship. Franchisors allow them to make payments throughout the term of the agreement in the form of continuing royalties. Franchisors also elect to receive payments through royalties because it allows them to receive larger payments as the franchised business grows its revenues. This occurs because most franchisors require franchisees to pay royalties as a percentage of gross sales.[26] Sometimes the franchisor will base royalties on a sliding scale. In other words, the franchisor will increase the percentage of gross sales required for royalties at certain locations, depending on the franchisee's range of sales and number of years in the system.[27] As well, royalties are often calculated on an accrual basis. In other words, the franchisee will have to pay royalties on all gross sales (including sales placed on credit that may not have been collected yet).[28]

In terms of drafting, this clause is the perfect example of why it is crucial to adequately define gross sales. If the franchisor drafts poorly, the franchisee might be able to earn income in connection with the franchised business without including the total sum of those earnings in the calculation of royalties. Thus, gross sales should be as encompassing as possible to ensure that all sums earned are considered in later fee calculations. Although royalties are usually non-negotiable, a franchisee may still try to negotiate, especially in situations where the franchisor is

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[24] William L. Killion, *Putting Critical Decision Making Where it Belongs: Scouring the Franchise Agreement of the "D" Word*, 24-SPR Franchise L.J. 128 (2005).

[25] Asbill, Barkoff & Selden, *supra* note 3 at 27.

[26] Blair & Lafontaine, *supra* note 23 at 57.

[27] Sherman, *supra* note 15 at 109.

[28] Asbill, Barkoff & Selden, *supra* note 3 at 26.

more desperate for the franchise to open.[29] More specifically, a franchisee might try to draft a clause stating that royalties will not exceed a certain percentage.[30]

The percentage amount in the sample clause is, of course, only an example. The percentage rates can vary greatly between and even within industries. Retail franchise royalties do tend to be in the four to six percent range, while service franchise royalties can sometimes be somewhat higher. Specific industries, such as the coffee industry, tend to have higher royalty rates compared to other food service offerings. Sometimes the rate is calculated through the franchisor's completion of a comprehensive business plan, while in other cases it is set based on the rates of other existing franchise systems in that industry. Technically, the franchisor should calculate the estimated costs of resources provided to the franchisee. The franchisor should then evaluate this calculation of costs against the competitor's royalties to help gauge a ceiling rate. Then, to ensure that the royalties calculated are accurate, the franchisor should work closely with *pro formas* financial statements to estimate cash flows for a certain future period of time. To perform a diligent review of the royalty amounts, sensitivity analyses should be conducted on the *pro formas* cash flow estimates in order to ensure that the royalties are satisfactory.[31] Of course, calculating the royalty rate is one of the most important decisions a franchisor will make, as even a one percentage point difference can mean a significant amount of money over the long term of a franchise relationship, multiplied by many number of franchises.

The sample clause requires that payment of continuing royalties be made weekly. Historically, it was common for payments to be made monthly, as franchisors would be dependent on waiting for checks to arrive for payment. With the increase of electronic payment and reporting methods, the trend has moved towards more frequent payments.

Royalties do not have to be based on gross sales. Some franchisors charge their franchisees a flat fee, often on a weekly or monthly basis. The benefits of a flat fee system are that the franchisor does not necessarily need to be concerned about whether the franchisee is accurately reporting its gross sales, as the franchisor's own revenues are not dependent on the franchisee's revenues. The downside is that the flat fee amount will not rise to take into account inflation or a growing business, unless a mechanism is built into the franchise agreement that will permit such an increase.

It should be noted that some franchisors charge no royalties whatsoever. These are most often so-called "product distribution" franchises, where the franchisor is the primary or sole supplier of the product being sold. In these instances, the franchisor makes its revenues on the basis of the ongoing sales that it makes to the franchisee.[32]

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[29] Lawrence V. Ashe & Harris J. Chernow, *Negotiating Franchise Agreements: The Franchisee Perspective*, A.B.A. 23rd Forum on Franchising (2000) at 12.

[30] Julie Bennet & Cheryl Babcock, *Franchise Times: Guides to Selecting, Buying & Owning a Franchise* (Sterling Publishing Co., Inc. 2008) at 183.

[31] Kenneth F. Darrow, Mark Siebert & Phyllis Alden Truby, *The Structural Elements of a Franchise System and Their Economic and Legal Implications for Start-Up and Existing Systems*, A.B.A. 30th Annual Forum on Franchising (2007) at 38-39.

[32] These product distribution franchises should be distinguished from distributorships that are outside in the franchise regulations. In those cases, the supplier also makes its revenues from its sale of products, but it sells them at a bona fide wholesale price and will not have charged a direct or indirect franchise fee or, depending on the jurisdiction, met other elements of the franchise definition under applicable law.

C. Late Payments

Any and all amounts owing to the Franchisor or its affiliates by the Franchisee shall bear interest at the rate of 18% per annum or the maximum contract rate of interest permitted by governing law, whichever is less, from and after the date of accrual thereof. In addition to interest charges on late continuing license fee and sales promotion program fee payments, the Franchisor has the right to require the Franchisee to pay to the Franchisor a service charge of up to $50 for each delinquent report or payment owed to the Franchisor under this agreement. A payment shall be deemed delinquent for any of the following reasons: (i) the payment is not received by the Franchisor on or before the date due; (ii) the payment is received by the Franchisor on or before the due date, but is not honored by the Franchisee's bank or financial institution; or (iii) if the Franchisee is required to pay by electronic transfer of funds or some other method of payment as described above, there are insufficient funds in the Franchisee's bank account to collect the payment by a transfer of funds on or after the date due. The service charge is not interest or a penalty. It is only to compensate the Franchisor for increased administrative and management costs due to late payment.

Discussion:

Many franchise agreements set a specific interest charge on late payments. As seen in the above example, some franchisors also include a late fee in addition to the interest charge.[33] Of course, drafters should ensure they are complying with the relevant maximum interest rates they are permitted to charge under applicable law. From a business perspective, the franchisor will want to institute higher interest charges so that the franchisee makes payments on time. This is especially important when a franchisor relies heavily on the cash flow from such payments to maintain its own current operations. The franchisor wishes to discourage the franchisee from turning the franchisor into a lender.

D. Electronic Fund Transfers

The Franchisor has the right to require the Franchisee to sign electronic transfer of funds authorizations, and/or such other documents as the Franchisor designates from time to time, to authorize and direct Franchisee's bank or financial institution to transfer either electronically or through some other method of payment designated by the Franchisor, directly to the account of the Franchisor or its affiliates and to charge to the account of the Franchisee all amounts due to the Franchisor and/or its affiliates from Franchisee. The Franchisee's authorizations shall permit the Franchisor and/or its affiliates to designate the amount to be transferred from the Franchisee's account. If the Franchisor requires payment through the electronic transfer of funds or through some other method of payment, the Franchisee shall thereafter maintain a balance in its account sufficient to allow the Franchisor and its affiliates to collect the amounts owed to them when due. The Franchisee shall be responsible for any penalties, fines or other similar expenses associated with the transfer of funds described in this subparagraph. The Franchisee acknowledges and agrees that the Franchisor has the right to require the Franchisee to pay either by electronic transfer of funds or through some other method of payment designated by the Franchisor, as described in this subparagraph, regardless of whether the Franchisor imposes the same requirement on other Franchisees.

[33] Asbill, Barkoff & Selden, *supra* note 3 at 27.

Discussion:

To make the transfer of funds as easy as possible, many modern franchise agreements allow for the electronic transfer of those funds. In this clause, the franchisee agrees to make deposits through electronic transfers. Perhaps more importantly, the clause allows the franchisor to make withdrawals from such accounts if the franchisee is late or fails to make any payments.[34] Franchisees should take time to understand the rights of the franchisor to withdraw amounts.

E. Application of Payments

All payments by the Franchisee will be applied in such order as the Franchisor may designate from time to time. The Franchisee agrees that it may not designate an order for application of any fees different from that designated by the Franchisor and expressly acknowledges and agrees that the Franchisor may accept fees paid pursuant to different instructions without any obligation to follow such instructions, even if such payment is made by its terms conditional on such instructions being followed. This provision may be waived only by written agreement signed by the Franchisor, which written agreement must be separate from the check or other document or medium constituting or transmitting payment.

Discussion:

This clause allows the franchisor to accept payments in any form, at any time, and apply them to such amounts owing by the franchisee as the franchisor sees fit. It is a way for the franchisor to maintain control over how the payments will be received, and it gives the franchisor the right to change those processes at any time. For instance, if the franchisee has missed a month's payment but makes a payment for the subsequent month, the franchisor might draft for the right to apply the later payment to the earlier default on payment. If the franchisor fails to speak to application of payments in the agreement, it might not be able to use a later month's payment to satisfy an earlier month's default on payment.

IV. TERM

A. Initial Term

The term of this agreement (the "Initial Term") shall commence on the date hereof, and shall expire either at midnight on the day preceding the tenth (10th) anniversary thereof or on the expiration of the Franchisee's lease of the Premises, whichever date shall be the earlier, unless terminated sooner in accordance with the provisions of this agreement.

Discussion:

The term of the agreement is a relatively brief provision, albeit critical. It is the starting point from which the rights and obligations of the agreement begin, and it establishes the length of the relationship between the parties. From a business perspective, the parties want to institute a term long enough for each to benefit from the franchise relationship. It is in the best interests of the franchisor to give the franchisee enough time to recoup the initial investment.[35] If

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[34] *Id.*

[35] *Id.*

the franchisor does not give the franchisee enough time to recoup the investment, the franchisee might choose to pursue an alternative franchise. For instance, a large restaurant franchise with a significant build out cost will typically require a term of at least ten years, if not more, to justify the investment being made. In contrast, a home-based, low-cost service franchise, without a significant up front investment, can and often does have a shorter initial term. Generally, there are average terms per industry.[36]

There are many factors that affect the parties' perspectives on the initial term. Some of the key factors are: the market conditions, the flexibility desired by the franchisor to make changes, the start-up costs, the lengths of associated agreements (*i.e.*, lease agreements, bank loans), and consumer demand.[37] The time necessary for site selection and build out of the premises also may be a factor, as savvy franchisees will not want to start the clock ticking on the initial term prior to the franchised unit being open for business. Franchisors may need to be creative and draft so that the initial term begins earlier than the opening of the location but also takes into account the realities of build out time, lease terms, and other factors. The approach to the term provision depends largely on the franchisor. Some franchisors might avoid a long-term agreement because it may signify less flexibility to adapt to the surrounding business environment. Others may want to attract franchisees or perhaps charge a larger initial fee by offering a longer initial term.

B. Renewal and Renewal Conditions

The Franchisee may, at its option, renew this franchise for one (1) additional period of ten (10) years, provided that, at the time of renewal:

a. *the Franchisee gives the Franchisor written notice of such election to renew not less than six (6) months nor more than twelve (12) months prior to the end of the Term;*

b. *the Franchisee executes the Franchisor's then current standard form of Franchise Agreement, which may include, without limitation, a higher royalty fee and a higher advertising contribution, if any, than that contained in this agreement;*

c. *the Franchisee executes a general release in a form prescribed by the Franchisor of any and all claims against the Franchisor and its subsidiaries and affiliates, and their respective officers, directors, agents, and employees;*

d. *the Franchisee is not in default of any provision of this agreement, or any amendment hereof or successor hereto, or any other agreement between the Franchisee and the Franchisor, or any subsidiary or affiliate of the Franchisor, and the Franchisee has fully and faithfully performed all of the Franchisee's obligations throughout the Term;*

[36] Shane, *supra* note 18 at 93.

[37] Sherman, *supra* note 15 at 106.

e. *the Franchisee has paid or otherwise satisfied all monetary obligations owed by the Franchisee to the Franchisor and its subsidiaries and affiliates and the Franchisee has timely paid or otherwise satisfied these obligations throughout the term of this agreement;*

f. *the Franchisee agrees, at its sole cost and expense, to reimage, renovate, refurbish and modernize the Franchised Business, within the time frame required by the Franchisor, including the building design, parking lot, landscaping, equipment, signs, interior and exterior decor items, fixtures, furnishings, trade dress, color scheme, presentation of trademarks and service marks, supplies and other products and materials to meet the Franchisor's then current standards, specifications and design criteria for the Franchised Business, as contained in the then current Franchise Agreement, Manual (as defined herein), or otherwise in writing, including, without limitation, such structural changes, remodeling and redecoration and such modifications to existing improvements as may be necessary to do so; and*

g. *the Franchisee shall have paid to the Franchisor a renewal fee of fifty percent (50%) of the Franchisor's then current initial franchise fee.*

Discussion:

Renewal has been defined as "the opportunity to sign a new franchise agreement using the franchisor's 'then current form of agreement' if the conditions of 'renewal' are met."[38] However, renewal can happen without any of those things actually taking place. There are generally four approaches that the parties can take to the renewal provisions. First, the franchisor might prohibit renewal. Second, renewal might be allowed, but only under certain conditions and upon the approval of the franchisor. Third, renewal might be automatic upon expiration. Fourth, the parties might agree that the agreement is perpetual ("evergreen").[39]

At the outset, the franchisee often seeks the broadest possible renewal rights, in the attempt to recapture the initial investment fully, and have a business to sell as a going concern.[40] On the other hand, the franchisor will want to draft for flexibility at the end of the term so that necessary changes can be made in the pursuit of system goals, profit and financial success.[41] The franchisor will usually benefit from a franchisee with a long term, vested interest in the franchised business.[42] However, the wise franchisor also understands that it will be best protected by restricting the renewal clauses to a certain extent. If done properly from the franchisor's perspective, it can negotiate to treat "each franchisee uniquely and create its own

[38] Robert M. Einhorn & Craig R. Tractenberg, *Renewals and Conditions on Renewal*, A.B.A. 27th Annual Forum on Franchising (2004) at 1.

[39] *Id.* at 4.

[40] *Id.* at 1.

[41] *Id*.

[42] Killion, *supra* note 24 at 228.

calculus to determine whether renewal is desirable."[43] As such, the franchisor will try to ensure that the language regarding term and renewals allows for at least some flexibility. Much of the detail contained in the renewal provision relates to the conditions that a franchisee must satisfy to exercise his or her right to renew.

Drafters should consider applicable state laws when drafting the renewal provision, as this is an area where the law may place certain restrictions on nonrenewal of a franchise agreement. The franchise statutes in some jurisdictions, for example, require franchisors to provide notice of and have "good cause" for nonrenewal under some circumstances, notwithstanding contract terms to the contrary.[44] In other jurisdictions, even if good cause is not required, franchisors must provide statutory-set minimum notice of non-renewal and take other mandatory steps.[45] Depending on the jurisdiction and statute, the statutory notice period may be as long as 180 days. If the provision included in the franchise agreement is contrary to any such laws, attorneys need to advise clients that they should research applicable state law when contemplating non-renewal of a franchise agreement, and should not merely rely on the contractual language.

In drafting, some franchisors prefer to exclude a renewal provision altogether while others will allow for a renewal period or two, or even (although rare in modern agreements) choose an evergreen renewal into perpetuity.[46] Essentially, the choice of renewal provisions depends on the particular situation of the franchisor at the time of the agreement, including its business plans, bargaining power, and the law of the relevant jurisdictions. The above provision goes into specific details about the "then current form," and drafters should consider doing the same to avoid future ambiguities about to what the "then current form" refers. If the franchisor wishes to change one or more of the fundamental business terms, such as royalties, advertising or other fees, in the then current form, it is recommended that this be specifically stated. This is an area ripe for negotiation by experienced franchisees, who are likely to request that certain terms from the original agreement (generally relating to fees) are preserved in the new agreement.

Many renewal conditions are controversial with franchisees. For example, a requirement that the franchisee refurbish the premises as a condition of renewal often causes difficulty, especially if the costs are going to be significant or if "refurbish" is not well defined. Most franchisors insist that the franchisee execute a release as a condition of renewal. But in some states, such releases are void and unenforceable.[47]

The fee for renewal in the sample clause is set at fifty percent of the then current initial franchise fee, although some franchisors charge the full initial fee amount. A renewal fee can vary greatly, sometimes as a fixed amount, while other times an amount that can fluctuate, as in the sample clause. It is not uncommon for the renewal fee, if any, to be tied to the initial

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[43] Craig R. Tractenberg, Robert B. Calihan & Ann-Marie Luciano, *Practice Pointer: Up for Renewal? Disclosure, Drafting and Registration Tips* 23-SPG Franchise L.J. 206 (2004).

[44] *See, e.g.,* Indiana Deceptive Franchise Practices Act, Ind. Code §23-2-2.71(8); Arkansas Franchise Practices Act, Ark. Code Ann. § 4-72-202(a)(2); Minnesota Franchise Act, Minn. Stat. §80C14(4).

[45] *See, e.g.,* Illinois Franchise Disclosure Act, Ill. Stat. §705/20; *see also* Einhorn & Tractenberg, *supra* note 38.

[46] Asbill, Barkoff & Selden, *supra* note 3 at 29-30.

[47] *See, e.g.,* Ind. Code Ann. §23-2-2.7-1(5); Rev. Code Wash. §19.100.180.

franchise fee, as then it can increase over time, which can be important when renewal will take place many years in the future.

Lastly, any renewal, but particularly if a renewal is deemed a new contract, will result in administrative implications for both parties. For instance, if the franchisee is required to sign a new agreement in connection with the renewal, the franchisor must comply with franchise disclosure laws, even though the franchisee likely knows of this information by virtue of its involvement in the system during the initial term.[48] Additionally, a new or renewed contract may come within regulations that presently exist but did not exist or apply to the "old" agreement (because those laws were enacted after the original agreement was executed and did not apply retroactively). As a result, the drafters should be clear on whether they intend to create a "new" agreement upon renewal and consider how the current regulatory landscape may affect the relationship and the costs and time associated with the renewal process.

V. TRAINING AND OPERATING ASSISTANCE

A. Initial Training by the Franchisor

The Franchisor shall provide to the Franchisee, prior to the opening of the Franchised Business, for itself and one (1) other key employee designated by the Franchisee, a training course of such duration and at such location as the Franchisor may deem necessary, covering all phases of the System. The Franchisee and its trainee shall be obligated to attend, and successfully complete, the Franchisor's training course. The Franchisee shall be responsible for all travel and living expenses and all wages payable to any trainees and no wages shall be payable by the Franchisor to any such trainee for any service rendered at any ● outlet during the course of such training. The Franchisor further agrees to furnish one (1) person, experienced in the System, to assist the Franchisee at the Premises for such period immediately preceding or following the opening as the Franchisor deems reasonable. Additional training, start-up assistance or retraining or refresher courses may be provided by the Franchisor (although the Franchisor is not required to do so) at a cost to the Franchisee based on the Franchisor's then current daily fee for the Franchisor's personnel performing such training or assistance, plus other reasonable expenses, including all travel, meal and accommodation expenses.

Discussion:

Most franchisors will require that franchisees attend and successfully complete an initial training course. The franchisor wants the franchisees to understand fully how to run the franchised business under the system. By requiring initial training, the franchisor is helping ensure that the experience of the customer remains the same across all franchise locations, and that system standards are maintained. Ideally, the franchisor will train the franchisee on all contents of the system, so that there are no unanswered questions before the franchisee begins operations.[49]

Ultimately, franchisors will decide the scope of their training programs. If a franchisor wants the franchisee to accept all forms of training at any time, it should draft a broad training clause. If a franchisor only wants to oblige the franchisee to current training, it should draft a

[48] Einhorn & Tractenberg, *supra* note 38 at 2-3.

[49] Darrow, Siebert & Truby, *supra* note 31 at 24-25.

narrow clause requiring only certain training. The sample clause is drafted purposefully broad. Typically, the franchise agreement does not go into great detail about the training program (*i.e.*, regarding topics, length, costs, and the like). This is done in recognition of the fact that the franchisor's training program will most certainly evolve over time, and therefore that it is better not to hamper changes by being too specific in the franchise agreement. The then current scope and length of training, along with associated costs, are required disclosures of the FDD. Also, franchisors often need to balance how much training they want a franchisee to receive with how much they want to provide. The more training they agree to provide, the more opportunities there are for a franchisee to claim a breach of contract based on lack of adequate training. If the agreement gives the franchisee any foothold, this is a common claim or counterclaim.

Although franchisors may wish to provide training only in their "discretion," it should be noted that the term "discretion" has become a loaded word that tends to open franchisors to judicial review, such that alternative ways of reserving the franchisor's options should be employed.[50] Although drafters may think that the term "discretion" gives the franchisor greater power over its future action, they should be aware that it also exposes the franchisor to good faith and fair dealing claims.

B. Ongoing Training by the Franchisor

To assist the Franchisee in the operation of the Franchised Business, the Franchisor may offer, but is not obligated to offer, additional training programs and/or refresher courses to the Franchisee, the Franchisee's branch manager/operations manager and/or the Franchisee's employees from time to time. The Franchisor may require the Franchisee's attendance at these programs and/or courses. The Franchisee is responsible for the expenses of the Franchisee, the Franchisee's branch manager/operations manager, and the Franchisee's employees, including transportation to and from the training site and lodging, meals, and salaries during such training. The additional training programs and refresher courses, if offered, will be at the Franchisor's then current tuition for such training.

Discussion:

Once the franchise has opened its doors, the franchisor might want to obligate the franchisee to attend additional training or various conventions or seminars. Most often, the franchisor drafts that the franchisee will be responsible to pay for its own travel and stay costs, and that the franchisor is not obligated to offer the additional training. The choice to mandate future ongoing training depends on the nature of the franchise business and the specific franchise system.

C. Franchisor's Operating Assistance

The Franchisor may advise the Franchisee from time to time regarding operating issues concerning the Franchised Business disclosed by reports the Franchisee submits to the Franchisor or on-site inspections the Franchisor will make from time to time. Such guidance may be furnished in the Franchisor's Manual, bulletins or other written materials (including electronic communication) and/or during telephone consultations and/or consultation at the Franchisor's office or the Franchised Business. In addition, the Franchisor may furnish guidance to the Franchisee with respect to:

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[50] *See, e.g.,* Killion, *supra* note 24 at 229-30.

a. *standards, specifications and operating procedures and methods utilized by the Franchised Business;*

b. *purchasing required fixtures, furnishings, equipment, signs, products, materials and supplies;*

c. *advertising and marketing programs;*

d. *administrative, bookkeeping and accounting procedures; and*

e. *use of authorized and approved computer systems.*

Discussion:

Franchisors typically draft agreements so that they are not required to do more than what they deem absolutely necessary for the success of the franchised business. Often times, franchise agreements sparsely assign obligations to the franchisor.[51] Instead, agreements state that the franchisor has the option to do certain things if and when it decides that it wants to do them. The above clause on franchisor's operating assistance is a typical example of this. Generally, this section is relatively brief and somewhat vague. The example above demonstrates a clause that is somewhat more detailed than what is often found (and therefore may invite disputes over specific subparts, what was and was not included in the list, and why), but its purpose is to allow the franchisor to keep ultimate discretion on what kind of operating assistance it will provide. Although intended to perform the same function as the detailed example above and give discretion to the franchisor, a clause that is too vague may invite disputes about the franchisor's exercise of this contractual discretion, including, for example, what advice and guidance was necessary in the circumstances.

If the franchisee feels it will need a certain type or level of assistance to make its franchised business successful, it should actively try to negotiate for more assistance, but do so with an understanding that franchisors typically are not inclined to offer more.

VI. LOCATION AND PREMISES

A. Approval and Choice of Location and Franchisor's Approval

The Franchisee acknowledges that, following the signing of this agreement, the Franchisee will find and submit to the Franchisor a location for the Franchised Business. The Franchisee acknowledges and agrees that the Franchisor's consent to the location, and any information regarding the location communicated to the Franchisee regarding the standard site selection criteria for ● businesses, does not constitute a representation or warranty of any kind, express or implied, as to the suitability of the location for a ● business or for any other purpose. The Franchisor's recommendation of or consent to the location indicates only that the Franchisor believes that the location falls within the acceptable criteria for locations that the Franchisor has established as of the time of the consent to the location. The Franchisee acknowledges and agrees that the Franchisee's selection of the location is based on the Franchisee's own independent investigation of the suitability of the location.

[51] For the perspective of franchisee counsel on this topic, *see* Peter C. Lagarias & Robert S. Boulter, *The Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections*, 29-WTR Franchise L.J. 139 (2010).

Discussion:

The franchisor's involvement in site selection varies from franchise system to franchise system. Some franchisors require the franchisee to submit location proposals, while others might actually select the sites and own and sublet the site to the franchisee.[52] Franchisors should be aware that an increased involvement in site selection often increases exposure to claims by the franchisee if the business fails. Thus, many franchisors add a clause in the agreement that places sole responsibility for site selection in the franchisee's hands. Some franchisors want to have more control over the location. To do this, some will mandate a sublease from the franchisee, where the franchisor becomes the landlord of the premises. Alternatively, a franchisor could mandate an automatic assignment of the lease upon termination of the franchise agreement (either through expiration or default).[53]

B. Purchase or Lease of the Location

The Franchisee must purchase or lease the location within six (6) months after signing this agreement. Failure to sign a lease within this timeframe constitutes grounds for immediate termination of this agreement and the loss of the Franchisee's non-refundable Initial Franchise Fee. The Franchisor has the right, but not the obligation, to review and approve the terms of any lease or purchase contract for the location, and the Franchisee agrees to deliver a copy to the Franchisor for approval before it is signed. The Franchisee agrees that any lease for the location must be in form and substance satisfactory to the Franchisor.

Discussion:

The franchisor often requires a deadline for a site lease or purchase to ensure that the business is going to be up and running soon after the franchise agreement is finalized. If the franchisee cannot satisfy this requirement, it should not agree to the deadline so that it avoids complete termination of the agreement.

C. Lease by the Franchisee

The Franchisee may not execute a lease, sublease, purchase contract or any modification thereof without the Franchisor's approval. The Franchisor's approval of the lease, sublease or purchase contract does not constitute a warranty or representation of any kind, express or implied, as to its fairness or suitability or as to the Franchisee's ability to comply with its terms. The Franchisor does not, by virtue of approving the lease, sublease or purchase contract, assume any liability or responsibility to the Franchisee or to any third parties. Such approval indicates only that the Franchisor believes that the location and certain terms of the lease, sublease or purchase contract fall within the acceptable criteria established as of the time of approval. The Franchisee further acknowledges that the Franchisor has advised the Franchisee to seek legal counsel to review and evaluate the lease. The Franchisee must deliver a copy of the fully signed lease, sublease or purchase contract to the Franchisor within five (5) days after its execution.

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[52] Darrow, Siebert & Truby, *supra* note 31 at 23.

[53] Sherman, *supra* note 15 at 108.

Discussion:

In addition to approval of a location for the franchise, the franchisor should reserve to itself the right to approve the agreement under which the franchisee obtains the right to possession of the premises. Some franchisors become quite involved in finding a location, and in the details of the lease being entered into by the franchisee, while others may reserve the right to approve the lease. In any event, the franchisor should state that the terms and conditions of the lease are the responsibility of the franchisee.

D. Relocation

With the consent of the Franchisor, the Franchisee may apply to relocate the Franchised Business to a location within the Territory, subject to the Franchisor's then current Relocation Policy. The Franchisee and each of the Franchisee's shareholders or equity owners with a 10% or greater interest in this agreement must execute a General Release in favor of the Franchisor, in the form prescribed by the Franchisor. The Franchisor will consent to or reject the Franchisee's relocation application in accordance with its then current Relocation Policy. If the Franchised Business is temporarily closed pending relocation, the Franchisee may not assign any interest in the franchise to another party or entity until such time as the Franchised Business is reopened and in operation.

Discussion:

It is typical for the franchisor to limit the franchisee's operations to a certain location that has already been approved. Business realities dictate that the franchised business might need to move at some point in the life of the agreement. Thus, it is not uncommon for drafters to include a provision on relocation.[54] In drafting, the franchisor might refuse all franchisee attempts at relocation, allow relocation in certain circumstances, and/or allow relocation with added conditions.[55] The franchisor must look at the specific circumstance and location of the franchised business and draft the relocation provisions accordingly. In some cases, the causes of relocation might be cause for termination of the agreement. This typically would only occur in situations where the location is a fundamental factor in the success of the franchised business. Note that this sample clause requires relocation to another location in the territory, thereby presuming that there is a territory to begin with. This is important, so as to avoid a relocated franchisee encroaching upon the sales of another franchisee already operating.

E. Modernization or Replacement

The Franchisee shall effect such items of modernization, refurbishing and/or replacement of the building, premises, equipment, signage and grounds as may be reasonably necessary to permit the same to reasonably conform to the standards then prescribed by the Franchisor for similarly situated new Franchised Businesses (i) as a condition of the renewal of this agreement; and (ii) every ten (10) years, or any shorter period required by any lease for the premises, provided, if this last requirement is triggered within two (2) years prior to the expiration of a nonrenewable lease, the Franchisee shall not be required to effect the same, unless the landlord of the Franchised Business premises requires the Franchisee to modernize

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[54] Douglas L. Carden & Peter L. Klarfeld, *"We Have to Live With it" - Tips From the Litigators' Perspective on Advanced Drafting* A.B.A. 28th Annual Forum on Franchising (2005) at 34.

[55] *Id.* at 34-35.

under the terms of the lease. The Franchisee acknowledges and agrees that the requirements of this subparagraph are both reasonable and necessary to insure continued public acceptance and patronage of ● and to avoid deterioration or obsolescence in connection with the operation of the business.

Discussion:

Some franchise agreements span a considerable period of time. Many franchisors will include an obligation for the franchisee to upgrade the premises throughout that time period or as triggered by a particular event, such as renewal or transfer. The franchisor should be mindful of this clause so that the general image of the trademarks is being adequately preserved and improved throughout the term of the franchise agreement.[56] If this clause is absent or inadequately drafted, the franchisor might risk not being able to require that franchisees keep their locations up to standard, which in turn might end up damaging the goodwill of the franchise. Franchisees will often balk at the notion of this type of provision, especially if it is drafted in such a way as to provide the franchisor with a "blank check" in terms of what renovations the franchisee can be required to undertake.[57] Some franchisors, particularly those that have consulted with franchisees while drafting this clause, include maximum required expenditures. Such limitations may provide franchisees with some clarity and comfort regarding the applicability of this provision and the potential effect on the bottom line.

VII. DESIGN AND CONSTRUCTION

A. Development of Premises by the Franchisee

The Franchisee shall construct and equip the Premises in conformity with the System standard layout plans, specifications and drawings approved by the Franchisor. The Franchisor shall have the right to inspect the construction and development of the Premises at all reasonable times. The cost of plans, designs, drawings, and specifications, any commissions or broker's fee payable by the Franchisor to find or secure the Premises and/or the Franchisee, and all costs and expenses pertaining to the construction and equipping of the Premises shall be borne exclusively by the Franchisee. The Franchisor shall provide such advice and assistance to the Franchisee in constructing and equipping the Premises as may reasonably be required. The Franchisee agrees to do or cause to be done the following at its sole cost and expense:

a. *ensure that all applicable laws, building codes, permit requirements and lease requirements and restrictions are complied with in connection with such construction;*

b. *obtain all required building, utility, sign, sanitation and business permits and licenses and any other required permits and licenses;*

c. *construct all required improvements to the Premises and decorate the Premises in compliance with plans and specifications approved by the Franchisor;*

[56] Hurwitz & Schnell, *supra* note 19 at 73-74.

[57] For a discussion of such wariness from the perspective of counsel representing franchisees, *see* Lagarias & Boulter, *supra* note 51 at 145 & n.84.

d. *subject to the provisions hereof, purchase or lease and install all fixtures, equipment and signs required for the Premises by the Franchisor; and*

e. *present a chosen contractor and contractor's tender for approval by the Franchisor and retain and compensate all contractors, subcontractors or other professionals required in connection with the construction and development of the Premises.*

Discussion:

It is common for the franchisor to place all construction related obligations solely on the franchisee. To maintain some control over the building and construction, the franchisor will often draft a requirement for the franchisee to seek franchisor approval of building plans and designs. It is important that this section include enough details for the franchisee to be aware of its specific obligations (*i.e.,* regarding permits, fixtures, contractors, design, among others). Most often, the franchisor will stay removed from the construction process so as to avoid or limit any vicarious liability claims or claims by the franchisee.

B. Licenses and Permits

The Franchisee must at all times maintain the Franchisee's premises and conduct operations in compliance with all applicable laws, regulations, codes and ordinances. The Franchisee must secure and maintain in force all required licenses, permits and certificates relating to the Franchised Business.

Discussion:

The clause regarding licenses and permits ties directly into the previous clause regarding development of the premises by the franchisee. The above example is relatively vague, but it stresses the importance of the franchisee's responsibilities. In drafting this clause, the franchisor is explicitly removing itself from the responsibility of ensuring compliance with relevant laws, and licenses, permits and certificates.

C. Fixtures, Equipment, Signs and Computer Systems

The Franchisee agrees to use in the operation of the Franchised Business only those brands or types of fixtures, equipment (including without limitation, computers, cash registers and point of sales systems), and signs that the Franchisor has approved as meeting its specifications and standards for design, appearance, function, performance and serviceability. The Franchisee may purchase approved brands or types of fixtures, equipment and signs only from suppliers approved by the Franchisor, which may include the Franchisor or its affiliates. The Franchisee further agrees to place or display at the Premises (interior and exterior) only such signs, emblems, lettering, logos and display materials that are from time to time approved in writing by the Franchisor.

Discussion:

As mentioned throughout this agreement, the franchisor drafts clauses to protect the goodwill and reputation of its trademarks and system. Franchisors often put in place minimum quality requirements for the fixtures, equipment, signs, and computer systems. At its root, the

intention behind this clause is to ensure a satisfactory and consistent customer experience across all franchise locations. The larger the franchisor becomes, the more likely it is to require that the franchised locations use specific materials. This is because there is a greater chance of discrepancy across more locations. In some cases, the franchisor acts as the supplier, while in other cases the franchisor merely will set in place minimum requirements for the supplies. Sometimes the franchisor also will recommend or require use of one or several approved suppliers. The specifications of this clause depend on the nature of the franchise and the franchisor's desire to put out a unified message to its customers.

Occasionally those desires must be balanced with franchisee interests. For instance, the franchisor may get a rebate or other consideration from the designated suppliers.[58] Rebate aside, volume purchasing should result in lower prices for the franchisees than they could get on their own. However, the franchisee might end up paying extra for supplies, and generally will also have knowledge that a portion of that additional money is going to the franchisor. The franchisor will want to explicitly outline the possibility of such rebates (because it is often a reality of these business affairs) so that the franchisee is not surprised by it during the term of the agreement, and the franchisor also must check the statutory regulations with respect to rebates in relevant jurisdictions. If the franchisor receives rebates, they must be disclosed in the FDD.

D. Commencement of Operations

The Franchisee agrees not to open the Franchised Business until: the Franchisee is notified by the Franchisor that the Franchised Business meets the Franchisor's standards and specifications; the Franchisee is fully-staffed; the Franchisee has successfully completed training to the Franchisor's satisfaction; the Franchisee has an approved marketing plan; the Franchisee has given the Franchisor a copy of the lease, sublease or purchase contract for the location; the Franchisor has been furnished with copies of all insurance policies required by the agreement, or such other evidence of insurance coverage and payment of premiums as the Franchisor requests or accepts them; the Franchisee has obtained all required permits, licenses, and certifications for operating the Franchised Business, and the location is in compliance with all laws, rules and regulations; and all applicable franchise fees and other amounts owing to the Franchisor have been paid.

Discussion:

Franchisors will generally not allow the franchised business to open without prior approval and confirmation that all necessary work prior to opening has been completed. The franchisee is usually required to do all of the preparatory work, and once this work is completed the franchisor will inspect the physical premises or other aspects of the business.[59] As mentioned above, this approval ensures that the franchisor does a last review before the franchised business begins to represent the system in a new location. The intent behind this clause is to ensure that there is no harm done to the value of the trademarks or system by prematurely opening and operating under the franchisor's name.

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[58] Joyce Mazero & Suzie Loonam, *Purchasing Cooperatives: Leveraging a Supply Chain for Competitive Advantage* 29-WTR Franchise L.J. 148 (2010).

[59] Bennet & Babcock, *supra* note 30 at 237.

VIII. OPERATION OF FRANCHISED BUSINESS

A. Ongoing Duties and Obligations of Franchisee

The Franchisee acknowledges that the Franchisor has invested and is investing time and capital in the advertising and promotion of ● franchises and other outlets as a chain of ● outlets conducting business in a uniform and high quality manner. The Franchisee understands and acknowledges that such advertising and promotion by the Franchisor has created and is creating goodwill and customer association in the Trademarks, which benefit the Franchisor, the Franchisee and all other ● franchisees. The Franchisee acknowledges that, to foster and preserve such goodwill, it is necessary for the Franchisee to operate the Franchised Business in a manner and to a quality consistent with the System and the businesses heretofore operated by the Franchisor and/or its franchisees. The Franchisee agrees to operate the Franchised Business strictly in accordance with the System, whether contained in the Manual, or otherwise. Without limiting the generality of the foregoing, the Franchisee agrees as follows:

a. *to operate the Franchised Business with due diligence and efficiency in an up-to-date, quality and reputable manner during such days, nights and hours as may be designated by the landlord and/or the Franchisor for the Premises;*

b. *the Franchisee shall ensure that at all times prompt, courteous and efficient service is accorded to its customers. The Franchisee shall in all dealings with its customers, suppliers and the public adhere to the highest standards of honesty, integrity, fair dealing and ethical conduct;*

c. *the Franchisee shall sell such products and only such products as meet the Franchisor's uniform standards of quality and quantity, as have been expressly approved for sale in writing by the Franchisor and as have been prepared in accordance with the Franchisor's methods and techniques for product preparation. The Franchisee shall sell all approved items and the Franchisee shall not offer for sale any other products from the Premises. The Franchisee shall discontinue the sale of any items or any other merchandise of any kind whatsoever as the Franchisor prohibits in writing;*

d. *the Franchisee agrees to maintain the condition and appearance of the Franchised Business and the equipment used therein consistent with the then current image, as it may be from time to time, of the Franchisor's franchised outlets as attractive, modern, clean, convenient and efficiently operated business offering high quality products and service. The Franchisee agrees to effect such maintenance of, and repairs to the Premises and the equipment installed therein as is reasonably required on a regular and frequent basis and maintain such condition and appearance;*

e. *the Franchisee shall not make or cause to be made any alterations to the interior or exterior of the Premises so as to modify the appearance thereof or any alterations or replacements*

of any of the leasehold improvements, fixtures or equipment at the Premises without first having obtained the written approval of the Franchisor;

f. *the Franchisee shall participate fully in all national, regional and local promotions initiated by the Franchisor;*

g. *the Franchisee shall, upon request by the Franchisor and at the option of the Franchisor, make available for a reasonable period of time each of the Franchisee's staff and manager for training or retraining by the Franchisor, at the Franchisor's head office or other locality designated by the Franchisor. Such training or retraining shall be conducted at no cost to the Franchisee, provided however, that the Franchisee shall be responsible for all travel, food and lodging costs;*

h. *the Franchisee shall comply with all municipal, state and federal laws and regulations and shall obtain and at all times maintain and keep in good standing, any and all permits, certificates and licenses necessary for the proper conduct of the Franchised Business pursuant to the terms of this agreement;*

i. *the Franchisee shall devote its full time and attention to the establishment, development and operation of the Franchised Business; and*

j. *the Franchisee agrees that, if specified by the Franchisor, all items will be served in containers bearing accurate reproductions of the Trademarks, which reproductions shall be submitted to the Franchisor for prior written approval before usage. All napkins, straws, bags, cups, matches, menus and other paper goods, promotional, packaging and point of sale materials, and like articles used in connection with the Franchised Business shall be of a quality and style and bear such reproductions of the Trademarks as the Franchisor shall specify and all art work and reproductions used in connection therewith shall conform to specifications established by the Franchisor and be submitted to the Franchisor for prior written approval before usage. Such imprinted items shall be purchased by the Franchisee only from the Franchisor or suppliers approved by the Franchisor.*

Discussion:

The service, product quality, and general experience of a customer at the franchised location are interpreted as a reflection of the franchisor. To mitigate this risk, the franchisor puts into the franchise agreement ongoing duties and obligations for the franchisee. The business purpose behind this clause is intuitive; the franchisor must ensure that the franchisee operates the business in a consistent manner with the other franchisees, so that the customer can have a uniform and positive association with the franchisor’s trademarks. This positive experience and association will lead to continued goodwill for the franchisor, and also will lead to more successful franchised businesses. Thus, it is in the franchisor’s (and the franchisee’s) best

interest to have a uniform system and operation that results in the positive experience of customers. In other words, "customers know what to expect when they patronize an outlet in a successful franchised chain, and it is important for the chains to meet these expectations time after time."[60]

The franchisor also uses this section to limit its liability for the franchisee's actions or omissions. Franchisors tend to avoid language that states or implies control over the ongoing operations of the Franchised Business (See discussion in Section XIX.C, Independent Contractor.). Additionally, as seen in section (h) of the above sample, the franchisor explicitly requires the franchisee to abide by all relevant laws. Franchisors draft this way not only to protect their brand, but to limit the risk of vicarious liability.[61]

In drafting this clause, franchisors should be careful to insert provisions that are consistent across all franchised businesses. The franchisor also should ensure that the clause allows for immediate renewal and update so that there is little discrepancy between the franchise locations at all times.[62] Realistically, there is little room for the franchisee to assert any opposition to this clause. The franchisee is purchasing a right to operate a franchised business but must realize that can only be done within the operating guidelines of the franchisor.

The sample clause contains a veritable shopping list of areas where the franchisor may dictate compliance with standard. Not all franchise agreements have such a long list, while some may have one that is even longer. It is however emblematic of all that needs to be considered when licensing to a franchisee use of a system and trademarks.

B. Restrictions on Services and Products

The Franchisee acknowledges that the reputation and goodwill of the System is based upon, and is maintained and enhanced by, the sale of high quality products and services and the satisfaction of customers who rely upon the uniformly high quality of products and services that are sold under the System and such continued uniformity is essential to the goodwill, success and continued public acceptance of the System. Accordingly, the Franchisee agrees to sell, offer or otherwise deal in only such products and services as the Franchisor shall first approve of in writing.

Recognizing that the products to be used in the Franchised Business must conform to the Franchisor's standards and specifications, the Franchisee hereby agrees to purchase all products, including without limitation, all inventory, only from the Franchisor, or suppliers approved or designated by the Franchisor (which may include affiliates of the Franchisor).

So long as the Franchisee is not in default hereunder, the Franchisor will endeavor to use its reasonable best efforts to fill all orders placed by the Franchisee as promptly as possible. However, the Franchisor will not be liable for loss or damage due to delay in delivery resulting from any cause beyond its reasonable control, including, but not limited to, compliance with any regulations, orders or instructions of any federal, state or municipal government or any department or agency thereof, acts or omissions of the Franchisee, acts of civil or military authority, fires, strikes, lockouts, embargoes, delays in transportation, and inability due to

[60] Blair & Lafontaine, *supra* note 23 at 60.

[61] Perkins, Yatchak & Hadfield, *supra* note 13 at 179.

[62] *Id.* at 180.

causes beyond the Franchisor's control to obtain the necessary products or ingredients. In no event shall the Franchisor be liable for financial loss, including consequential or special damages on account of delay due to any cause.

The Franchisee shall not dispose of products at prices greater than the prices set by the Franchisor from time to time as the maximum selling price for products. Wherever reasonably possible, the Franchisee shall sell or dispose of all products at such prices as the Franchisor may reasonably suggest from time to time; provided it is hereby agreed that notwithstanding the foregoing, the Franchisee is under no obligation to accept such suggested resale prices and the Franchisee may sell the products, at any reasonable prices, less than the maximum selling price set by the Franchisor.

Discussion:

It is trite to say that a successful franchise will generally have the same products and services offered at each location. Mandating the same offering allows the customer to rely on the services and products, thus positively adding to the franchise system's goodwill. So, a franchisor will almost always reserve the right to dictate strictly the products and services that its franchisees can offer. This uniformity is one of the hallmarks of almost every franchise system. This often necessarily extends to source of supplies and inventory, so as to ensure the uniformity of product offering. To do this, the franchisor commonly drafts restrictions on the products and services the franchisee can sell, and on suppliers. The franchisor will often restrict the franchisee from selling competitive products and services.[63] The franchisor does this for the obvious reason of not wanting to promote its competitors' products and services.

If the franchisor (or an affiliate) is also the supplier, then the franchise agreement should have provisions dealing with such supply issues. For instance, franchisors often draft a clause allowing for temporary or even permanent delays in the delivery of franchise products. Although it is in the franchisor's interests to get inventory and supplies into the hands of its franchisees, it seeks to limit its liability if that is simply not possible.

Another significant issue that arises within this section is with regards to pricing restrictions placed on the franchisee. Pricing arrangements must be drafted to avoid running afoul of federal and state antitrust laws.

The Sherman Act, Section 1, the basic U.S. federal antitrust statute, prohibits every "contract, combination or conspiracy in restraint of trade." Because franchising is a vertical relationship, a particular area of pricing concern is vertical resale price maintenance.[64] Resale price maintenance ("RPM" or "vertical price-fixing") is an agreement between a seller and a buyer as to the buyer's resale price, including either an actual or advertised resale price.[65] In

[63] Shane, *supra* note 18 at 87.

[64] In some circumstances, franchise relationships may be horizontal for antitrust purposes as well, such as in a dual distribution setting (where the franchisor's company-owned outlets compete against franchised outlets). *See, e.g.,* Quentin R. Wittrock & Jeremy L. Johnson, *Can Franchisors Control Franchisee Prices?,* 28-SPG Franchise L.J. 199 (2009). Horizontal agreements may present the "classic case of a *per se* illegal agreement" -- "one between competitors...to fix prices or divide customers between themselves, which is subject to criminal prosecution as well as civil liability." Richard J. Hoskins, *Resale Price Maintenance under the Federal and State Antitrust Laws* (Schiff Hardin 2010).

[65] This should not be confused with a seller's cooperative advertising program, which is *permitted* to condition participation on the buyer's agreement to advertise at a certain price. In other words, even where a seller and buyer are prohibited from agreeing on buyer's actual or advertised resale price, the seller is not required to extend its coop

1911, the U.S. Supreme Court declared that all RPM agreements were *per se* illegal; the only thing necessary for liability was proof that the parties had reached an express or tacit understanding as to resale price.[66]

In 1997, the U.S. Supreme Court changed the law to provide that *maximum* RPM agreements (agreements setting a resale price ceiling) were no longer *per se* illegal but would be judged under the rule of reason.[67] Then, in 2007, in *Leegin Creative Leather Products, Inc. v. PSKS, Inc*.,[68] the Court ruled that all RPM agreements, including minimum RPM agreements for price floors, would be judged under the rule of reason rather than the *per se* rule. This is significant because now, under Federal law, a RPM agreement is not unlawful unless it is proven that its overall effect is to restrict competition in a properly-defined market. For example, an agreement would not violate federal law where it fosters competition in the "inter-brand" market (*e.g.,* competition between the franchise system and its competitors), even if it adversely affects "intra-brand" competition (*e.g.,* among franchisee-buyers for the resale of the same-branded product).[69]

Importantly, however, the state antitrust laws remain a concern because they may not be affected by the Supreme Court's rulings, depending on the specific state statute. In at least three of the most commercially important states – New York, New Jersey, and California – all RPM agreements remain *per se* illegal. And in Maryland, minimum RPM agreements are *per se* illegal as a result of that state's post-*Leegin* amendment of its law. Other states are also free to retain the *per se* rule without amending their statutes, if they choose.[70]

In view of state-law concerns, many franchisors have, for the time being, continued their existing "brand equity" programs, which avoid any agreements with franchisees as to resale price or, at least, minimum resale price (in the franchise agreement and elsewhere). Brand equity programs, in simple terms, are developed with counsel to ensure that the franchisor only suggest prices, that those "suggested resale prices remain only suggestions," and that the

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advertising support to a buyer who chooses to advertise at a price below (or above) the suggested resale price. *See, e.g.,* Hoskins, *supra* note 64 at 1.

[66] Certain types of agreement are considered to be always or almost always anticompetitive and therefore "*per se*" illegal. Under the *per se* rule, once such an agreement is proven, liability attaches without regard to the agreement's effect on competition (because an adverse effect is presumed as a matter of law). It is notoriously easy to prove an agreement under the antitrust laws, particularly in a jury trial. No actual words of agreement need be exchanged; a tacit or implied agreement may be inferred from conduct as well as words. *See, e.g.,* Hoskins, *supra* note 64 at 1.

[67] *State Oil Company v. Khan,* 522 U.S. 3 (1997). Ordinarily, under the Rule of Reason analysis, a plaintiff alleging an antitrust violation must show (a) the existence of a contract, combination or conspiracy ("agreement") between the defendant and at least one other person, that (b) had an adverse effect on competition in a properly-defined geographic and product market.

[68] 551 U.S. 877, 127 S. Ct. 2705 (2007).

[69] "Thus, under Federal antitrust laws, criminal liability has been eliminated and the risk of treble-damage civil lawsuits has been reduced, although not eliminated. RPM agreements can still be challenged, but only under the rule of reason: they are unlawful *if but only if* they can be shown to injure competition in a properly-defined market, with particular reference to the effect of the agreement on interbrand competition." Hoskins, *supra* note 64 at 2.

[70] Hoskins, *supra* note 64 at 2 ("Published articles have suggested that a dozen or more states would be able, under their statutes, to enforce RPM as a *per se* illegal offense. Only time will tell how many actually do so, but of course, the uncertainty is itself problematic.") *See also* Quentin R. Wittrock & Jeremy L. Johnson, *Can Franchisors Control Franchisee Prices?* 28-SPG Franchise L.J. 199, 205, 243 (2009).

franchisee's "resale prices remain unilaterally its own, without economic discrimination or coercion."[71]

Given all of these issues, drafters must carefully consider what pricing restrictions, if any, to place on the franchisee in the franchise agreement. In addition to antitrust concerns, drafters must understand, of course, that once a franchisor contracts in the franchise agreement that it will not mandate franchisee retail prices, it is contractually bound by that agreement, notwithstanding any later change in state antitrust law that might permit it to do so.

The supply of products and materials by the franchisor can be a significant source of revenue for the franchisor, as well as a significant point of contention between the franchisor and its franchisees. There is no one answer to dealing with the issue, and many franchise systems have their own approach. But one reason franchisees buy into a franchise system is the implied or expected promise of volume buying power for inventory and supplies. If the franchisees therefore are in fact paying more for their inventory and supplies than if they were independent, then a franchisor should not be surprised if difficulties arise.

As noted, some franchisors specify what supplies must be used, some specify where those supplies must be purchased, others specify both the content and source of supplies, and some provide the supplies themselves.[72] Theoretically, a perfect franchise would be entirely vertically integrated and would monitor quality by supplying the franchised businesses internally.[73] However, having a perfectly vertically integrated system is very difficult to accomplish and sometimes risky. A franchisor might make itself vulnerable to an accusation of violating antitrust or trade laws because it went too far in controlling sourcing.[74] As a result, many agreements try to balance on a fine line of source specifications. Most franchisors establish relationships with specific, trusted suppliers and require all of their franchised businesses to buy from those suppliers. Increasingly, franchisors are realizing that they can use their supply chain procedures to decrease costs by six to eight percent and gain a competitive advantage.[75]

There are some notable tensions that evolve in the context of this section of the franchise agreement. From the franchisor's perspective, such clauses allow the franchisor to ensure a unified experience for the customers so that the goodwill of the franchisor can continually improve, thus, providing for more financial success.[76] However, from the franchisee's perspective, such clauses have some potentially negative implications. In many situations, a franchisee will benefit from the ease and quality assurance that comes with approved supplies and suppliers.[77] However, franchisees might be frustrated by the fact that they have to buy supplies from certain sources, when they may be able to get those same supplies for less

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[71] Hoskins, *supra* note 64 at 2. *See also* Wittrock, & Johnson, *Can Franchisors Control Franchisee Prices?, supra* note 70; Quentin R. Wittrock & Jeremy L. Johnson, *Advising Companies in the Wake of Leegin*, 28-SPG Franchise L.J. 202 (2009).

[72] Asbill, Barkoff & Selden, *supra* note 3 at 31-32.

[73] Blair & Lafontaine*, supra* note 23 at 60.

[74] Asbill, Barkoff & Selden, *supra* note 3 at 32.

[75] Mazero & Loonam, *supra* note 58 at 148.

[76] Blair & Lafontaine, *supra* note 23 at 60.

[77] Darrow, Siebert & Truby, *supra* note 31 at 29.

elsewhere. Of course, the more that the franchisee has to pay for supplies, the less end-of-day profit it can enjoy. This has less impact on the franchisor, because the franchisor will still get royalty payments (which are most frequently based on a percentage of gross sales). Thus, the franchisor may risk little and gains a rebate by requiring the use of a certain supplier. In other words, the franchisor may lose nothing because the royalty payments are calculated from gross sales, which makes no account for costs (it is simply the gross revenue of the business). On the other hand, the franchisee may have to pay more for supplies that it could have purchased more cheaply elsewhere. Additionally, franchisees often have knowledge of the frequent rebates and other payments that designated suppliers give franchisors. Thus, franchisees often get frustrated by the fact that they are paying more for supplies, while the franchisor is receiving a cut of their supply payments. Of course, in situations where the franchisor is prevented from keeping the rebate (*i.e.,* where the franchisor did not properly disclose rebates in the FDD or the rebate is otherwise not legally available under a statute), the above discussion does not apply.

It is worth noting that a service driven franchise system might not need the above clause as much as a product driven franchise system, if at all.[78]

C. Request for Change of Supplier

In the event that the Franchisee wishes to purchase any unapproved item, including inventory, and/or acquire approved items from an unapproved supplier, the Franchisee must provide the Franchisor with the name, address and telephone number of the proposed supplier, a description of the item that the Franchisee wishes to purchase, and purchase price of the item, if known. At the Franchisor's request, the Franchisee must provide the Franchisor, for testing purposes, a sample of the item the Franchisee wishes to purchase. If the Franchisor incurs any costs in connection with testing a particular product or evaluating an unapproved supplier at the Franchisee's request, the Franchisee or the supplier must reimburse the Franchisor for the Franchisor's reasonable testing costs, regardless of whether the Franchisor subsequently approves the item or supplier. Nothing in the foregoing will be construed to require the Franchisor to approve any particular supplier. The Franchisor may base the Franchisor's approval of any such proposed item or supplier on considerations relating not only directly to the item or supplier itself, but also indirectly to the uniformity, efficiency, and quality of operation the Franchisor deems necessary or desirable in the Franchisor's System as a whole. Nothing herein will require the Franchisor to approve an unreasonable number of suppliers for a given item, which approval might, in the Franchisor's judgment, result in higher costs or prevent the effective or economical supervision of approved suppliers. The Franchisor may revoke the Franchisor's approval of particular products or suppliers when the Franchisor determines that such products or suppliers no longer meet the Franchisor's standards. Upon receipt of written notice of such revocation, the Franchisee must cease purchasing products from such supplier. The Franchisee must use products purchased from approved suppliers solely in connection with the operation of the Franchised Business and not for any competitive business purpose.

The Franchisee shall purchase all ingredients, products, materials, supplies, and other items required in the operation of the Franchised Business which are or incorporate trade-secrets of the Franchisor, as designated by the Franchisor only from the Franchisor or suppliers designated by the Franchisor ("Trade Secret Products"). The parties expressly acknowledge that the ability of the Franchisee to receive shipments of the Franchisor's Trade Secret Products is an essential element of and condition to the grant made herein. If the Franchisor is prevented

[78] Sherman, *supra* note 15 at 108.

by a governmental authority from delivering such Trade Secret Products to the Franchisee, or if the Franchisee is so prevented from receiving such Products, the prohibited party shall immediately notify the other and, at which time, the Franchisor may, at its sole option, do one or more of the following: (i) the Franchisor may, at its option, arrange for other suppliers of such Trade Secret Products [in the country in which the Franchised Business is located] during such period of prohibition; or (ii) the Franchisor may, at its option, terminate the agreement.

Discussion:

As a result of the complications inherent to the franchisor placing sourcing and supply restrictions on the franchisee, many agreements include a clause that allows for the franchisee to request an exception or change of supplier. The franchisor's ultimate goal is to have each and every franchised business succeed, and earn increasing gross sales (so that the franchises can simultaneously contribute to the franchisor's goodwill and profits through royalty payments). If a franchisee will perform better using a different supplier, and this will not hurt the general experience of the franchise's customers, then the franchisor often allows the franchisee to change suppliers. Franchisors that include this section in their franchise agreement accept these business realities, and are willing to allow for such flexibility, as long as it is approved and standards are met. The franchisor can then please the franchisee, while still ensuring a similar, quality experience for customers.

That being said, more and more franchisors rely on revenues generated from the supply chain, and therefore such clauses are by no means universal, or even universally adhered to if in the agreement. That is because more and more franchisors are a supplier, affiliated to a supplier, or receive volume rebates from third party suppliers only by delivering to the third party supplier a certain minimum volume of purchases from the franchisees of the system. When contained in a franchise agreement, the clauses often generate a fair amount of controversy. Some franchisors include these clauses in their agreements and only later begin to benefit from the supply chain. Those franchisors are then not motivated to permit use of previously unauthorized suppliers. Sometimes the item being supplied is proprietary to the system, either because it is sold under a specific and unique brand name or because it is created using a proprietary recipe. In these instances, it is difficult to determine what a replacement could and should cost, or whether it will ever be possible to secure one. Some agreements therefore exclude the franchisees from seeking replacement sources for core or proprietary products, and that may be an advisable practice to avoid controversy over such items.

D. Volume Rebates and Bonuses

The Franchisee acknowledges that the Franchisor shall be entitled to the direct or indirect benefit from mark-ups, rebates, discounts, allowances, benefits, and other similar receipts and advantages that the Franchisor may obtain from any supplier by reason of such supplier supplying products or services all of which the Franchisor is entitled to retain for its own use and credit without accounting to the Franchisee in respect thereof.

Discussion:

This section of the franchise agreement requires the franchisee to acknowledge the possibility of franchisor rebates. For a discussion of rebates and their implications, please see Section VIII.B "Restrictions on Services and Products" above. It should additionally be noted that this is an area that has historically generated a fair amount of debate and attention, which in turn has led to the Federal Trade Commission ("FTC") requiring significant and detailed

disclosures to be included in a franchisor's FDD. Franchisors that profit by the system's supply chain are not uncommon. This tension arises often when the franchisor profits in an amount that then means that the franchisees pay more for their inventory and supplies than if they were independent operations, and not part of a franchise network.

E. System Modifications

The Franchisee acknowledges and agrees that the Franchisor may from time to time hereafter add to, subtract from, modify or otherwise change the System, including, without limitation, the adoption and use of new or modified trademarks or trade names, new products or services and new techniques in connection therewith, and the Franchisee agrees, at its own cost, to promptly accept, implement, use and display all such alterations, modifications and changes.

Discussion:

Most, if not all, franchise agreements allow the franchisor to modify the system to suit changing business needs.[79] This flexibility is incorporated into the franchise agreement so that the franchisor can make decisions to stay competitive and relevant in a changing marketplace. All franchisors should draft this clause so as to protect their ability to make decisions that affect their franchised locations in the future. Because this section can be relatively onerous on the franchisee, franchisees might consider negotiating for certain restrictions on the franchisor's modification rights. For instance, the franchisee might want to include that the system changes cannot materially increase the franchisee's financial obligations.[80] A friction inherent in franchising and particularly with this type of provision is that a franchisor must act on the best interests of the system, whereas a franchisee's motivation to act will most often be driven by its individual needs and desires.

F. Franchised Business Telephone Numbers, E-Mails and Web Site

The Franchisee acknowledges that, at all times, the Franchised Business telephone number(s) and listing(s) shall remain in the name, and the sole property, of the Franchisor. Provided that the Franchisee shall be responsible for any and all costs, expenses and deposits associated with the Franchised Business telephone number(s) and listing(s) including, without limiting the generality of the foregoing, any telephone company deposits and all local, long distance, installation, and connection charges.

The Franchisee agrees to advertise the Franchised Business (at the Franchisee's expense) in the white pages and classified section (yellow pages) of all local telephone directories or any other directories (hard copy or electronic) as Franchisor designates, using only such advertisements as may be approved by the Franchisor. If other ● businesses are served by the same white pages or classified section, the Franchisor shall have the right to require group listings therein, to make direct arrangements with the telephone company on behalf of any Franchisees included.

The Franchisor retains all rights relating to the Franchisor's web site, e-mail address, and intranet system or other online communications and specifically the Franchisee's use of the

[79] Hurwitz & Schnell, *supra* note 19 at 3.

[80] Ed Teixeira, *Franchising From the Inside Out* 88 (2005).

Trademarks or any advertising is subject to this agreement. The Franchisor reserves the right to establish and modify rules which will govern the Franchisee's use of the Trademarks on the Internet and in domain names and the Franchisee agrees to abide by such rules. The Franchisee's right to use the Trademarks on the Internet will terminate immediately upon the expiration or termination of this agreement. The Franchisee must maintain: (i) an e-mail account for the Franchisor's direct correspondence with the Control Person; and (ii) a separate e-mail account for the Franchised Business.

Discussion:

The phone number, e-mail address, and websites are all ways that customers access the franchised business. The extent to which a franchise system, and its consumers, use the various means will vary between industries and concepts, and drafters should consider the reality of the business when drafting this clause. For example, a service based industry is much more likely to see the benefits of yellow page advertising than would a restaurant concept. Furthermore, with the advent of social media, franchisors may want to add specific language regarding this form of communication. Given this direct link to the customers, many franchisors feel the need to control those representations and keep ownership of them. Additionally, if a franchised business closes, these are identified with the goodwill of the system and trademarks. If the franchisors do not own the contacts (*i.e.,* the phone number), then they risk losing the customers that would have used those contacts. If not prohibited, a former franchisee may operate a similar business and simply use the original contacts to retain customers. Thus, franchisors often include clauses that prohibit the franchisee from retaining ownership of these contacts.

G. Participation in Internet Web Site or Other On-line Communications

The Franchisee will, at all times during the term of this agreement, at the Franchisee's expense, have access to the Internet through an Internet Service Provider. The Franchisee must participate in the Franchisor's Web Site listed on the Internet or other on-line communications, developed now or in the future (collectively, "Web Site"). The Franchisor will determine the content and use of the Web Site and will establish the rules under which the Franchisee will participate in the Web Site or separately use the Internet or other on-line communications. The Franchisor may, but is not obligated to, provide the Franchisee with a webpage on the Web Site. If the Franchisee is provided with a webpage, the Franchisee must provide the Franchisor with any information and materials requested to develop, update and modify the webpage and notify the Franchisor whenever any information on the webpage is not accurate. The Franchisor will own all intellectual property and other rights in the Web Site including the Franchisee's webpage, and all information it contains, including, without limitation, the domain name or URL for the Franchisee's webpage, the log of "hits" by visitors, and any personal or business data that visitors supply. The Franchisor will retain all rights relating to the Web Site and has the absolute right to alter or terminate the Web Site. The Franchisee's general conduct on the Web Site and specifically its use of the Trademarks or any advertising on the Web Site (including the domain name and any other Trademarks the Franchisor may develop as a result of participation in the Web Site) will be subject to the provisions of this agreement. The Franchisee acknowledges that certain information obtained through its participation in the Web Site may be considered Confidential Information, including passwords, access codes and identification codes. The Franchisee is responsible for ensuring that the Franchisee's employees maintain the same level of confidentiality. The Franchisee may not separately register any domain name containing any of the Trademarks nor participate in any web site that markets goods and services similar to a ● Franchised Business. The Franchisee

may not use or reference the Trademarks in any online communication or web site (including, without limitation, all current and future social media platforms) absent the Franchisor's prior approval. The Franchisee's right to participate in the Web Site or otherwise use the Trademarks or System on the Internet or other on-line communications will terminate when this agreement expires or terminates.

Discussion:

Although the Internet presents great opportunity for any business, it always necessitates the careful protection of the franchisor's intellectual property.[81] As such, it has become increasingly necessary for drafters to include a clause that specifically enumerates each party's obligations and rights with respect to the Internet, and that requires franchisees strictly to adhere to the franchisor's rules regarding websites. From the franchisor's perspective, it is generally better to err on the side of being too specific with regards to Internet rights. More often than not the franchisee is prohibited from having its own website, and must rely on the franchisor for developing and operating an Internet presence for the system.

H. Central Ordering and Reservation Systems

Alternative #1 (Food Service Ordering System)

The Franchisor shall be at liberty to institute a non-exclusive home delivery system, including without limitation, a call-ahead, Internet-order, or other similar program (the "Delivery System") through, without limitation, a third party service provider, the Franchisor, an affiliate of the Franchisor, one telephone number and/or through the Internet, for use by some or all businesses using the System, or in conjunction with third parties in areas determined by the Franchisor from time to time. In the event that the Franchisor establishes a non-exclusive Delivery System within an area determined by the Franchisor which encompasses the Franchised Business (the "Delivery Area"), and qualifies the Franchisee as able to participate, the Franchisee shall thereafter not conduct any type of delivery system or similar service of any kind of its own, nor publish any other phone number, domain name or e-mail address (each of the foregoing, an "Address") for any type of delivery or similar service of any kind offered by the Franchisee, except the Address designated by the Franchisor for the Delivery System. The Franchisee acknowledges that any Address shall be the sole property of the Franchisor, its affiliates, or its designated supplier.

The Franchisee shall execute all documents required by the Franchisor relating to the Franchisee's participation in the Delivery System and shall be responsible for all fees and charges levied by the Franchisor, its affiliate or its designated supplier for the Franchisee's participation in the Delivery System, including, without limitation, per order or transaction fees, charges for all capital costs, operating costs and overhead incurred in the establishment and operation of the Delivery System. If and when operated by the Franchisor, in levying such charges in respect of costs, the Franchisor shall use its best efforts to allocate all such costs and expenses among the various Franchisees participating in the Delivery System on a fair and equitable basis. The Franchisee shall be obligated to follow all rules and procedures established from time to time by the Franchisor in regard to the Delivery System. Subject to the Franchisee from time to time being qualified by the Franchisor to participate, and to the Franchisee being in compliance with such rules and regulations, all orders for System specific products received through such the Delivery System from customers in the Delivery Area, shall be directed to the

[81] Hurwitz & Schnell, *supra* note 19 at 54-55.

Franchisee, who shall promptly fill such orders. The Franchisee acknowledges that, for the purposes of the better operation of the Delivery System, the Delivery Area shall be non-exclusive and may not be consistent in any way with the geographic limits of the Territory, and the Delivery Area is subject to change by the Franchisor from time to time. Without limiting the generality of the foregoing, the Franchisee's failure to abide by the rules and procedures established from time to time by the Franchisor in regard to the Delivery System shall be a default under this agreement. Without limiting the Franchisor's rights in the event of such a default, the Franchisor shall be permitted to temporarily or permanently suspend the Franchisee from participation in the Delivery System.

Alternative #2 (Car Rental Reservation System)

The Franchisee shall participate in and promote any Reservation System that is now maintained or may hereafter be established or designated by the Franchisor. Such Reservation System may, at the Franchisor's option, be combined with reservation systems which service Rental, leasing and sales systems other than the System, including, without limitation, such owned or operated by the Franchisor's affiliates. The Franchisee shall comply with all of the terms, conditions and procedures of the Reservation System, shall accept and service all reservations received through the Reservation System, regardless of the medium by which the reservation is received (e.g. telephone, central Reservation System, global distribution systems, Internet, or other collection or distribution systems) and shall pay to the Franchisor or its designee the fees and other charges imposed by the Franchisor and/or due under the Reservation System. In addition, the Franchisee shall accept and service all reservations for Rental services which are received from other Franchisees of the System and the Franchisor and shall transmit all reservations which the Franchisee is requested to place by any Customer to the appropriate Franchisee of the System or the Franchisor, without charge to the Customer and without fee to the receiving Franchisee or the Franchisor, other than as may be specified in the Operations Manual. The Franchisee shall not conduct any type of reservation system or similar service of any kind of its own, nor publish any other phone number, domain name, e-mail address or other means of communication for such purpose, except that which is designated by the Franchisor for the Reservation System. Furthermore, the Franchisee shall not establish or utilize a system for collecting and distributing reservations, either separately or in combination with other travel services, which in the Franchisor's sole determination, competes with or is duplicative of a reservation, collection or distribution system established by or under the Franchisor's authority, including, but not limited to, any telephone, computer or Internet reservations system. In addition to all rights and remedies available in this agreement, at law and in equity, if the Franchisee is in breach of any of the obligations under this agreement or any other agreement with the Franchisor or its affiliates, the Franchisor shall have the right to remove, suspend or block any Franchised Businesses of the Franchisee from all Reservation Systems, until such breach has been cured to the Franchisor's satisfaction. By execution of this agreement, the Franchisee agrees that the Franchisor, its affiliates, and the directors, officers, employees and agents of them shall not be responsible for any damages, direct, incidental, or consequential, resulting from the Reservation System.

Discussion:

The first sample clause only applies to franchised businesses that use a central ordering system. These are common in the quick service food business. But just as common in the hotel and car rental business is the central reservation system that is the subject of the second sample clause. In either case, the reservation systems often involve use of one telephone number or one Internet website, either or both of which may be heavily advertised and

promoted. These can become so identified with the system that they can themselves become a trademark for the brand. Not unexpectedly, central ordering and central reservation systems have become a feature of a system's Internet presence. These clauses therefore can tie into any other provisions in the franchise agreement that address the franchisor's requirements regarding use of a website for the system.

If franchisors choose to employ some form of central ordering or reservation system it is common for them to draft a clause prohibiting the franchised businesses from creating their own methods of contact, by prohibiting the franchisees from advertising other telephone numbers or domain names. From a business perspective, franchisors want to avoid confusing the customers in any way possible. Additionally, the rights and the roles of the franchisee within that central ordering or reservation system should be considered. Participation by franchisees can often be mandatory, but in some systems it is optional. In some cases, the franchisees are charged a per transaction fee, while in others the costs are spread amongst the users in other ways. It all depends on the business.

IX. OPERATING MANUAL AND CONFIDENTIALITY

A. Compliance With and Ownership of Manual

The Franchisee shall conduct the Franchised Business strictly in accordance with all of the provisions set out in the Manual as amended from time to time.

The Franchisee hereby acknowledges that the contents of the Manual are on loan to the Franchisee and shall at all times remain the sole and exclusive property of the Franchisor, and upon a Transfer, or the expiration or termination of this agreement for any reason whatsoever, the Franchisee shall forthwith return all written portions of the Manual together with any copies which the Franchisee may have made, to the Franchisor.

The Franchisor may from time to time revise the contents of the Manual. The Franchisee agrees to update their copies of the Manual, and agrees to comply with each new or changed standard upon reasonable notice thereof from the Franchisor. In the event of a dispute about the contents of the Manual, the master copies maintained by the Franchisor at the principal offices will be controlling.

Discussion:

Most franchisors should include a clause that requires the franchisee to comply with all contents of the manual. Of course, some franchisors choose to characterize their manual or portions thereof as suggestions rather than strict obligations. In these cases, the clause should be drafted accordingly.

The manual includes key information on how to run the franchised business.[82] However, the manual does not usually include employee hiring, firing, discipline, lending, and landlord procedures, among other issues. This is for fear that the franchisor will be deemed vicariously

[82] Sherman, *supra* note 15 at 107.

liable, as discussed in Section XI.B, below. Otherwise, the manual is usually meant to be the step by step instruction manual on how to operate the franchised business.[83]

Perhaps the most important part of the above clause is how the term "Manual" was defined in the agreement. The definition sets out exactly what the "Manual" means and therefore what the franchisee is obligated to comply with. If the definition is incomplete, then the franchisee's obligations as set out in the manual will not accurately and fully represent the intentions of the franchisor.

In some cases the franchisee has a misunderstanding of the rights he or she is buying in a franchise relationship. In many cases the franchisee may assume that he/she is buying perpetual rights to use the system, trademarks and manual, which would be akin to ownership rights in those items, including the manual. However, as mentioned earlier in this Annotation, the franchise relationship merely confers a right temporarily to use the franchisor's trademarks and system to conduct business.[84] This right expires at the end of the term (subject to the renewal provisions, if they exist). To clarify any potential confusion and provide an express term in case of a later dispute, the franchisor often includes a clause that explicitly states the franchisor's retention of all ownership rights.

Similar to the discussion regarding ownership rights, some franchisees may wrongfully believe that they are purchasing a right to make creative decisions regarding the manual. To avoid any confusion and, most importantly, to preserve its flexibility to adapt the system to changing conditions over time, the franchisor should reserve exclusive rights to change the manual. If the franchisor does not include this clause, the franchisee might wrongfully assume that the manual is static or that changes are open to negotiation, or that the franchisee itself can make changes to the manual. Those changes might be in conflict with the efforts and intentions of the franchisor and might hurt the goodwill and success of the franchisor (*i.e.,* by sending conflicting messages to the customers).[85] Thus, it is important for the franchisor to be very clear on all of the rights within and around the manual.

B. Non-Disclosure and Confidentiality

The Franchisee acknowledges that it has had no part in the creation or development of nor does it have any property or other rights or claims of any kind in or to any element of the System, the Trademarks or any matters dealt with in the Manual and that all disclosures made to the Franchisee relating to the System and including, without limitation, the specifications, standards, procedures and the entire contents of the Manual are communicated to the Franchisee solely on a confidential basis and as trade secrets, in which the Franchisor has a substantial investment and a legitimate right to protect against unlawful disclosure. Accordingly, the Franchisee agrees to maintain the confidentiality of all such information during the term of this agreement or at any time thereafter and shall not disclose any portions of the Manual or any information whatsoever with respect to the Franchisee's or the Franchisor's business affairs or the System other than as may be required to enable the Franchisee to conduct its business from the Premises, and the Franchisee further agrees not to use any such information in any other business or in any manner not specifically approved in writing by the Franchisor.

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[83] *See generally* Amy Cheng, Craig Dietz & David W. Oppenheim, *Operating Manuals – The Devil is in the Details,* A.B.A. 31st Annual Forum on Franchising (2008) at W6.

[84] Sherman, *supra* note 15 at 110-111.

[85] Hurwitz & Schnell, *supra* note 19.

Discussion:

A key feature of most franchise systems is the proprietary and unique nature of the way in which the business is to be operated. The points of differentiation between one business and a competitor can be as simple as the use of different recipes or as complicated as entirely unique methodologies. In any event, franchisors are usually keen to keep their system information confidential and prohibit their franchisees from disclosing such information to anyone or using the information elsewhere. Accordingly, franchisors put a non-disclosure and confidentiality clause in the franchise agreement to protect their intellectual property and trade secrets adequately.

This clause should be specific enough so that the franchisee understands exactly what it is to treat as confidential information. Of course, a key element is what is contained in the manual. In the above clause, the drafters listed the specific items that are meant to be confidential. However, if the drafter includes a very specific definition of the manual in the key terms section of the franchise agreement, then he or she might consider merely stating that all aspects of the manual are to be kept confidential.

X. ADVERTISING

A. Advertising Funds

Recognizing the value of uniform advertising and promotion to the goodwill and public image of the System, the Franchisee agrees that the Franchisor may maintain and administer a general advertising fund or funds (the "Fund") for such national, regional, local and other advertising programs as the Franchisor may deem necessary or appropriate, in its sole discretion. The Fund is not a trust or escrow account, and the Franchisor has no fiduciary obligation to the Franchisee or any franchisees with respect to the Fund. The Franchisor has the absolute right to direct all such advertising programs with respect to the creative concepts, materials, endorsements and media used therein, and the placement and allocation thereof.

The Franchisee shall contribute to the Fund in each year an amount equal to two percent (2%) of the Gross Sales for such year. Any amounts payable hereunder to the Fund, shall be paid together with the royalty fees hereunder and shall be based upon Gross Sales for the preceding week.

The Fund shall be used and expended for media costs, commissions, market research costs, creative and production costs, including, without limitation, the costs of creating promotions and artwork, printing costs, and other costs relating to advertising and promotional programs undertaken by the Franchisor. The Franchisor reserves the right to place and develop such advertisements and promotions and to market same as agent for and on behalf of the Franchisee and the System, either directly or through an advertising agency retained or formed for such purpose or through co-operative advertising groups composed of franchisees designated by the Franchisor. The Fund shall be accounted for separately from the other funds of the Franchisor and shall not be used to defray any of the Franchisor's general operating expenses, except for such reasonable salaries, administrative costs and overhead (calculated on a fully allocated basis), if any, as the Franchisor may incur in activities reasonably related to the administration or direction of the Fund and its advertising programs (including, without limitation, conducting market research). A statement of the operations of the Fund shall be prepared annually and shall be made available to the Franchisee upon request, the cost of such statement to be paid by the Fund.

The Franchisee acknowledges and agrees that the Fund is intended to maximize general public recognition and patronage of ● businesses for the benefit of all outlets and franchisees in the System and that the Franchisor undertakes no obligation in administering the Fund to ensure that any particular franchisee, including the Franchisee, benefits directly or pro-rata from the placement or conduct of such advertising and promotion.

Discussion:

Advertising funds clauses are extremely common in franchise agreements.[86] The idea behind advertising funds is relatively simple: a franchisor can arguably do more effective advertising once it has pooled together the smaller amounts received from its franchisees.[87] Even if a franchisor is not staffed appropriately at the onset of the franchise relationship to handle the formation or management of an advertising fund, the franchise agreement should contain language about the franchisor's ability to form and administer a fund in the future. The pooling of funds allows the franchisor to invest in more elaborate and expensive advertising on a larger scale.[88] These funds can be managed by the franchisor, an advertising agency or a franchisee association.[89] Franchisees often support these funds because the funds provide for a greater chance of profit at their franchised businesses. Conflicts may arise when franchisees feel they are not getting enough return for their contributions to the fund. These problems exist because it is often difficult for the franchisee to measure the local impact and effect of a nationwide or larger scale advertising campaign. Based on this issue, franchisees may claim the funds were used improperly.[90]

From a drafting perspective, this clause should address the structure of the program, permissible uses of the funds, advertising approval processes, and how the funds received from each franchise will be accounted for and used.[91] Advertising funds can be raised through charging each franchisee a percentage of gross sales, or by charging a flat fee. To a certain extent, the franchisor will be more limited by charging a flat rate.[92] Charging a flat rate will guaranty a certain amount of money for the fund, but the franchisor can collect more if it charges a percentage of presumably growing gross sales. Of course, this is only true if the franchisee's gross sales are increasing. If they are, the franchisor can scale up the advertising program along with the success of the company. Ultimately, this decision depends on the circumstances and rests with the franchisor.

In terms of drafting, it is especially important for the franchisor explicitly to indicate that the funds might be used to cover administrative costs associated with handling of the funds. The clause should state that the franchisor will administer the fund in its sole judgment and that there is no guaranty that individual units will benefit. Further, if the franchisor owns and operates

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[86] Blair & Lafontaine, *supra* note 23 at 55.

[87] *Id.*

[88] American Bar Association, Fundamentals of Franchising – Canada 121 (Peter Snell & Larry Weinberg, eds. 2004).

[89] Sherman, *supra* note 15 at 109.

[90] Carden & Klarfeld, *supra* note 54 at 12.

[91] Asbill, Barkoff & Selden, *supra* note 3 at 34.

[92] Shane, *supra* note 18 at 97.

individual outlets, it may want expressly to provide that these outlets will be given "X" dollars from the fund, so as to avoid any franchisee complaints.

The franchisor needs to consider whether to include in this section an obligation to report on the activities of the advertising fund. Note that the sample does require the franchisor to provide an annual statement of the fund's operations. In some jurisdictions, whether or not such an annual accounting is provided is a fact that must be disclosed in the franchise disclosure document.

Drafters should be aware of alternatives to funds. For instance, the idea of a fund could be abandoned altogether in favor of adding advertising fees to the royalty payments (or other fees). In this situation, the franchisee could advocate to draft requirements on how those fees are to be spent (to ensure they are spent on advertising).[93]

B. Local Advertising

The Franchisee must use best efforts to promote and advertise the Franchised Business and participate in any local marketing and promotional programs the Franchisor establishes from time to time. In addition to the Advertising Fee, the Franchisee is required to spend ½% of Gross Sales on approved local marketing and promotion. Upon the Franchisor's request, the Franchisee must provide itemization and proof of marketing and an accounting of the monies that have been spent on approved local marketing. If the Franchisee fails to make the required expenditure, the Franchisor has the right to collect and contribute the deficiency to the Fund.

The Franchisee shall have the right to conduct such advertising and promotions in respect of the Franchised Business as the Franchisee shall, in its reasonable discretion desire, provided that:

a. *the Franchisee shall advertise and promote only in a manner that will reflect favorably on the Franchisor, the Franchisee, the products, and the good name, goodwill and reputation thereof;*

b. *the Franchisee shall submit to the Franchisor for its approval, which approval shall not be unreasonably withheld or unduly delayed, all advertising and promotions to be utilized by the Franchisee and until such time as the Franchisor shall give its prior written approval to the use of such advertising and promotions, the Franchisee shall not utilize same in any advertising or promotion;*

c. *the Franchisee shall prominently display, at its expense, in and upon the Premises signs of such nature, form, color, number, location and size and containing such matter as the Franchisor may direct or approve in writing from time to time and such signs shall be purchased from the Franchisor or, at its option, from suppliers approved by it; and*

d. *the Franchisee hereby acknowledges that the Franchisor is the sole and exclusive owner of all copyrights and any and all*

[93] Carden & Klarfeld, *supra* note 54.

advertising and promotional material prepared by or on behalf of the Franchisor and shall at all times remain the property of the Franchisor.

Discussion:

There are several reasons why a franchisor might give franchisees the responsibility for advertising locally. The franchisor might not be located in the area of the franchised business and might not have the resources to research that area's market and develop an appropriate advertising strategy to meet its needs. Franchisors who recognize this limitation will allow the franchisee to make at least some advertising decisions for its local areas. To limit conflicts between advertising efforts across regions, franchisors often will require that all advertising plans be approved. If the franchisor does this, it will be better able to ensure that a consistent message is being sent to customers across various regions.

In terms of drafting, the franchisor should retain ownership of the copyrights used in advertising. Some franchisors will also draft clauses that specifically outline what kind of local advertising medias can or should be used.[94] From a franchisee's perspective, there should be a clear understanding of exactly what advertising freedoms exist, if any.

It should be noted that some franchisors *require* local advertising, while others merely grant the franchisee *permission* to do so. There is a fundamental difference between these two options, and it is critical that the franchisee understand this clause in its franchise agreement. If the franchisor requires the franchisee to advertise locally, the franchisee should consider proposing a clause that allows for a lower sum to be spent in the first year. If the franchisor must approve all local advertising efforts, then the franchisee should consider drafting for a maximum time period for the approval process.[95]

C. Grand Opening Advertising

The Franchisee must conduct certain advertising and public relations activities in connection with the opening of the Franchised Business. The Franchisor requires the Franchisee to spend, in addition to the required local advertising contribution described above, $12,500 for such opening activities, which must be spent some time within 45 days prior and 45 days following the opening of the Franchised Business, unless otherwise approved by the Franchisor. In addition, the Franchisee must perform opening advertising and promotions as required by this paragraph every time that the Franchisee (i) relocates the Franchised Business or (ii) reopens the Franchised Business after having it closed for 30 days or more. Upon the Franchisor's request, the Franchisee must provide to the Franchisor proof of these expenditures. The Franchisor has the right, but not the obligation, to collect and administer these funds on the Franchisee's behalf.

Discussion:

The grand opening is a critical moment for any business. It sets the stage for future business and allows for a clear message to be sent to potential customers about the value the business will bring. Given its importance, many franchisors require their franchisees to spend a

[94] Mathews, DeBolt & Percival, *supra* note 17 at 185.

[95] Teixeira*, supra* note 80 at 88.

certain amount of money on the grand opening. The franchisor can either write a separate clause for the advertising to be spent on the grand opening, or it merely can designate a certain amount of the other advertising requirements that must go towards this event.

D. Advertising Cooperatives

The Franchisor has the right to designate local or regional advertising markets and if designated, the Franchisee must participate in and contribute to the cooperative advertising and marketing programs in the Franchisee's designated advertising market. If established, the Franchisee must contribute a minimum of ½% of Gross Sales to the local cooperative, which satisfies the local marketing requirement described in subparagraph B. If, however, the cooperative votes to spend a percentage greater than ½% per location, the Franchisee must contribute such amount. Each Franchised Business, including those operated by the Franchisor, its parent company or affiliates within a designated local advertising area is a member of the local advertising cooperative and each Franchised Business has one vote on all matters requiring a vote. Each advertising cooperative will be required to adopt governing bylaws that meet the Franchisor's approval. The Franchisor will provide each advertising cooperative with a sample form of bylaws, containing certain terms and conditions that the Franchisor requires, although the bylaws can not modify the voting structure set forth in this paragraph. The Franchisee will be required to contribute to the cooperative the percentage as designated by a majority vote of the cooperative members. The Franchisor reserves the right to administer the advertising cooperatives' funds and require payment from its members via electronic funds transfer. The contribution amount designated by the cooperative must be on a percentage of Gross Sales basis and per Franchised Business, and must be at least ½%. The members of each cooperative and their elected officers will be responsible for the administration of the advertising cooperative. Each advertising cooperative must engage the services of a professional advertising agency or media buyer that meets with the Franchisor's approval and has expertise in the industry and in the particular market. Further, the Franchisee must obtain the Franchisor's written approval of all promotional and advertising materials, creative execution and media schedules prior to their implementation. Each advertising cooperative will be required to prepare annual financial statements, which must be made available to all members of the cooperative and to the Franchisor upon request. Also, each advertising cooperative must submit to the Franchisor its meeting minutes upon request. The Franchisor has the right to require advertising cooperatives to be formed, changed, dissolved or merged.

Discussion:

An advertising cooperative occurs when franchised businesses in the same general region combine advertising efforts and funds. The idea behind advertising cooperatives is that franchisees can do more effective and potentially cheaper advertising when their resources are pooled together.[96] The advertising cooperative is not suitable for every system, as it usually needs to be a certain size (critical mass) to be effective, and it works best in more densely populated areas.[97]

It is important for the franchisor to set out detailed rights and obligations in this area in the franchise agreement. Sometimes the franchisor will give the franchisees the right to

[96] Teixeira*, supra* note 80 at 88.

[97] Stephen Spinelli, Jr., Robert M. Rosenberg & Sue Birley, Franchising: Pathway to Wealth Creation 97 (Prentice Hall 2004).

establish an advertising cooperative, while other times the franchisor might require it. Further, franchisors may decide to operate exclusively under advertising cooperatives, an advertising fund, or both. Even if the franchisor feels it is unnecessary to draft for the possibility of an advertising cooperative, it might be wise to include the provision so that the option is available in the future.[98]

The sample clause adds a level of formality to the operation and rules surrounding the advertising cooperative, by requiring that the franchisee members adopt and abide by certain by-laws. This level of formality is not universal, but certainly recommended. Also note that the franchisee agrees in advance to abide by the majority's views on whether the financial contribution to the cooperative is to increase. This is key, although again not universal, as otherwise the franchisee would later need to consent to any increase.

XI. TRADEMARK LICENSING AND OTHER INTELLECTUAL PROPERTY

A. Trademark Ownership

Neither this agreement nor the operation of the Franchised Business shall in any way give or be deemed to give to the Franchisee any interest in the Trademarks except for the right to use the Trademarks solely at and on the Premises and in accordance with the terms and conditions of this agreement, during the term of this agreement. The Franchisee shall not use the Trademarks in any manner calculated to represent that it is the owner of the Trademarks. Neither during the term of this agreement nor at any time after a Transfer, or the expiration or termination hereof, shall the Franchisee, either directly or indirectly, dispute or contest the validity or enforceability of the Trademarks, attempt any registration thereof, or attempt to dilute the value of any goodwill attaching to the Trademarks. Any goodwill associated with the Trademarks shall ensure exclusively to the benefit of the Franchisor.

Without in any way restricting or limiting the terms above, the Franchisee covenants and agrees as follows:

a. *that upon any request by the Franchisor, the Franchisee will execute such applications or agreements or such other instruments in such form and with such parties, as the Franchisor in its sole discretion shall specify, protecting the interests and rights of the Franchisor in such Trademarks, or complying with any applicable trade name, trademark or other similar legislation;*

b. *that the Franchisee will not use either the Trademarks or any variations thereof as any part of its corporate, firm or business name or for any other purposes, save and except in accordance with the terms and conditions of this agreement or as may otherwise be specifically authorized by the Franchisor in writing; and*

c. *forthwith upon a Transfer, or the expiration or termination for any reason whatsoever of this agreement, the Franchisee shall cease all use of the Trademarks (including any colorable imitations thereof) for any purposes whatsoever and the Franchisee shall not*

[98] *Id.*

make known, either directly or indirectly, following such Transfer, expiration or termination, that the Franchisee previously conducted business under the Trademarks.

Discussion:

Trademarks are the cornerstones of every franchise relationship.[99] Without the trademark there presumably would be no value to doing business under the franchisor's name. In other words, the franchisee believes that there is value in the franchisor's trademark - enough so that the franchisee is willing to spend a significant capital outlay, fees and royalties all so that it can do business under such a name. The trademark is the franchisor's most valued asset, and, between the parties, the franchise agreement is the most appropriate place for a franchisor to protect that asset.[100] Thus, the franchisor should explicitly state that the franchisee cannot contest ownership of the trademarks under any circumstances.[101] The franchisor should state that any goodwill as a result of the trademarks remains the sole and exclusive property of the franchisor.[102] In drafting clauses relating to the franchisor's trademarks, it is important that at least the specific principal trademarks are identified (*e.g.*, in an appendix to the agreement).[103] The agreement should also specify how those trademarks may permissibly be used by the franchisee and that the franchisor has the right to modify the trademarks from time to time.

In view of the importance of trademarks, the franchisor must restrict the franchisee's use of such trademarks. Franchisors can place prohibitions on certain uses of the trademarks or include a more general statement that the trademarks may not be used in any manner other than that expressly set forth in the agreement.[104] The franchisor intends these restrictions to protect what may be its most valuable asset.

B. Notice of Independent Ownership and Operation and Identification of Franchised Business

The Franchisee may use the Trademarks on various materials, such as business cards, stationery and checks, provided that the Franchisee (i) accurately depicts the Trademarks on the materials as the Franchisor prescribe, (ii) includes a statement on the materials indicating that the business is independently owned and operated by the Franchisee, (iii) does not use the Trademarks in connection with any other trademarks, trade names or service marks unless the Franchisor specifically approves in writing prior to such use, and (iv) makes available to the Franchisor, upon the Franchisor's request, a copy of any materials depicting the Trademarks. The Franchisee must post a prominent sign in the Franchised Business identifying the Franchisee as a ● Franchisee in a format the Franchisor deems reasonably acceptable, including an acknowledgment that the Franchisee independently owns and operates the Franchised Business and that the ● Trademark is owned by the Franchisor and the Franchisee's use is under a license the Franchisor has issued to the Franchisee. All of the Franchisee's internal and external signs

[99] Asbill, Barkoff & Selden, *supra* note 3 at 37.

[100] Duffin & Watson, *supra* note 10 at 132.

[101] Asbill, Barkoff & Selden, *supra* note 3 at 37-38.

[102] *Id.*

[103] *Id.*

[104] *Id.*

must comply at all times with the Franchisor's guidelines, requirements and practices, as they are modified from time to time.

Discussion:

To aid customers in understanding with whom they are doing business and to limit the franchisor's vicarious liability to the extent possible, franchise agreements often require franchisees to display notices that make clear that the franchised business is independently owned and operated by the franchisee and that provide the franchisee's identity. A prudent franchisor should ensure that this notice is prominently placed and visible to the franchisee's customers.[105] A careful franchisor also will require the franchisee to disclose its identity as an independent contractor on all documentation exchanged between the franchised business and third parties (including but not limited to contracts and business cards).[106]

Plaintiffs injured at franchised business may bring vicarious liability claims under an apparent agency theory, arguing that the franchisee was the franchisor's apparent agent at the time of the incident. Under the doctrine of apparent agency, a principal can be held vicariously liable in tort for injury caused by the negligent acts of its apparent agent if the alleged principal has represented, or permitted it to be represented, that the party dealing directly with the plaintiff is its agent, and the plaintiff relies on this representation in dealing with the agent.[107]

Plaintiffs often argue that a franchisor, by allowing its franchisee to use its trade name, trademarks and logos, has misrepresented or allowed its franchisee to misrepresent to the public that the franchised location is part of the franchisor's national chain.[108] The mere display of the trademarks should not mean that a franchisor holds its franchisee out as its agent and should not be sufficient for apparent agency.[109]

It is nevertheless critical that franchisors ensure that their franchisees take all appropriate action to limit the possibility that injured customers or third parties will claim that

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[105] Perkins, Yatchak & Hadfield, *supra* note 13 at 174.

[106] *Id.*

[107] Restatement (Second) of Agency §§ 27, 267 (1958) (One who represents that another is his servant or other agent and thereby causes a third person justifiably to rely upon the care or skill of such apparent agent is subject to liability to the third person for harm caused by the lack of care or skill of the one appearing to be a servant or other agent as if he were such).

[108] *See, e.g., Hayman v. Ramada Inn, Inc.*, 86 N.C. App. 274, 279, 357 S.E.2d 394, 398 (1987).

[109] *See, e.g., D.L.S. v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 13,159 (Wash. Ct. App. Sept. 16, 2005) (using young people in advertisements, serving "Happy Meals," sponsoring the Ronald McDonald house, and supporting Olympic athletes were not enough to create an apparent employment relationship between McDonald's Corporation and its franchisee's employees); *Rosser v. AAMCO Transmissions, Inc.*, 1040056, 2005 WL 2108554, at *6 (Ala. Sept. 2, 2005) ("the mere display of AAMCO's logos in Enterprises' premises did not mean that AAMCO held Enterprises out to the public as its agent"); *Drake v. Maid-Rite Co.*, 681 N.E.2d 734, 738 (Ind. Ct. App. 1997) ("Maid-Rite authorizing Sweeden, as a franchisee, to use Maid-Rite's letterhead and logo was not a sufficient act to clothe Sweeden with apparent authority"); *Gonzalez v. Walgreens Co.*, 878 F.2d 560, 562 (1st Cir. 1989) (franchisee's mere use of franchisor's logo, by itself, does not create genuine issue of material fact with respect to apparent authority). Although discredited, *cf. Holiday Inns, Inc. v. Shelbourne*, 576 So.2d 322, 334 (Fla. Dist. Ct. App. 1991), *review dismissed*, 589 So.2d 291 (Fla. 1991) ("In fact, Holiday Inns, Inc.'s standard sign was displayed in front of the Fort Pierce Holiday Inn in order to draw customers through name recognition. Clearly, this evidence shows that Holiday Inns, Inc. represented to the public that this particular hotel was part of the national chain of Holiday Inns and that it could find a certain level of service (and safety) at its hotel and bar.").

they believed the franchised business was owned by the franchisor. To this end, the franchisor typically includes a contractual requirement that the franchisee must avoid any confusion on the part of customers, creditors, lenders, investors and the public as to the ownership and operation of the franchised business and the identity of the franchisee.[110] In standard franchise agreements, franchisees also are contractually required to identify themselves as independent owners and operators of the franchised business and affirmatively disclose their franchise status to the public in all advertising, business stationery, as well as in a posted, clearly visible sign displayed prominently in a public area of the franchised location.[111] Doing so may negate a finding that the franchisor represented the franchisee, or permitted the franchisee to represent itself, as its agent.[112] (*See also* Section XIX.C, Independent Contractor.)

C. Infringement of Trademarks

In the event of any claim of infringement, unfair competition or other challenge to the Franchisee's right to use the Trademarks, or in the event the Franchisee becomes aware of any use of or claims to the Trademarks by persons other than the Franchisor or its Franchisees, the Franchisee shall promptly (but in no event more than 15 days later) notify the Franchisor in writing. The Franchisee shall not communicate with anyone except the Franchisor and their respective counsel in connection with any such infringement, challenge, or claim except pursuant to judicial process. The Franchisor shall have the absolute right to determine whether they take any action in connection with any such infringement, challenge or claim, and the sole right to control exclusively any litigation or other proceeding arising out of any infringement, challenge or claim relating to the Trademarks. The Franchisee must sign all instruments and documents, render any assistance, and do any acts that the Franchisor's attorneys deem necessary or advisable in order to protect and maintain the Franchisor's interest in any litigation or proceeding related to the Trademarks or otherwise to protect and maintain the Franchisor's interest in the Trademarks.

The Franchisor agrees to indemnify the Franchisee against and to reimburse the Franchisee for all damages for which he is held liable in any proceeding arising out of the use of any of the Trademarks in compliance with this agreement and for all costs reasonably incurred by the Franchisee in the defense of any such claim brought against him or in any such proceeding in which he is named as a party, to a maximum aggregate amount equal to the initial franchise fee paid hereunder.

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[110] *Hunter v. Ramada Worldwide, Inc.*, No. 1:04CV00062ERW, 2005 WL 1490053, at *6, n.6 (E.D. Mo. June 23, 2005).

[111] *Hayman*, 86 N.C. App. at 279, 357 S.E.2d at 398. *See also D.L.S. v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 13,159 (franchisor was not vicariously liable for minor and father's claim that an assistant manager of the franchisee's business introduced the minor to drugs and sex; the minor testified that she knew she worked for the franchisee, not the franchisor, she knew the franchisee was the owner of the restaurant, and the employment application signed by the minor stated that she understood her employer to be the franchisee and she was not employed by the franchisor).

[112] *See, e.g., Allen v. Greenville Hotel Partners, Inc.*, No. C.A.6:04-2327-HMH, C.A.6:04-1260-HMH, C.A.6:04-2328-HMH, 2006 WL 89516, at *8 (D.S.C. Jan. 12 2006) (the franchisor's "national advertisements and [the franchisees'] usage of the [franchisor's] mark and name, when coupled with notice at the [franchised business] that [the franchisor does] not run and operate the [franchised business], [do] not constitute a 'representation' for purposes of establishing apparent agency.")

Discussion:

Great care should be taken when drafting clauses concerning the infringement of trademarks, given the importance of those marks to the franchisor. As demonstrated in the sample clause, it is important for the franchisor to maintain control over the handling of actions with respect to trademark infringements to provide adequate protection for the trademarks.[113] The franchisor also should expressly provide how quickly the franchisee is expected to notify the franchisor of infringement of the trademarks. The franchisor will want immediate or prompt notification of such infringements so that the franchisor can issue a cease and desist demand and/or seek injunctive or other appropriate relief without delay.

The second paragraph of the sample clause is the franchisor's indemnity of the franchisee in the event the franchisee is sued for infringement by a third party for using the trademarks permitted by the agreement. Such a provision is not all that common, but more often is necessary when a franchisor is new and its trademarks are not yet well established, and perhaps not even then registered. Note that the sample provision limits the franchisor's liability to a maximum aggregate amount equal to the initial franchise fee paid by the franchisee.

D. Additions and Substitutions of Trademarks

The Franchisor has the absolute right to modify or discontinue the use of any of the Trademarks and/or use one of more additional or substitute names or marks, for reasons including, but not limited to, the rejection of any pending registration or revocation of any existing registration of any of the Trademarks, or the superior rights of senior users thereof. The Franchisee will immediately, upon written notice from the Franchisor and at the Franchisee's expense, make all changes or modifications to the Trademarks as specified by the Franchisor.

Discussion:

Similar to the clauses regarding system and manual changes, most franchise agreements give exclusive rights to the franchisor to modify or discontinue any of its trademarks. Some agreements even delineate which party should pay for the re-branding costs.[114] The business purpose behind this clause is to allow the franchisor to make any necessary changes to the system to remain competitive in the marketplace.[115] It is in the best interests of the franchisee to allow for such changes because the franchisee presumably will benefit from the business judgment of the franchisor in this regard. That being said, there have been some noteworthy situations where franchisees did not accept the wholesale change of the system name and litigation ensued.[116]

E. Copyright

The Franchisee acknowledges that the Franchisor owns the worldwide copyright and other ownership rights to the Manual, and all components of the ● System that are media

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[113] Duffin & Watson, *supra* note 10 at 132.

[114] Asbill, Barkoff & Selden, *supra* note 3 at 38.

[115] Hurwitz & Schnell, *supra* note 19 at 44-45.

[116] *See Independent Ass'n of Mailbox Ctr. Owners, Inc. v. Sup. Ct. of San Diego County*, 133 Cal. App. 4th 396 (Cal. Ct. App. 2005).

subject to copyright (collectively, the "Copyright Materials"). The Franchisee acknowledges and agrees that it may only make translations, copies or adaptations of or modifications to the Copyright Materials upon receiving prior written consent of the Franchisor.

The Franchisee acknowledges that the Franchisor will own the copyright and all other rights to translations, modifications or adaptations of or to the Copyright Materials approved from time to time. The Franchisee hereby assigns to the Franchisor its copyright and economic rights and waives any moral rights and similar rights with respect to the copyright in the translated, modified or adapted Copyright Materials, and agrees to execute any and all instruments and documents, render such assistance and do such acts and things as may, in the opinion of the Franchisor's counsel, be necessary or advisable in furtherance of such assignment and waiver, and the Franchisee will require the same assignment, waiver and covenant in favour of the Franchisor by the Franchisee's Officers and employees and by any independent contractors or other third parties who translate, modify or adapt the Copyright Materials.

If registration of the copyright of any of the Copyright Materials, or translations, modifications or adaptations of the Copyright Materials, is required by law or deemed advisable by the Franchisor, the Franchisee agrees to cooperate with and assist the Franchisor in obtaining the registration in the name of the Franchisor as applicable and will not register or attempt to register or assist or be involved in any way with the registration (either directly or indirectly) of the Copyright Materials, or translations, modifications or adaptation of the Copyright Materials, in the name of anyone other than the Franchisor.

The Franchisee agrees to use proper copyright and other proprietary notices in connection with all Copyright Materials or translations, modifications or adaptations of the Copyright Materials and conform to the Franchisor's standards for protecting their rights.

Discussion:

Few franchise agreements contain any protective restrictions on the copyrights used in the system. But more should, when one considers the importance to the system of the copyrighted materials, as defined in the sample clause. The idea behind this clause is that if a copyrighted material brings value to the franchisor and the system, then it is an asset that warrants protection. This protection and the franchisee's obligations with respect to any copyrighted material should be explicitly outlined in the franchise agreement because the franchisees and their principals are the primary individuals who are close enough to these assets to cause substantial harm.

XII. ACCOUNTING, RECORDS, REPORTS, AUDITS AND INSPECTIONS

A. Bookkeeping, Accounting and Records

The Franchisee shall establish and continuously use an inventory, ordering, bookkeeping, accounting and record-keeping system conforming to the requirements prescribed from time to time by the Franchisor, including, without limitation, invoices, cash receipts, inventory records, purchase orders, payroll records, check stubs, bank deposit receipts, sales tax records and returns, cash disbursement journals and general ledgers together with such further and other equipment, records and documents as may from time to time be required by the Franchisor, and including computerized point-of-sale, inventory, ordering, bookkeeping and accounting systems established from time to time. When, or in the event that, the Franchisor

requires the establishment of, or specifies changes to, the computerized point of sale, inventory, ordering, bookkeeping, accounting or record keeping systems for its franchisees, the Franchisee agrees to purchase or lease all necessary computer hardware and software, and to utilize such systems and pay all fees charged by the Franchisor or others for the use and maintenance of such systems. The Franchisee and all personnel employed by the Franchisee shall record, at the time of sale, in the presence of customers, all receipts from sales or other transactions, whether for cash or credit, on point-of-sale systems, cash registers or other equipment approved by the Franchisor.

Discussion:

Because the franchisee pays the franchisor through royalties and other fees over the life of the term, the franchisor wants to ensure reliability of reports, and often does so by mandating a certain accounting system. From the franchisor's perspective, it is important that the franchisee uses an accounting system that the franchisor understands so that the franchisee has less opportunity to disguise income (perhaps in an attempt to avoid paying the franchisor). Thus, many franchisors explicitly mandate a specific "point of sale" accounting system that is uniform across all of the franchisor's company-owned and franchised locations. Some franchisors take it a step further and require a proprietary system that must be purchased from the franchisor or a designated source. However, even though the franchisor might require a particular accounting system, the franchisor generally should not recommend a certain accounting firm or bookkeeper, to avoid potential liability issues. From the franchisee's perspective, there is sometimes conflict surrounding the point of sale systems and their costs to acquire, install, and maintain. Often franchisees claim that point of sale systems do not work properly, or are not worth the price paid. There is no particular way to diffuse this tension through the franchise agreement, but the franchisor should ensure that the point of sale system is truly user friendly across its franchised businesses.

B. Reports and Financial Information

The Franchisee shall furnish to the Franchisor such reports as the Franchisor may require from time to time. Without limiting the generality of the foregoing, the Franchisee shall furnish to the Franchisor in the form from time to time prescribed by the Franchisor and together with such detail and breakdown and copies of supporting records as the Franchisor may from time to time require:

a. *by the Tuesday of each week a report of the Gross Sales for the preceding week (Monday to Sunday), signed and verified by the Franchisee;*

b. *within fifteen (15) days after the end of each three consecutive months, a balance sheet and profit and loss statement for the Franchised Business for such months;*

c. *within sixty (60) days after the end of each fiscal year of the Franchised Business, financial statements for the Franchised Business, including a balance sheet, profit and loss statement, a change in cash position statement and a statement of retained earnings for such period, which statements shall be prepared by an independent certified public accountant approved by the Franchisor, and signed and verified by the Franchisee; and*

d. *within thirty (30) days of filing, a true copy of all tax returns, schedules and reports filed by the Franchisee for employer health tax, workers compensation, income, corporate or sales tax purposes.*

Discussion:

The franchisor is compensated in the form of royalties and fees that require honest reporting by franchisees, so many franchisors require periodic financial disclosures as an ongoing feature of the franchise relationship. A prudent franchisor will specify in the contract exactly what is to be included in each report, when certain reports are due, where they are to be delivered and by whom. If a franchisor is specific on these terms, then the franchisee will be better able to disclose information accurately, and without complaint. Franchisees generally should be aware of the difference between audited, certified, and compiled financial statements so that they can accurately prepare and provide such reports to the franchisor.

C. Inspection and Audit of Books and Records

The Franchisor shall have the right, during normal business hours and without prior notice to the Franchisee, to inspect or audit, or cause to be inspected or audited the financial books, records, bookkeeping and accounting records, documents or other materials in respect of the Franchised Business, including the right, without limitation, to have a person on the Premises to check, verify and tabulate Gross Sales, and/or to examine and make copies of all accounting and business records and procedures.

In the event that any such audit or inspection shall disclose an understatement of Gross Sales, the Franchisee shall pay to the Franchisor, within two (2) days after receipt by the Franchisee of the inspection or audit report, the royalty and other sums due on account of such understatement. Further, if such audit or inspection is made necessary by the failure of the Franchisee to furnish reports, financial statements or any other documentation as herein required, or if it is determined by any such audit or inspection that the Franchisee's records and procedures were insufficient to permit a proper determination of Gross Sales for any year or part thereof to be made, or that Gross Sales for the period in question were understated by three percent (3%) or more of the Gross Sales actually received, or that the Franchisee was not complying with each of the provisions of Section XII hereof, the Franchisee shall immediately take such steps as may be necessary to remedy such default in accordance with the recommendations of such auditor and the Franchisee shall promptly pay to the Franchisor all costs incurred in connection with such audit or inspection, including, without limitation, charges of an accountant and the travel expenses, room, board and compensation of employees of the Franchisor.

If the Franchisee's records and procedures were insufficient to permit a proper determination of Gross Sales, the Franchisor shall have the right to deliver to the Franchisee an estimate, made by the Franchisor, of Gross Sales for the period under consideration and the Franchisee shall immediately pay to the Franchisor any amount shown thereby to be owing on account of the royalty fees and other sums due on account of any understatement. Any such estimate shall be final and binding upon the Franchisee.

Discussion:

In addition to requiring that the franchisee submit periodic financial reports, most franchisors draft an express right to inspect or make inquiry of the financial records at each franchised business. Essentially, the franchisor drafts these clauses so that it can ensure accurate royalty payments are being made or, if they suspect they are not, to confirm that so that the franchisor can pursue termination, if warranted, or take other appropriate action. The franchisee may claim that some of the inspections included in such sections are irrelevant and unnecessary.

D. Right to Inspect Franchised Business and Premises

The Franchisor and/or its representatives shall have the right at all times, without notice to the Franchisee, to inspect the Premises and the furnishings, equipment and fixtures thereon, the products, to take inventory of such products, and otherwise to examine the manner in which the Franchisee is conducting its business; in the event of any such inspection, the Franchisee and its staff shall co-operate fully.

Discussion:

The franchisor invariably reserves the right to inspect the physical premises of the franchised businesses. The business purpose behind this clause is to ensure that the franchised business appears and operates according to the franchisor’s system standards. These clauses promote greater accountability and adherence to all of the contents of the franchisor's manual. If the franchisee knows that the franchisor has the right to inspect its business (and the franchisor actually exercises that right), the franchisee may adhere more closely to the manual and system standards. This allows the franchisor to feel more confident that customers of the entire system are receiving a quality experience and unified message.

E. Right to Information

The Franchisee hereby authorizes the Franchisor to make inquiry of the Franchisee's bankers, suppliers and other trade creditors as to their dealings with the Franchisee in relation to the Franchised Business, to discuss the affairs, finances and accounts of the Franchised Business (and by its execution hereof the Franchisee authorizes and directs such bankers, suppliers and other trade creditors to discuss with the Franchisor the affairs, finances and accounts of the Franchised Business) and to obtain information and copies of invoices relating to sales or other dealings with all such persons and the Franchisee in any way relating to the Franchised Business. If requested, the Franchisee agrees to execute and deliver such directions and other documents as the Franchisor may require in order to permit such bankers, suppliers or other trade creditors to release or disclose any such information and documents to the Franchisor.

Discussion:

A franchisor has any number of reasons why it needs to access the franchisee’s financial information, including that available from banks and other creditors of the franchisee. However, for the franchisor to get access to this information the franchisee needs to provide its consent. Whether this sample clause will satisfy the bank or other institutions is never known for certain, in which case the franchisor may wish to reserve to itself the right to ask the franchisee to sign other forms.

XIII. INSURANCE

The Franchisee must purchase and maintain in full force and effect, at the Franchisee's expense and from a company the Franchisor accepts, insurance that insures both the Franchisee and Franchisor, and any other persons the Franchisor designates by name. The insurance policy or policies must be written in accordance with the standards and specifications (including minimum coverage amounts) set forth in writing by the Franchisor from time to time, and, at a minimum, must include the following (except as different coverages and policy limits may be specified for all franchisees from time to time in writing): (i) "special" causes of loss coverage forms (sometimes called "All Risk Coverage" or "All Peril Coverage") on the Franchised Business, Franchised Business improvements and all furniture, fixtures, equipment, supplies and other property used in the operation of the Franchised Business, for full repair and replacement value, except that an appropriate deductible clause is permitted; (ii) business interruption insurance covering a minimum of 12 months loss of income, including coverage for the Franchisor's Royalty Fees (for example, in the event of a fire or destruction of the Premises, the insurance must cover the Franchisor's average royalty payments (based on the previous 12-month timeframe, or if a shorter timeframe, the total operating timeframe for the Franchised Business) during the rebuilding process); (iii) comprehensive general liability insurance including product liability insurance and contractual liability insurance; (iv) workers' compensation insurance covering all of the Franchisee's employees; (v) motor vehicle insurance; (vi) umbrella liability insurance which also includes employers liability; (vii) "Per Location" aggregate limits when multiple franchise locations are insured under one comprehensive general liability and umbrella liability policy(cies); (viii) ● named as an additional insured on all liability policies required by this subparagraph; (ix) severability of interests and/or separation of insured's provisions must be included in the liability policies and all policies must be primary and non-contributing with any insurance policy carried by ●; and (x) any other such insurance coverages or amounts as required by law or other agreement related to the Franchised Business.

The insurance coverages referenced in (iii), (iv), (v), (vi), (vii), (viii) and (ix) must commence as of the date the Franchisee signs this agreement. The insurance coverages referenced in (i) and (ii) of this subparagraph must commence as of the date construction begins at the Franchised Business. The Franchisee must deliver to the Franchisor at commencement and annually or at the Franchisor's request a proper certificate evidencing the existence of such insurance coverage and the Franchisee's compliance with the provisions of this subparagraph. The insurance certificate must show the Franchisor's status as an additional insured and provide that the Franchisor will be given 30 days' prior written notice of a material change in or termination or cancellation of the policy. The Franchisor also may request copies of all policies. The Franchisor may from time to time modify the required minimum limits and require additional insurance coverages, by providing written notice to the Franchisee, as conditions require, to reflect changes in relevant circumstances, industry standards, experiences in the ● system, standards of liability and higher damage awards. If the Franchisee does not procure and maintain the required insurance coverage required by this agreement, the Franchisor has the right, but not the obligation, to procure insurance coverage and to charge the costs to the Franchisee, together with a reasonable fee for the expenses the Franchisor incurs in doing so. The Franchisee must pay these amounts to the Franchisor immediately upon written notice.

Discussion:

Any and every business requires insurance. A franchisor wishes to protect itself, the system and the value of its trademarks by requiring that franchisees carry the right kind and

sufficient amounts of insurance. As a result, many franchise agreements contain detailed provisions relating to insurance. Often times, the agreement requires the franchisee to name the franchisor (and potentially its affiliates) on the franchisee's liability policies. Many franchisors go further and explicitly identify a minimum dollar amount of coverage in such policies. Franchisors also often specify the different types of insurance required. For instance, franchisors typically require general liability insurance, insurance related to relevant products/services (*e.g.*, vehicle liability insurance and business interruption insurance.[117]

From the franchisor's perspective, this section should be carefully drafted to ensure compliance by the franchisee. For instance, the franchisor could require the franchisee periodically to update and provide documentation of its insurance policies.[118] The franchisor also could require approval of the insurance policies every "X" months. Franchisors may even require that the franchisee only be insured by a credible company with a minimum acceptable insurance rating.[119] Franchisors may adopt any combination of these approaches. However, franchisors should be aware that requiring certain minimum dollar amounts of coverage might prevent them from easily adapting and changing those minimums in the future. Thus, some might suggest that the insurance minimums should be drafted at a more general level.

XIV. RESTRICTIVE COVENANTS AND TRADE SECRETS

A. Competition During Term of Agreement

The Franchisee and the Guarantor (in consideration of the Franchisor entering into this agreement), jointly and severally, covenant and agree that, beginning on the Commencement Date, and during the Initial Term and any renewal period thereof, each of the Franchisee, any stockholder of the Franchisee if the Franchisee is a corporation, any member if the Franchisee is a limited liability company, any partner of the Franchisee if the Franchisee is a partnership, the Guarantor, and any of their respective spouses and children, shall not either individually or in partnership or jointly or in conjunction with any person, firm, association, syndicate or corporation, as principal, agent, stockholder or in any manner whatsoever, carry on or be engaged in or be concerned with or interested in or advise, lend money to, guaranty the debts or obligations of or permit their names or any part thereof to be used or employed in any business operating or franchising a [type of business should be specifically described here] business of any kind (a "Competing Business").

Discussion:

Please see Section XIV.B below for a discussion of Competition During Term of Agreement.

B. Competition After Transfer, Expiration or Termination

In the event of a Transfer, or the expiration or termination of this agreement for any reason whatsoever, the Franchisee and the Guarantor (in consideration of the Franchisor entering into this agreement) jointly and severally covenant and agree that each of the Franchisee, any stockholder of the Franchisee if the Franchisee is a corporation, any member if

[117] Sherman, *supra* note 15 at 110.

[118] Perkins, Yatchak & Hadfield, *supra* note 13 at 180.

[119] *Id.*

the Franchisee is a limited liability company, any partner of the Franchisee if the Franchisee is a partnership, the Guarantor, and any of their respective spouses and children, shall not, at any time during the period of two (2) years from the date of such Transfer, expiration or termination, either individually or in partnership or jointly or in conjunction with any person or persons, firm, association, syndicate, company or syndication as principal, agent, stockholder or in any other manner whatsoever carry on, be engaged in or be concerned with or interested in or advise, lend money to, guaranty the debts or obligations of or permit its name or any part thereof to be used or employed in any Competing Business, or franchising Competing Businesses, at the Franchised Business, within the Territory, or within fifteen (15) miles of the perimeter of the Territory. This 2-year period shall be tolled during any period of noncompliance and extend thereafter.

Discussion:

Franchise agreements typically include in-term non-compete covenants, which restrict competition during the term of the franchise agreement, and often include a post-term covenant that restricts competition following the termination or expiration of the agreement as well. No matter how well drafted, if such restrictive covenants are not enforceable, they are of little value to the franchisor.[120] Because restrictive covenants restrain trade and freedom of enterprise, courts typically subject them to strict or close scrutiny. For example, most jurisdictions require that post-term covenants be reasonable in temporal and geographic reach, line-of-business or other scope (such as the type of activities restricted or particular market segment or customers that are off limits), and necessary to protect a franchisor's legitimate business interest. Depending on the jurisdiction, covenants not to compete may be subject to state contract law, franchise statutes and more generally-applicable statutes that cover franchising as well as other enterprises.[121]

With respect to both in-term and post-term covenants, enforceability, judicial approaches, and the permissible parameters of the covenants vary by jurisdiction, sometimes widely.[122] Some states, for example, permit courts to "blue pencil" an overly broad covenant and enforce a reworked scope that is, in the court's view, more reasonable. Elsewhere, the law prohibits courts from blue penciling, which may render a covenant, even if just slightly too broad, void in its entirety.[123] Given the differences in state law, it is critical that drafters, working with franchisors, do their homework to determine the franchisor's actual protectable interest and, once determined, narrowly tailor the non-compete covenants to protect that interest. In doing so, the drafters must consider how courts in the jurisdiction whose law the franchisor has chosen to apply to the franchise agreement approach in-term and post-term covenants not to compete, as well as the laws in the states where franchisees are likely to be located. Most franchisors either are or hope to be national, which means that a franchisor may have to draft its standard non-compete covenant with an eye toward the majority approach, and then handle particular

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[120] Peter J. Klarfeld, *Introduction to the Second Edition* of Covenants Against Competition in Franchise Agreements xv (Peter J. Klarfeld, ed., 2d ed. 2003).

[121] For a helpful discussion of the legal background, judicial treatment and enforcement of non-compete covenants in franchise agreements, *see* Jason M. Murray & Michael R. Gray, *The Enforcement of Covenants Against Competition*, A.B.A. 28th Annual Forum on Franchising (2005), at Tab L6.

[122] For a helpful state-by-state survey of the law of covenants not to compete as they relate to franchising, *see* Covenants Against Competition in Franchise Agreements (Peter J. Klarfeld, ed., 2d ed. 2003).

[123] *See, e.g.,* Murray & Gray, *supra* note 121, at 16-17, and materials cited therein.

jurisdictional differences (to the extent they may significantly impact enforceability or approval by regulators) either through state- or franchisee-specific addenda.

Franchisors also must consider their franchisee target market when drafting or negotiating non-compete provisions. As the business model of franchising becomes more widely used, and competition for savvy, well capitalized franchisees heats up, this may be an area where a franchisor needs to be more flexible and understand that "competitive business" should be narrowly defined. For instance, it is not realistic for a food franchisor to expect a publically traded company or even a large multi-unit operator not to have *any* interest in another restaurant concept (without defining what type of restaurant truly is competitive with the franchised business). Being too broad in the non-compete provision may foreclose opportunities to attract a certain level or type of franchisee.

In-term non-competition covenants are important to franchisors for a variety of reasons. These restrictions protect the franchised trademarks, promote loyalty from franchisees, and help to prevent the threat of customer loss.[124] In-term non-competes are critical to franchisors because unlike the employment context, where employees typically owe their employers a duty not to compete elsewhere while employed, franchisees are independent contractors of a franchisor and, without an in-term covenant not to compete, otherwise may not be restricted under the law from competing, even during the term of the franchise agreement.[125]

In-term non-competes traditionally have been broader in scope than post-term non-competes, to protect a franchisor's legitimate expectation that a franchisee's efforts, focus and use of know-how is directed solely to the franchised business during the term of the franchise agreement.[126] In some jurisdictions, however, courts apply the same strict scrutiny to in-term covenants as post-term covenants, despite the realities of the franchise relationship. Notably, in the 2009 Georgia case *Atlanta Bread Co. Int'l, Inc. v. Lupton-Smith*,[127] the Georgia Supreme Court refused to enforce, and invalidated as a matter of law, an in-term non-compete in a franchise agreement on the basis that it did not meet the strict requirements typically applied to post-term non-competes with respect particularly to territory and nature of the business. Because Georgia applies a non-severability rule, the court also invalidated the franchisor's more narrow post-term non-compete. This case is somewhat of an anomaly particular to Georgia law and the facts, but the result starkly demonstrates the impact local law may have on non-competes, including the in-term covenants that most franchisors view as critical.[128]

Post-termination covenants against competition often are subject to more strict judicial scrutiny than in-term covenants given their restraint on trade following the end of the contractual relationship and their potential impact on a former franchisee's ability to earn a livelihood. As

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[124] Asbill, Barkoff & Selden, *supra* note 3 at 46.

[125] Klarfeld, *supra* note 120, at xvii.

[126] *See, e.g., McDonald's Systems, Inc. v. Sandy's Inc.*, 195 N.E.2d 22 (Ill. Ct. App. 1963) (drawing distinction, under Illinois law, between in-term and post-term non-compete covenants); *see also* Murry & Gray, *supra* note 125, at 14-16 and citations therein.

[127] 679 S.E.2d 722 (Ga. 2009).

[128] Following this case, the Georgia legislature took steps to change state law on this issue through legislative action, by passing HB 173 (codified at O.C.G.A. 13-8-50-59). Because Georgia's constitution prohibits contractual restraints of trade, however, the statutory provisions only will become effective if state voters ratify an enabling amendment to the constitution in the November 2010 general election.

mentioned above, post-term non-competes therefore must be reasonable in geographic, temporal and line-of-business scope, and necessary to protect a franchisor's legitimate business interest, to pass muster in most jurisdictions.[129]

Covenants not to compete may focus not only on the franchisee and guarantors, but also on family members of the franchisee. These clauses depend on the particulars of the franchise situation; if the family members are more heavily involved in the franchised business then care should be given to the drafting of such clauses to be appropriately inclusive. Essentially, the franchisor should restrict competition by anyone who is significantly involved in the daily running of the franchised business, to the extent enforceable under applicable law.

C. Non-Solicitation Covenants

The Franchisee covenants that it will not, for a period of eighteen (18) months after the expiration, non-renewal or termination of this agreement, regardless of the cause of termination, or within eighteen (18) months of the sale of the Franchised Business or any interest in the Franchisee, solicit business from customers of the Franchisee's former Franchised Business or from any National Accounts, or contact any of the Franchisor's suppliers or vendors for any competitive business purpose, or solicit any of its former Franchised Business employees, or the employees of any franchised business operated by another franchisee, the Franchisor or the Franchisor's affiliates to discontinue employment.

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[129] For examples of recent judicial treatment of covenant not to compete opinions in franchising, *see Tinder Box Int'l Ltd. v. Patterson*, 2010 WL 2302298 (E.D. Pa. 2010) (court held, after bench trial, that franchisor's failure to bring claim within contractual limitation period foreclosed non-compete claim, in case where neither franchisor or franchisees had noticed expiration of franchise agreement for some time); *Native New Yorker Franchising, Inc. v. Shabaz, Inc.*, 2010 WL 1740854 (D. Ariz. 2010) (Franchisor granted preliminary injunction on post-term non-compete); *Maaco Franchising, Inc. v. Augustin*, 2010 WL 1644278 (E.D. Pa. 2010) (Franchisor's 1-year, 10-mile post-term non-compete was reasonable under Pennsylvania law, warranting grant of preliminary injunction, but 1-year period would not be extended due to former franchisee's violation; according to court, franchisor could have drafted for such an extension but it was not available under contract provision as written, applicable law and the facts); *Doyle v. Nutrilawn U.S., Inc.*, 2010 WL 1980280 (W.D. Wash. 2010) (holding, on cross-motions for summary judgment, that expiration of the franchise agreement constituted "termination" for purposes of the non-compete clause, without deciding either reasonableness of clause or enforceability on current record); *In re All American Properties, Inc.*, 2010 WL 1541694 (Bkrtcy M.D.Pa. 2010); *Klosek v. American Express Co.*, Slip Copy, 2010 WL 1286841 (8th Cir. 2010) (not for publication) (no actual controversy for declaratory judgment purposes where no allegation that franchisor intended to enforce non-compete or that franchisees had more than potential interest in competing in the future); *Medi-Weightloss Franchising USA, LLC v. Sadek*, 2010 WL 1837767 (M.D.Fla. 2010) (preliminary injunction granted to franchisor under Florida law; two-year, 25 mile post-term non-compete was reasonable in geographic, temporal and line-of-business scope and necessary to protect franchisor's legitimate business interest); *Victory Lane Quick Oil Change, Inc. v. Hoss*, 2010 WL 727242 (E.D.Mich. 2010) (denying summary judgment to franchisor on post-term non-compete claim; franchisor had not presented sufficient evidence, in court's view, that 3-year, 10-mile quick oil change business restriction was reasonable in relation to franchisor's competitive business interest); *H & R Block Tax Services LLC v. Kutzman*, 681 F.Supp.2d 1248, (D. Mont. Jan. 26, 2010) (post-termination covenant that prohibited former franchisee from providing tax preparation services to new or former clients within 45 miles of franchised location for one year was enforceable under Montana law, entitling franchisor to preliminary injunction); *Anytime Fitness, Inc. v. Family Fitness of Royal, LLC,* 2010 WL 145259, Bus. Franchise Guide (CCH) ¶14,303 (D.Minn. 2010); *Verlo Mattress Factory Stores, LLC v. Mattress Crafters Corp.*, Bus. Franchise Guide (CCH) ¶ 14,285 (N.D. IL Dec. 23, 2009) (court held, on preliminary injunction motion, that post-term covenant with 50-mile territorial scope and two year term was reasonable to protect franchisor's legitimate business interest); *Bundy Am., LLC. V. Hawkeye Transp.*, Bus. Franchise Guide (CCH) ¶ 14,282 (W.D. Wash. Dec. 1, 2009) (post-termination covenant prohibiting a competitive business within five miles, for two years, was enforceable under Washington law).

Discussion:

Many franchise agreements prohibit the franchisee from soliciting customers or employees from the franchisor, its subsidiaries or other franchisees. A system that uses "national accounts" should restrict the franchisee from soliciting the franchisor's national accounts as well.[130] If a previously franchised business solicits an employee or national account customer, then the franchisor ultimately loses the value that employee or customer brought to the system. Thus, many franchisors draft a non-solicitation clause to prevent the franchisee from threatening the value of the system in this way. The enforceability of such clauses varies by jurisdiction.

XV. TRANSFER

A. Transfer by the Franchisee

The franchise granted under this agreement is personal to the Franchisee. During the Term, the Franchisee shall not sell, assign, transfer or otherwise dispose of (collectively "Transfer") or mortgage, charge, grant a security interest in or otherwise encumber (collectively "Encumber") all or any of the Franchisee's interest hereunder or in any assets of the franchise, including the lease for the Premises, nor shall any of the Principals Transfer (except to another Principal) or Encumber any of their interests in the franchise or the Franchisee, nor shall the Franchisee issue any further shares in the Franchisee's capital (except to the Principals) or admit new partners, nor shall the Franchisee amalgamate, merge, reorganize or engage in any similar proceedings, without in each case obtaining the prior written consent of the Franchisor, which consent shall not be unreasonably withheld. Any proposed Transfer by the Franchisee shall be initiated by the Franchisee providing the Franchisor with not less than sixty (60) days notice prior to the proposed Transfer date of the Franchisee's intention to Transfer this agreement. Any actual or purported Transfer or Encumbering (including whether by operation of law or otherwise) without the Franchisor's prior written consent shall constitute a breach of this agreement and shall be null and void. The Franchisee agrees to initiate the Transfer process by advising the Franchisor of the intent to Transfer its Franchised Business by sale or otherwise and requesting procedural/administrative instructions. In considering a request for a Transfer, the Franchisor shall consider, among other things, the qualifications, apparent ability and credit standing of the proposed transferee.

Discussion:

The contract clause concerning the franchisee's transfer rights is one of the few areas in the franchise agreement where the franchisee may be able to assert some power.[131] The franchisee will want to ensure that it has a right of transfer because transfer is the only way to ensure that its investment in the franchise can be liquidated if need be.[132] In protecting this right, the franchisee might want to draft that the franchisor cannot unreasonably withhold consent to

[130] Asbill, Barkoff & Selden, *supra* note 3 at 47.

[131] Killion, *supra* note 24 at 229.

[132] Asbill, Barkoff & Selden, *supra* note 3 at 48.

transfer.[133] Drafters should be aware that some state statutes impose such a requirement as well.[134]

Although a transfer might not be ideal for the franchisor, the franchisor's ultimate intent is for the franchised business to run successfully. Franchisors should also want there to be a healthy secondary market in their franchises, as that points to a franchise system whose units are in demand, and that people want to own. If the current franchisee wishes to sell to make a profit, is not performing or no longer wants to run the business, it is in the best interest of the franchisor to allow the franchisee to sell the business. Naturally, the franchisor will want to ensure that any prospective franchisees meet its standards for new franchisees, as discussed below.

B. Conditions of Transfer

In considering the request for a Transfer, the Franchisor may consider, among other things, the information set out in the Franchisee's application, the qualifications, good character, requisite general business experience, apparent ability to operate the Franchised Business and credit standing of the proposed transferee, and its partners, managers, principal stockholders, directors and officers, as appropriate. In addition, the Franchisor shall be entitled to require as a condition precedent to the granting of its consent that:

a. *the proposed assignee or an affiliate of the proposed assignee is not a competitor of the Franchisor;*

b. *the Franchisor is provided with a copy of the agreement of purchase and sale between the Franchisee and the proposed assignee and all documents referred to therein as relied upon by the parties. If any financial statements are included, the Franchisor shall be entitled but not obligated to question any figures relating to matters in respect of which the Franchisee is required to report to the Franchisor under this agreement;*

c. *as of the date of the Franchisee's request for consent and as of the effective date of Transfer there shall be no default in the performance or observance of any of the Franchisee's obligations under this agreement or any other agreement between the Franchisee and the Franchisor or any affiliate or supplier thereof, and if the Franchisee intends to transfer its rights of possession of the Premises, that the Franchisee have obtained the consent of all necessary parties to the assignment of any licenses, and the lease or sublease, to the proposed transferee;*

d. *the Franchisee shall have settled all outstanding accounts with the Franchisor, its affiliates and all other trade creditors of the Franchised Business up to the date closing of the proposed Transfer;*

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[133] Teixeira, *supra* note 80 at 89.

[134] *See, e.g.,* Minn. Stat. § 80C.14(5).

e. *the Franchisee shall have delivered to the Franchisor a complete release of the Franchisor, its directors and officers, their affiliates and the directors and officers thereof, from all obligations under this agreement of any such persons, in a form satisfactory to the Franchisor;*

f. *the proposed transferee shall have entered into a written assignment in a form prescribed by the Franchisor or, at the option of the Franchisor, shall have executed a new Franchise Agreement in the form then being used by the Franchisor, which may provide for a higher royalty and for greater expenditures for advertising and promotion than are provided hereunder, and shall have executed such other documents and agreements as are then customarily used by the Franchisor in the granting of franchises;*

g. *the proposed transferee providing guaranties from anyone whom the Franchisor may request, guaranteeing the proposed transferee's performance of its obligations under the agreements to be entered into;*

h. *the proposed transferee completing, to the satisfaction of the Franchisor, such training in the operations of the Franchised Business, at the proposed transferee's or the Franchisee's sole expense, as the Franchisor may require;*

i. *the proposed transferee providing, to the satisfaction of the Franchisor, a business plan indicating that the proposed transferee possesses the required level of business experience and acumen necessary in the operation of a ● business;*

j. *the purchase price to be paid to the Franchisee by the proposed transferee, or if applicable, the proposed encumbrance and debt associated therewith is reasonable in the circumstances having regard to the debt and interest charges being acquired or already in existence;*

k. *the Franchisee paying to the Franchisor, any fees and/or expenses which may be incurred by the Franchisor in dealing with the Franchisee's said application for approval and the Franchisor's then existing Transfer fee, which Transfer fee shall not exceed fifty percent (50%) of the Franchisor's then existing initial franchise fee charged to new Franchisees; and*

l. *the Franchisee and the proposed transferee agree to perform all maintenance and upgrades required to bring the Franchised Business up to the Franchisor's then current standards for an Franchised Business, including upgrading any computer hardware and software as the Franchisor may require.*

The refusal of the Franchisor to consent to the proposed Transfer based upon the non-compliance with any of the foregoing conditions shall not be deemed to be an unreasonable

withholding of such consent. The Franchisor's consent to a Transfer shall not operate to release the Franchisee from any liability under this agreement.

Discussion:

Any franchisor will want to think carefully about the conditions of transfer, of course. Although the franchisor will agree that it is not in its best interest to keep in the system a franchisee who no longer wants the franchised business, the franchisor also wants to do whatever it can to ensure that the franchised business ends up in what it considers competent hands. Most commonly, the franchisor will require, as conditions for transfer, that the existing franchisee and/or potential transferee bring the facility to current standards, cure any issues, pay a fee, comply with the contractual transfers of leases, sign a new franchise agreement (or sign an assignment agreement), provide guaranties, and lastly but most importantly, provide detailed information about the potential transferee.[135] The sample clause provides for a long, but relatively complete, list of common conditions of transfer.[136]

In drafting, the franchisor will want to make it explicit that its approval of transfer does not constitute a waiver of claims. In other words, even if the transfer has been approved, the original franchisee is still held liable under its franchise agreement (both in cases where the agreement is assigned as well as in those where the original agreement is terminated).[137] It should also be noted that by signing a new agreement, state franchise registration/disclosure laws and the FTC Rule designate the transfer as a ”sale” of the franchise.[138] If this is not desired, the franchisor should consider drafting clear intentions regarding transfers. Lastly, many agreements expressly provide the consequences of an unauthorized transfer.[139] This can be important in any dispute; a franchisor wants any unauthorized transfer to be void, and any attempted or actual unauthorized transfer to be a default or grounds for termination, respectively. The franchisor should give thought to those consequences and put them into the franchise agreement.

C. Right of First Refusal

Without in any way derogating from the Franchisor's right to reject a proposed Transfer in accordance with this agreement, if at any time or times during the Initial Term, or any renewal of this agreement, the Franchisee obtains a bona fide offer (the "Offer") to acquire the whole or any part of his interest in the Franchised Business, which the Franchisee wishes to accept, the Franchisee shall promptly give written notice thereof to the Franchisor together with a true copy of the Offer. Upon receipt of such notice and Offer, the Franchisor shall have the option of purchasing the property forming the subject matter thereof upon the same terms and conditions as those set out in the Offer except that:

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[135] Asbill, Barkoff & Selden, *supra* note 3 at 49.

[136] Not surprisingly, franchisor responses to transfer requests have spawned litigation by franchisees and prospective transferees. *See, e.g., Western Convenience Stores, Inc. v. Burger King Corp.*, Bus. Franchise Guide (CCH) ¶ 13, 708 (D. Neb. 2007); *Maple Shade Motor Corp. v. Kia Motors America, Inc.*, Bus. Franchise Guide (CCH) ¶ 13,418 (D. N.J. 2006); *Promus Hotels, Inc. v. Hadnot Hotel Properties, LLC*, 2006 WL 2505335 (W.D. La. 2006).

[137] Carden & Klarfeld, *supra* note 54 at 36-37.

[138] Asbill, Barkoff & Selden, *supra* note 3 at 49.

[139] *Id.* at 51.

a. *there shall be deducted from the purchase price the amount of any commissions, fee or transfer fee that would otherwise have been payable to the Franchisor, any broker, agent or other intermediary in connection with the Transfer;*

b. *the Franchisor shall have the right to substitute cash for any other form of consideration specified in the Offer and to pay in full the entire purchase price at the time of closing.*

The Franchisor may exercise its option at any time within thirty (30) days after receipt of the said notice by giving written notice to the Franchisee. If the Franchisor declines to exercise such option and if such Transfer is approved by the Franchisor in accordance with this agreement, the Franchisee shall be at liberty to complete the Transfer to such third party transferee in accordance with the Offer, provided that, notwithstanding the terms of the Offer, such transaction must be completed within thirty (30) days of the date on which the Franchisor notifies the Franchisee of its approval of such transaction. If the transaction is not completed within thirty (30) days, the foregoing provisions of this right of first refusal shall apply again in respect of the proposed Transfer and so on from time to time;

Discussion:

In the attempt to protect the franchised business from ending up in the "wrong" hands, from the franchisor's perspective, many franchisors will insist on a right of first refusal. This right allows the franchisor to prevent any transfer that is of concern by giving the franchisor the opportunity to purchase the franchised business first. This clause should include details on when the franchisor wants notice of a proposed transfer, with copies of proposed agreements. The franchisor also should provide for its right to ask for additional information, as well as the right to negotiate with the potential transferee. Lastly, the franchisor should state a period of time reserved for a full review of the offer.[140]

D. Transfer or Assignment by the Franchisor

The Franchisor shall have the right to transfer this agreement to any person or legal entity without prior notice to, or consent of the Franchisee. Specifically, and without limitation of the foregoing, the Franchisee agrees that the Franchisor may sell its assets, its interest in the Trademarks or the System to a third party; may offer its securities privately or publicly; may merge, acquire other entities or be acquired by another entity directly or indirectly; may undertake a refinancing, recapitalization, leveraged buyout or other economic or financial restructuring; and with regard to any or all of the above sales, assignments and dispositions, the Franchisee expressly and specifically waives any claims, demands, or damages against the Franchisor arising from or related to the transfer. Nothing contained in this agreement shall require the Franchisor to continue any business operating under the System or to offer any services or products, whether or not bearing the Trademarks, to the Franchisee if the Franchisor assigns its rights in this agreement in accordance with the provisions of this subparagraph. In the event of a transfer or assignment of this agreement by the Franchisor, the Franchisor shall be freed and relieved of any and all liability under this agreement.

[140] *Id.* at 50-51.

Discussion:

The franchisor may want to sell its own business at any point in the term of the franchise agreement. Thus, it is important for the franchisor explicitly to reserve the right to do so. Otherwise the franchisor might be obliged to seek a consent to it assigning each and every franchise agreement, from each individual franchisee who is a party to that agreement. The sample clause above expressly provides the franchisor the right to transfer and assign the system and agreement and relieves the franchisor of all obligations under the agreement at the time of the transfer.

In negotiating this section, some prospective franchisees may wish to insist that any new franchisor be of a certain qualification and identity.[141] From a franchisee's perspective, it will want contractual assurances that the system will remain in appropriate and competent hands. Established franchisors, however, are unlikely to negotiate conditions on their transfer right. Instead, franchisors typically insist on an unrestricted right to assign the system and agreement.[142] From a franchisor's perspective, clauses that put conditions on a franchisor's transfer right limit their flexibility and invite claims by unsatisfied franchisees.[143]

XVI. DEATH OR INCAPACITATION

A. Incapacitation

For the purposes of this article, the Franchisee or any controlling shareholder(s) or partner(s) as the case may be shall be deemed to have a "permanent disability" if the usual participation of the Franchisee or any controlling shareholder(s) or partner(s), as the case may be, in the Franchised Business is for any reason curtailed for a cumulative period of one hundred and eighty (180) days in any twelve (12) month period during the term of this agreement, including renewals.

Discussion:

Most franchise agreements include provisions concerning the franchisee's death or incapacitation. If so, it is crucial that the agreement include a definition of incapacitation, so as to avoid as much conflict as possible. Drafters include such a section to avoid ambiguity surrounding what constitutes incapacitation for purposes of the agreement, and its implications (as set out below). Parties also should be aware that some franchise statutes (*e.g.,* the Indiana

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[141] *Id.*

[142] For the types of claims that may arise over Franchisor transfers, particularly transfers to a competing Franchisor, *see generally* Kirk W. Reilly, L. Seth Stadfeld & Phillip L. Wharton, *Litigation After Acquisition of a Competing Franchise System*, A.B.A. 29th Annual Forum on Franchising (2006) W6 at 12-13. As the authors note, however, '[t]he best claim available to a franchisee would be that the transfer of its franchise agreement to the acquiring entity breached express contract terms. Normally this claim is not available, however, because most modern franchise agreements contain language allowing the franchisor to assign the contract without franchisee consent." Foreclosing franchisee claims is, of course, one of the franchisor's goals when drafting such a clause.

[143] Such claims typically involve fact issues about whether the conditions have been met, which means not only the expense of discovery, but also that claims may survive dispositive motion practice. *See, e.g., A.J. Temple Marble & Tile, Inc. v. Marble Care, Inc.*, 618 NYS.2d 155 (N.Y. Sup. Ct. 1994) (denying summary judgment to the defendant upon the plaintiff/franchisee's argument that the transferee lacked sufficient experience, where the franchise agreement permitted franchisor transfer only when "(1) the assignee shall, at the time of assignment, be financially responsible and economically capable of performing the obligations of the Franchisor hereunder, and (2) the assignee shall expressly assume and agree to perform such obligations.")

Deceptive Franchise Practices Act and, more broadly, motor vehicle laws and equipment statutes in some jurisdictions) may override the contractual terms with respect to franchisee deaths or incapacitations.[144]

B. Options for Franchisor on Death or Incapacitation of Franchisee

Upon the death or permanent disability of the Franchisee or the controlling shareholder or partner or partners of the Franchisee as the case may be, if such person has at the date of such death or permanent disability a spouse or any adult children surviving, the following shall apply:

a. *if the surviving spouse and/or adult child desire and are, in the reasonable opinion of the Franchisor, capable of carrying on the Franchised Business, the said spouse and/or adult child shall have the right to continue, to operate the Franchised Business provided that they shall directly covenant and agree with the Franchisor to be bound by the terms and conditions of this agreement and any other agreements made between the Franchisor and the Franchisee;*

b. *if the surviving spouse and/or an adult child do not desire or are not, in the reasonable opinion of the Franchisor, capable of carrying on the Franchised Business, or cannot devote their full time and attention to the Franchised Business or if the Franchisee does not have a spouse or adult child surviving, the Franchisor shall have the right, such right to be exercised by the Franchisor giving written notice to the Franchisee or to the Franchisee's estate within ninety (90) days of the date of the Franchisee's death or death of the controlling shareholder(s) or partner(s) of the Franchisee or the date upon which the Franchisee's permanent disability arises or the permanent disability of the controlling shareholder(s) or partner(s) of the Franchisee arises, to purchase all or any part of the assets of the Franchisee used in the operation of the Franchised Business for a purchase price equal to the "asset value" of the Franchisee's assets less all proper business liabilities assumed by the Franchisor as at the date the said purchase is completed. To satisfy the aforesaid purchase price, the Franchisor shall pay the difference between the said "asset value" and the amount of the liabilities assumed by it, on the date of the completion of the purchase by way of cash or certified check.*

Discussion:

It is common for the franchisor to allow the family, heirs, or estate of a deceased franchisee to continue operations of the franchised business immediately after death, even if not

[144] *See, e.g.,* Indiana Deceptive Franchise Practices Act, Ind. Code Ann. § 23-2-2.7-2(3) (violation of Act to deny "the surviving spouse, heirs, or estate of a deceased franchisee the opportunity to participate in the ownership of the franchise under a valid franchise agreement for a reasonable time after the death of the franchisee, provided that the surviving spouse, heirs, or estate maintains all standards and obligations of the franchise.")

thereafter. Most often, these individuals must satisfy the franchisor's requirements (*i.e.*, character and competency requirements). If the family or heirs do not satisfy such requirements, the franchisor typically requires the sale of the franchised business to someone who successfully meets those requirements.[145] Of course, the business reason behind this clause is that the franchisor wants to ensure that suitable people are running its franchises. As noted above, state statutes in some jurisdictions may override the contract terms in this area.

Although many agreements have provisions dealing with death and disability and, as noted, it is common to permit a sale to or by family or heirs, there is not a universal approach to what happens if there are no heirs or family capable of stepping in, or if those individuals cannot sell within a reasonably short period of time. In that situation, some franchisors insist on the right to purchase as if the franchise agreement were being terminated, meaning a purchase for a depreciated book value, with little or no amount for going concern value. In other situations, the franchisor is obliged to pay what may approach fair market value. So, in the sample clause, the important but missing feature is the definition of "asset value."

XVII. TERMINATION

A. Events of Default and Right of Termination

The Franchisee shall be deemed to be in default under this agreement, and all rights granted herein shall automatically terminate without notice to the Franchisee, if the Franchisee shall become insolvent or make a general assignment for the benefit of creditors; if a petition in bankruptcy is filed by the Franchisee or such a petition is filed against the Franchisee and not opposed by the Franchisee; or if the Franchisee is adjudicated bankrupt or insolvent; or if a receiver or other custodian (permanent or temporary) of the Franchisee's assets or property, or any part thereof, is appointed by any court of competent jurisdiction; or if proceedings for a composition with creditors under the applicable law of any jurisdiction should be instituted by or against the Franchisee; or if a final judgment remains unsatisfied or of record for thirty (30) days or longer (unless a supersedeas bond is filed or other steps are taken to stay effectively the enforcement of such judgment in the relevant jurisdiction); or if the Franchisee is dissolved; or if execution is levied against the Franchisee's property or business; or if suit to foreclose any lien or mortgage against the premises or equipment of any Franchised Business developed hereunder is instituted against the Franchisee and not dismissed within thirty (30) days; or if the real or personal property of any Franchised Business developed hereunder shall be sold after levy thereupon by any sheriff, marshal, constable or equivalent governmental authority.

The Franchisee shall be deemed to be in default and the Franchisor may, at its option, terminate this agreement and all rights granted hereunder without affording the Franchisee any opportunity to cure the default (effective immediately upon receipt of written notice by the Franchisee), upon the occurrence of any of the following events:

a. *if the Franchisee fails to complete construction of the Franchised Business and to open for business within one hundred eighty (180) days of execution of this agreement. The Franchisor may, but is not required to, extend this period to address unforeseen construction delays, not within the control of the Franchisee;*

[145] Carden & Klarfeld, *supra* note 54 at 39.

b. *if the Franchisee at any time ceases to operate the Franchised Business or otherwise abandons the Franchised Business, or loses the right to possession of the premises of the Franchised Business, or otherwise forfeits the right to do or transact business in the jurisdiction where the Franchised Business is located. Provided, however, that if, through no fault of the Franchisee, the Premises are damaged or destroyed by an event not within the control of the Franchisee such that repairs or reconstruction cannot be completed within one hundred eighty (180) days thereafter, then the Franchisee shall have thirty (30) days after such event in which to apply for the Franchisor's approval to relocate and/or reconstruct the Premises, which approval shall not be unreasonably withheld, but may be conditioned upon the payment of an agreed minimum royalty to the Franchisor during the period in which the Franchised Business is not in operation;*

c. *if the Franchisee is convicted of a felony involving moral turpitude, or any other crime that the Franchisor believes is reasonably likely to have an adverse effect on the System, the Trademarks, the goodwill associated therewith, or the Franchisor's interest therein;*

d. *if a threat or danger to public health or safety results from the construction, maintenance, or operation of the Franchised Business or from the material violation of any health and safety laws, rules, or regulations which poses a significant public health and safety concern, or if the Franchised Business is closed as a result of a failed inspection by the health department and in such event the Franchisor determines, in its sole discretion, that critical violations of applicable health codes are the result of repeated or material failure by the Franchisee to comply with the requirements of the Franchise Agreement or the health department. Notwithstanding anything in this agreement to the contrary, the Franchisor shall have the right, in lieu of exercising any right of termination, to require that the Franchised Business be closed to the public and/or remain closed until the applicable food, health, or safety matters are cured;*

e. *if the Franchisee, or any partner, shareholder, or member of the Franchisee purports to transfer any rights or obligations under this agreement or any interest in the Franchisee to any third party without the Franchisor's prior written consent contrary to the transfer provisions of this agreement;*

f. *if the Franchisee fails to comply with the in-term non-competition covenants in this agreement or fails to obtain execution of the covenants required from the owners of the Franchisee;*

g. *if, contrary to the terms of this agreement, the Franchisee discloses or divulges the contents of the Manual or any other confidential information provided to the Franchisee by the Franchisor;*

h. *if an approved transfer is not effected as required by this agreement, following the death or mental incapacity of person as described therein;*

i. *if the Franchisee knowingly maintains false books or records, or submits any false reports to the Franchisor;*

j. *if the Franchisee or any individual, group, association, limited or general partnership, corporation or other business entity which directly or indirectly controls, is controlled by, or is under common control with the Franchisee; or which directly or indirectly owns, controls, or holds power to vote ten percent (10%) or more of the outstanding voting securities of the Franchisee; or which has in common with the Franchisee one or more partners, officers, directors, trustees, branch managers, or other persons occupying similar status or performing similar functions ("Affiliate") commits any act of default under any other Franchise Agreement, Development Agreement (except for failure to meet the development schedule thereunder), asset purchase agreement, promissory note, or any other agreement entered into by the Franchisee or an affiliate of the Franchisee, and the Franchisor or any affiliate or predecessor of, or successor to, the Franchisor;*

k. *if the Franchisee, after or during a default, commits the same default again, whether or not such default is cured after notice;*

l. *if the Franchisee defaults more than once in any twelve (12) month period, whether or not cured after notice;*

m. *if the Franchisee refuses to permit the Franchisor or its agents to enter upon the premises of the Franchised Business to conduct any periodic inspection as permitted by this agreement;*

n. *if the Franchisee uses any of the Trademarks in any unauthorized manner or is otherwise in default of the provisions of this agreement.*

Except as outlined above, upon any default by the Franchisee which is capable of being cured, the Franchisor may terminate this agreement only by giving written Notice of Termination stating the nature of such default to the Franchisee at least ten (10) days prior to the effective date of termination if the default is for failure to pay royalties, Advertising Fund Contributions (including Cooperative contributions, if any are due and/or any other financial obligations owed to the Franchisor by the Franchisee), and thirty (30) days, prior to the effective date of termination for any other default; provided, however, that the Franchisee may avoid termination by curing such default to the Franchisor's satisfaction within the ten (10) day or thirty (30) day period, as applicable. If any such default is not cured within the specified time, this agreement shall terminate without further notice to the Franchisee effective immediately upon the expiration of the ten (10) day or thirty (30) day period, as applicable, or such longer period as applicable law may require.

Discussion:

It is important that franchisors take care in drafting the events of default and right of termination provision. The events listed in this section are those that the franchisors will rely upon (subject to any statutory requirements) when issuing a default notice at a later date, should default occur. Franchisors should be clear, specific and concise when listing such events in the agreement.[146] Because termination severs the business relationship, usually with finality, and because the parties usually bear obligations post termination (both outlined by the contract and by relevant statutes[147]), it is important that the parties are clear on exactly what events will provide grounds for termination.

The termination clause is one of the most powerful ways that a franchisor can elicit compliance from its franchisee, and one of the most important ways that the franchisor controls its system.[148] The franchisor is provided the right to terminate the agreement, typically upon the franchisee's failure to cure a breach of the agreement. The default and termination clause is frequently written in categories, as reflected in the sample provision. Defaults are categorized into those that are viewed as incurable and provide grounds for immediate termination, usually without a notice requirement, those that provide grounds for termination immediately upon notice, and those defaults that require notice of default and provide an opportunity to cure, and provide grounds for termination if not cured within the cure period.

It is important that the franchisee fully understands which types of default circumstances fall under which category so that the franchisee can avoid termination if possible. The franchisor also needs to understand the logic behind those defaults that are in fact incurable, versus those that merit exercise of discretion and those that merit some time to cure. From a business perspective, the franchisor generally will want to instill confidence in franchisees that they will be able to conduct their businesses largely without fearing precipitous termination by the franchisor.

Importantly, those state franchise statutes which govern the post-sale relationship typically impose requirements on franchisors with respect to defaults, opportunities to cure and termination, and associated notices. These requirements almost always override the contractual terms, to the extent inconsistent with the statute, and they vary by jurisdiction. State franchise relationship statutes often require franchisors to have statutory-defined "good cause" for termination before terminating a franchisee, and what constitutes "good cause" varies by jurisdiction according to the particular statutory wording and the relevant case law interpreting the statute.[149] Whether or not a "good cause" requirement is imposed, state franchise statutes often require prior notice of defaults and termination, with varying statutory requirements as to forms of notice and notice periods for particular types of defaults. Most states that have franchise relationship statutes also require franchisors to provide an opportunity for the

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[146] Joseph J. Fittante Jr. & Meredith Bauer, *Practice Pointers: Drafting Notices of Defaults and Termination*, 28-SPG Franchise L.J. 216 (2009).

[147] Joseph J. Fittante Jr. & Meredith Bauer, *Defaults and Terminations: An Unfortunate Reality of a Challenging Economy*, 28 Franchise L.J. 214 (2009).

[148] Blair & Lafontaine, *supra* note 23 at 55.

[149] Fittante, Jr. & Bauer, *supra* note 147 at 214.

franchisee to cure certain types of defaults, and termination thereafter only if the franchisee fails to cure.[150] The specific cure periods and requirements vary by jurisdiction as well.

Careful franchisors must consider this regulatory landscape in drafting the default and termination clause -- and when or if it becomes necessary to enforce the clause. Not surprisingly, default and termination issues lead to much of the litigation in franchising. With respect to drafting, national franchisors typically manage the variation among the state law requirements through state-specific addenda, crafted in a manner acceptable to state regulators that amend the standard contract provision where necessary.

B. Liquidated Damages

Upon the Franchisor's termination of this agreement in accordance with the terms of this agreement, the Franchisee shall pay to the Franchisor within 30 days of the date of the termination, as liquidated damages for the premature termination of this agreement and not as a penalty, an amount equal to 3½ times the continuing royalty fees payable to the Franchisor in respect to the last 12 months of the Franchised Business' active operations or the entire period the Franchised Business has been open for business, whichever is the shorter period. The Franchisee acknowledges and agrees that such liquidated damages are a reasonable approximation of the damages the Franchisor will incur resulting from the premature termination of the Franchise Agreement as a result of breach by the Franchisee, are appropriate because actual damages incurred by the Franchisor will be difficult or impossible to ascertain, are not a penalty, and shall not affect the Franchisor's right to, and are not in lieu of, any other payment or remedy, damages or relief to the Franchisor.

Discussion:

Franchisors typically wish to include a liquidated damages clause in the franchise agreement. Liquidated damages clauses provide a contractually-agreed formula for calculating the franchisor's damages resulting from the termination of the franchise agreement before the end of its natural term due to the franchisee's breach. Absent such a clause, a franchisor may face challenges in proving its actual damages resulting from such premature termination, as well as protracted discovery and fact disputes with the terminated franchisee over this category of damages. Drafters should be aware that liquidated damages cannot be used as a form of penalty and therefore must not be disproportionate to the harm to the franchisor. Although the enforceability of liquidated damages clauses varies by jurisdiction, broadly speaking, a court may enforce a liquidated damages clause if it is established that the parties intended liquidated damages not as a penalty, but as an approximation of damages to compensate the franchisor for harm resulting from the premature termination of the franchise agreement due to the franchisee's breach; that the liquidated damages amount set at the time of contract was a reasonable estimate of actual damages that the franchisor would incur in such event; and that actual damages were difficult to ascertain.[151]

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[150] *Id.*

[151] Deborah S. Coldwell, Altresha Q. Burchett-Williams & Melissa L. Celeste, *Liquidated Damages*, 29-SPG Franchise L.J. 211 (2010) (surveying U.S. jurisdictions).

C. Termination by the Franchisee

The Franchisee may terminate this agreement as a result of a breach by the Franchisor of a material provision of this agreement provided that: (i) the Franchisee provides the Franchisor with written notice of the breach that identifies the grounds for the breach; and (ii) the Franchisor fails to cure the breach within thirty (30) days after the Franchisor's receipt of the written notice. If the Franchisor fails to cure the breach, the termination will be effective sixty (60) days after the Franchisor's receipt of the Franchisee's written notice of breach. The Franchisee's termination of this agreement under this subparagraph will not release or modify the Franchisee's post-term obligations set out in this agreement.

Discussion:

Most franchise agreements provide few termination rights to the franchisee. Most often, if there is an alleged breach of the agreement by the franchisor, the franchise agreement will provide that the franchisee has the right to sue for damages, but not to terminate the agreement. However, sometimes the franchisee is granted the explicit right to terminate the agreement if the franchisor has failed to cure a breach of the agreement, as in the above sample clause. The sample clause is relatively favorable for the franchisee; however, often times the franchisor will restrict the franchisee's ability to terminate the agreement to "material breaches." Typically, if provided a termination right, the franchisee also will be restricted from terminating the contract if the franchisee itself is in breach of the agreement in any way. The franchisor also will often require a reasonable period of time for notice and cure so that it has the ability to cure the agreement upon an alleged breach.[152] In addition to a termination right exercisable upon cause, some franchise agreements may provide to the franchisee a "without cause" termination right exercisable during a particular time period and upon certain conditions.

Note, though, that even if the franchisee exercises a right to terminate the agreement (whether for cause or not), it will be bound to comply with the same post-term obligations as if it were terminated for breach or the agreement expired. Those obligations involve, as will be seen below, the requirement that the franchisee give up use of the system and trademarks and perform other post-termination obligations. Although this is a logical end result of any termination of the franchise agreement, it usually provides a non-defaulting franchisee with little comfort when this is its sole option apart from commencing a suit.

D. Franchisee Obligations on Termination

Upon the expiration or termination of this agreement for any reason whatsoever, the following shall apply:

a. *the Franchisee shall, immediately upon the Franchisor's request (in order that the Franchisor may protect the Trademarks and the Franchisor's other franchisees), permit the Franchisor or its representatives to enter the Premises and, at the Franchisor's option, to cure any default by the Franchisee, to operate the Franchised Business for the Franchisor's account or to secure the Franchisee's complete and timely compliance with the other post-termination obligations set forth in this agreement;*

[152] Asbill, Barkoff & Selden, *supra* note 3 at 52-53.

b. *the Franchisee shall pay to the Franchisor, within seven (7) days after the effective date of termination or expiration, all royalties, advertising fees and other charges then due and unpaid by the Franchisee including, but not limited to the Franchisor's costs and expenses in re-entering the Premises and in completing the acts specified in this agreement;*

c. *the Franchisee shall immediately discontinue the operation of the Franchised Business, use of the System and the use of the Trademarks and other proprietary rights licensed under this agreement, and similar names and marks, or any other designations or marks associating the Franchisee with the Franchisor or the System. The Franchisee shall cease displaying and using all signs, stationery, letterhead, packaging, forms, containers, Manuals, bulletins, instruction sheets, printed matter, advertising and other physical objects used from time to time in connection with the System or containing or bearing any of the Trademarks or other names, marks or designations, and shall not thereafter operate or do business under any name or in any manner or that might tend to give the general public the impression that it is associated with the Franchisor or the System or that it is operating a business similar to a ● business or that it previously conducted its business under the Trademarks;*

d. *if the Franchisee retains possession of the Premises, the Franchisee shall promptly and, at its expense, make such modifications to the interior and/or exterior decor of the Premises as the Franchisor shall require to remove all identification as a ● business;*

e. *the Franchisee shall promptly execute such documents or take such actions as may be necessary to abandon the Franchisee's use of any assumed name containing any of the Trademarks adopted by the Franchisee and to remove (in respect of the next publication), at the Franchisor's request, the Franchisee's listing as a ● business from the yellow pages, all other telephone directories and all other trade or business directories and to assign to the Franchisor or any other party designated by the Franchisor all of the Franchisee's telephone numbers and listings in connection with the Franchised Business; and*

f. *within three (3) days after the effective date of expiration or termination, the Franchisee shall return to the Franchisor all items making up the Manual, all other confidential material provided to the Franchisee by the Franchisor and all other materials required to be returned in accordance with this agreement or the Manual.*

Discussion:

The provision outlining the franchisee's post-termination obligations is very important to protect the franchisor's trademarks and system, and it is a very powerful clause. Upon

termination or expiration of the agreement, the franchisee should be required to discontinue all use of any trademarks, remove any and all visual identification of the trademarks and return the manual and any other confidential information.[153] In addition, the franchisor usually requires the return or destruction of any item that previously used the trademarks. This might include the return of any telephone numbers used or an assignment of the lease for the previously used premises. It may include a prohibition on the former franchisee indicating in any way its former affiliation with the franchisor.[154] The purpose behind this clause is to make plain that the franchisee's authorization to use the trademarks and system ends upon termination or expiration of the agreement. The clause is also meant to protect against the franchisee harming the goodwill of the system by continuing to use or display the trademarks or maintaining possession or access to those valuable assets. If a former franchisee fails to de-identify the former location upon termination or expiration, the post-termination obligations also provide the franchisor with an additional contract claim against the franchisee, in addition to its statutory recourse under the trademark laws.

The sample clause provides a quite typical list of the actions that the franchisee is required to take when the agreement expires or is terminated. As noted above, this would even apply if the franchisee were to terminate the franchise agreement due to the breach by the franchisor.

E. Franchisor's Right to Repurchase

Upon the expiration or termination of this agreement for any reason whatsoever, save and except in the event of a purchase, the Franchisor shall have the right, but not the obligation, such right to be exercised by notice in writing delivered to the Franchisee within thirty (30) days of the date of expiration or termination of this agreement for any reason whatsoever, to purchase from the Franchisee all or any portion of the inventory located on the Premises or otherwise held by the Franchisee for the purposes of sale or distribution at the Premises, and/or all or any part of the fixtures, equipment, furniture or other assets located on, in or at the Premises or otherwise used in connection with the Franchised Business.

Discussion:

In addition to requiring the franchisee to return or destroy all trademarked or proprietary items, the franchisor may want to reserve the right to repurchase some or all of the assets used in the franchised business, including unique, system specific inventory, fixtures or equipment. The rationale behind this clause is to recapture items of value upon the relationship's end, either to use or sell them elsewhere or to prohibit the former franchisee from doing so. If the franchisor does not recapture these items, then the former franchisee may be able to sell the items, risking damage to the franchisor's goodwill. In terms of drafting, many franchisors include the right to repurchase items at the depreciated book value. They often do this so that they do not have to pay any additional amounts for the goodwill. In some jurisdictions, state franchise acts require franchisors to repurchase certain franchisee equipment or inventory upon termination.[155]

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[153] Carden & Klarfeld, *supra* note 54 at 4.

[154] *Id.*

[155] For a chart of particular state statutory requirements and a helpful discussion of return and repurchase issues, *see* Clay A. Tillack & Mark E. Ashton, *Who Takes What: The Parties' Rights to franchise Materials at the Relationship's End*, 28-FALL Franchise L.J. 88 (2008).

F. Additional Remedies

The Franchisee expressly consents and agrees that, in addition to any other remedies the Franchisor may have, at law or under this agreement, nothing herein shall bar the Franchisor's right to obtain injunctive relief against threatened conduct that will cause it loss or harm, under the usual equity rules, including the applicable rules for obtaining restraining orders and preliminary injunctions.

Discussion:

Drafters typically include a clause describing additional remedies so that the franchisor can obtain injunctive relief in the event of default, prior to or without having to resort to termination. The franchisor typically drafts this section so that it preserves its right to alternative ways in which to seek recourse in the event of default.

G. Survival of Covenants

Notwithstanding the expiration or termination of this agreement for any reason whatsoever, all covenants and agreements to be performed and/or observed by the Franchisee and/or the Guarantor under this agreement or which by their nature survive the expiration or termination of this agreement hereof shall survive any such expiration or termination.

Discussion:

In almost every franchise agreement, the parties intend that some rights and obligations survive the termination or expiration of the agreement. It is crucial from the franchisor's perspective that survival of terms is addressed in the agreement to avoid an argument that all rights and obligations end when the contract ends. Drafters may include a general clause such as the sample above; a clause that specifically identifies, by contract section, which rights and obligations shall survive termination or expiration; terms within particular contract sections (such as within the trademark sections) that state that those particular obligations survive; or, most often, some combination of these. As the U.S. Supreme Court has explained, under the common law, "contractual obligations will cease, in the ordinary course, upon termination of the [contract]. Exceptions are determined by contract interpretation.... [S]tructural provisions relating to remedies and dispute resolution-for example, an arbitration provision-may in some cases survive in order to enforce duties arising under the contract."[156] Because exceptions are determined by contract interpretation, the more clearly drafted the survival terms are, the better.[157] From a drafting perspective, survival clauses also serve the purpose of alerting

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[156] *Litton Financial Printing Div., a Div. of Litton Business Systems, Inc. v. N.L.R.B.*, 501 U.S. 190, 207-08, 111 S.Ct. 2215 (U.S. 1991). In *Litton*, the Court further explained that a post-expiration claim "arises under the contract" only if "it involves facts and occurrences that arose before expiration, where an action taken after expiration infringes a right that accrued or vested under the agreement, or where, under normal principles of contract interpretation, the disputed contractual right survives expiration of the remainder of the agreement." *Id.*

[157] Notwithstanding the standard nature of survival clauses, disputes that concern them do still arise in the franchise context. For example, *see Meineke Car Care Centers, Inc. v. RLB Holdings, LLC*, 2009 WL 2461953 (W.D.N.C. Aug. 10, 2009) (holding, in context of a summary judgment motion on franchisor's claim for prospective damages, that contract provisions on royalties and ad fund fees did not survive termination under the terms of the franchise agreement and therefore any future obligation with respect to them ended upon termination); *Doctor's Associates, Inc. v. Thomas*, 898 So.2d 159 (Fla. Ct. App. 2005) (rejecting former franchisee's argument that arbitration requirement ceased upon termination of the franchise agreement; arbitration clause did not exclude its application to post-termination disputes and therefore survived); *Johnson v. Polaris Sales, Inc*., 257 F.Supp.2d 300, 309-10 (D. Me. 2003) (considering survivability of arbitration clause by examination of survival clause in dealer agreement and

franchisees that they have obligations that survive termination or expiration of the franchise agreement.

XVIII. DISPUTE RESOLUTION AND LITIGATION

A. Mediation

Before any party may bring an action in court or against the other, or commence an arbitration proceeding (except as noted below), the parties must first meet to mediate the dispute. The mediation will be held in the city in which the Franchisor's headquarters are located at the time of the mediation. Any such mediation will be non-binding and conducted by the American Arbitration Association in accordance with its then current rules for mediation of commercial disputes.

Notwithstanding the foregoing, the parties agree that the following claims will not be subject to mediation: (i) Any action for declaratory or equitable relief, including, without limitation, seeking preliminary or permanent injunctive relief, specific performance, other relief in the nature of equity to enjoin any harm or threat of harm to such party's tangible or intangible property, brought at any time, including, without limitation, prior to or during the pendency of any mediation or arbitration proceedings initiated hereunder, and (ii) Any action in ejectment or for possession of any interest in real or personal property.

Discussion:

As the use of alternative dispute resolution techniques evolve, it is becoming increasingly important for drafters to consider including mediation or arbitration clauses in their franchise agreements.[158] Mediation is a dispute resolution method where a neutral, trained mediator attempts to bring the parties to a settlement of their dispute, usually through a structured process. Franchisors and franchisees alike may desire a mandatory mediation clause in the hope that it will help foster the resolution of disputes before those disputes result in arbitration demands or lawsuits. Besides that primary purpose, franchisors and franchisees also may be interested in a mandatory mediation clause to the extent that it may provide them with advance notice that a claim is brewing. Franchisors also may benefit to the extent that the clause acts to slow or stop franchisee claims by providing a pre-suit hurdle that must be cleared.[159]

Franchise agreement mediation clauses typically include terms on the circumstances in which mediation must or may be used and where the mediation will take place. Agreements also may include specific detail about pre-mediation steps, who is required to attend, who pays the costs, how the mediation should be documented, and over what period the mediation occurs.[160] In addition, mediation clauses often include requirements for the qualifications and

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common law); *Carvel Corp. v. Eisenberg*, 692 F.Supp. 182, 183-185 (SDNY 1988) (contractual interpretation of survival clause to determine whether restrictive covenant survived contract expiration as well as termination).

[158] Asbill, Barkoff & Selden, *supra* note 3 at 63.

[159] *See* Edward Wood Dunham, *Enforcing Contract Terms Designed to Manage Franchisor Risk*, 19-WTR Franchise L.J. 91, 92 (2000) (discussing two federal dealership opinions in which the auto manufacturer won summary judgment "because the dealer had ignored mandatory mediation procedures and the contractual deadlines for mediation had passed.").

[160] Asbill, Barkoff & Selden, *supra* note 3 at 64.

selection of the mediator.[161] Some or all of these types of details can be important to sort out in the franchise agreement, particularly because once a dispute has arisen, the parties may not be able to agree on much of anything. It is worth noting that the sample provision above explicitly provides that the location of the mediation will be the "city in which the Franchisor's headquarters are located at the time of the mediation," rather than a specific city, to provide the franchisor with flexibility in case its headquarters moves.[162] Alternatively, the parties may negotiate a mutually convenient, neutral location or, depending on the jurisdiction, agree that mediation take place in the franchisee's home city or state, so as not to impose overly burdensome conditions on the franchisee.

B. Arbitration

Except as qualified below, any dispute between the Franchisee and the Franchisor or any of the Franchisor's or Franchisee's affiliates arising under, out of, in connection with or in relation to this agreement, the parties' relationship, or the Franchisee's Authorized Location must be submitted to binding arbitration under the authority of the Federal Arbitration Act and must be determined by arbitration administered by the American Arbitration Association pursuant to its then current commercial arbitration rules and procedures. Any arbitration must be on an individual basis and the parties and the arbitrator will have no authority or power to proceed with any claim as a class action or otherwise to join or consolidate any claim with any other claim or any other proceeding involving third parties. In the event a court determines that this limitation on joinder of or class action certification of claims is unenforceable, then this entire commitment to arbitrate will become null and void and the parties must submit all claims to the jurisdiction of the courts. The arbitration must take place in the city where the Franchisor's headquarters are located at the time of the dispute. The arbitrator must follow the law and not disregard the terms of this agreement. The arbitrator must have at least five (5) years of significant experience in franchise law. A judgment may be entered upon the arbitration award by any state or federal court in the state where the Franchisor maintains its headquarters or the state where the Franchisee's Franchised Business is located. The decision of the arbitrator will be final and binding on all parties to the dispute; however, the arbitrator may not under any circumstances: (i) stay the effectiveness of any pending termination of this agreement; (ii) assess punitive or exemplary damages; or (iii) make any award which extends, modifies or suspends any lawful term of this agreement or any reasonable standard of business performance that the Franchisor sets.

Notwithstanding the foregoing, the parties agree that the following claims will not be subject to arbitration: (i) Any action for declaratory or equitable relief, including, without limitation, seeking preliminary or permanent injunctive relief, specific performance, other relief in the nature of equity to enjoin any harm or threat of harm to such party's tangible or intangible property, brought at any time, including, without limitation, prior to or during the pendency of any arbitration proceedings initiated hereunder, and (ii) Any action in ejectment or for possession of any interest in real or personal property.

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[161] *Id.* at 63.

[162] *Practice Pointer: Franchisor Considerations*, 27-WTR Franchise L.J. 120 (2007).

Discussion:

Arbitration clauses have become increasingly complex in recent years and are important for drafters to consider carefully.[163] In contemplating whether an arbitration clause is desired, the franchisor typically will balance, among other factors, whether the benefits of avoiding juries and avoiding the precedential effect of rulings outweigh the cost of losing the right of appeal in all but the most limited circumstances.[164] As a practical matter, arbitration often is not a faster or more cost effective dispute resolution mechanism than a judicial forum, particularly given typical arbitration rules and standards (and arbitrator preferences) with respect to full, unfettered discovery and loose evidentiary standards. For these and other reasons, some franchisors and their counsel have begun to disfavor arbitration clauses, although others continue to favor arbitration clauses and it is not uncommon for franchise agreements to include them.[165] The above clause is an example of a relatively detailed arbitration provision. Generally, arbitration clauses should state what types of disputes will be subject to arbitration; what arbitration service will administer the arbitration; what rules (or deviations from the rules) will apply, including with respect to pre-hearing, evidentiary and discovery issues; how many arbitrators will decide the dispute; where the arbitration hearing will be held; who bears the arbitration expenses; and the extent of the arbitrator's power. Other issues that may be covered in an arbitration clause include such things as minimum arbitrator qualifications, pre-hearing and hearing procedures, and whether interim relief can be pursued, among others.[166] Because both the arbitrator's and arbitration administrator's authority flows from, and is bounded by the parties' contractual agreement to arbitrate, sophisticated franchisors may wish to include a quite detailed arbitration provision to ensure that they know exactly what kind of arbitration proceeding will take place. Of course, governing law – and courts' case-by-case analysis under that law – may override certain arbitration provisions, no matter what the contract provides.[167]

C. Governing Law

This agreement and the relationship between the Franchisor and the Franchisee will be governed by the laws of the state in which the Franchisor has its principal place of business from time to time. In the event of any conflict of law question, the laws of such state will prevail, without regard to the application of such state's conflict-of-law rules. This subparagraph is not intended to subject this agreement to any statute or regulation which would not by its own terms apply to this agreement.

Discussion:

Franchise agreements often include a contractual "choice of law" provision similar in substance to the example above. A valid choice of law provision is of critical importance. Given

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[163] Asbill, Barkoff & Selden, *supra* note 3 at 63.

[164] *See* Carden & Klarfeld*, supra* note 54 at 5.

[165] *See* Julianne Lusthaus, Mary Leslie Smith & Quentin R. Wittrock, *Is Franchising Abandoning Arbitration? Current Trends in Arbitrating Franchise Disputes*, A.B.A. 32nd Annual Forum on Franchising W16 (2009) at 4-5, 10-12.

[166] Asbill, Barkoff & Selden, *supra* note 3 at 64-66.

[167] As just one example, an arbitration clause must be balanced enough, including with respect to the place of hearing, that it is not deemed unconscionable. *See, e.g., Nagrampa v. MailCoups, Inc*., 469 F.3d 1257 (9th Cir. 2006) (*en banc*).

the differences in state law, which law governs is often determinative to the outcome of disputes.

Contractual choice of law provisions are enforceable as a general matter, assuming the parties have a sufficient relationship with the chosen state, there is a reasonable basis for the choice, and the choice does not offend the law of a state with a materially greater interest.[168] Many state franchise statutes, however, include anti-waiver provisions that prohibit a contractual choice of law provision from acting to avoid application of the state statute, such that those statutory provisions "trump" conflicting franchise agreement terms or common law regardless of the parties' contractual choice of law. Some franchise statutes further prohibit the parties from selecting any choice of law other than the law of the state in which the franchisee/franchised business is located. Further, even if a state statute does not include a specific provision relating to choice of law, the state franchise relationship statute may still (and very often does) represent a fundamental public policy of that state, leading to application of the statute even in the face of a contrary choice of law in the franchise agreement.[169] Like other state variances, franchisors often handle these statutory issues through state-specific addenda to their standard form franchise agreement.

In drafting a choice of law provision, the key considerations are which state's law to choose and how broadly the provision is intended to apply. With respect to which law to choose, franchisors typically select the law of the state of their headquarters, either by naming that particular state or, sometimes, by taking the approach in the sample clause above, in case the franchisor may relocate. Drafters, however, should be aware that in opting for flexibility through a more open-ended provision such as the one above, the franchisor may be more susceptible to disputes down the road over what constitutes its "principal place of business"[170] and, if the business location does change over the contract term, what law governed during which relevant time periods. Adapting to judicial decisions, franchisors often expressly state that the parties' choice of law does not constitute an "opt in" to the franchise regulations of that particular state, to the extent that those regulations otherwise would not apply. Contracting parties also should state that their choice of law is without application of the state's conflict of law principles.

With respect to the breadth of the provision, drafters must consider whether they intend the choice of state law to apply solely to contract construction and interpretation or more broadly to include all aspects of the parties' relationship (including, for example, tort claims) -- or something in between. State case law provides specific guidance on what particular wording works best, in various jurisdictions, to encompass which types of claims.

D. Venue and Jurisdiction

Any cause of action, claim, suit or demand allegedly arising from or related to the terms of this agreement or the relationship of the parties that is not subject to arbitration, must be

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[168] *See* Restatement (Second) of Conflicts, § 187.

[169] For cases in which courts have ruled different ways on these issues, *see* Kerry L. Bundy & Kevin M. Kennedy, *Procedural Considerations for Filing a Franchise Complaint: Jurisdiction, Venue and Choice of Law*, ABA 27th Annual Forum on Franchising LB3 (2004) at 30, n.142-43.

[170] There has been significant litigation over the meaning of the phrase "principal place of business" in the analogous context of jurisdiction, with different results depending on the court (*e.g.,* some courts focused on the level of business in the state, requiring a burdensome factual inquiry, as opposed to focusing on the physical brick and mortar location). "Headquarters" appears to have less litigation associated with the term.

brought in the state or federal district court located in the county or district encompassing the Franchisor's headquarters. Both parties hereto irrevocably submit themselves to, and consent to, the jurisdiction of said courts. The provisions of this subparagraph will survive the termination of this agreement. The Franchisee is aware of the business purposes and needs underlying the language of this subparagraph, and with a complete understanding thereof, agree to be bound in the manner set forth.

Discussion:

Franchise agreements generally include a forum selection and jurisdiction clause, and franchisors typically draft the provision both to provide for a forum in its home state and to obtain the franchisees' consent to jurisdiction in that forum. The forum selection clause and consent to jurisdiction serve different purposes from the choice of law provision; they concern where proceedings will take place, separate from which law will apply. Like choice of law provisions, however, the forum of the dispute often determines the outcome,[171] and franchisors typically will not negotiate away from their standard provisions unless they already are required to modify them to conform with applicable state statutory law. Several state franchise statutes do constrain contractual forum selection clauses by voiding clauses that call for a judicial forum outside the franchisee's state.[172] Aside from that, forum selection clauses typically are valid and enforceable, as a matter of strong public policy in favor of freedom of contract, unless "unreasonable under the circumstances."[173]

Importantly, drafters should be aware that a franchisee's agreement to choice of law and forum does not constitute consent to jurisdiction in that forum; the franchise agreement should include a separate and specific consent to jurisdiction. A party can contractually consent to personal jurisdiction in a forum even if personal jurisdiction would not otherwise exist.[174] From there, the choice between state and federal court depends on whether subject matter jurisdiction for federal court exists, and then both on the drafters' and parties' general views on state versus federal forums and on specific information about the courts in particular jurisdictions (such as quality of judges and jury pools, rules and procedures, litigation pace and local or other bias).[175] Because of strict subject matter jurisdiction requirements in federal court, franchise agreements typically include language that sets the permissible forum as any court "of or sitting in" a particular state, county or district that has subject matter jurisdiction, to include both state and federal courts.

XIX. GENERAL PROVISIONS

A. Indemnification of the Franchisor

The Franchisee hereby agrees, during and after the term of this agreement to indemnify and hold the Franchisor and its directors, stockholders, officers, employees and agents harmless from any and all liabilities, losses, suits, claims, demands, costs, fines and actions of

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[171] *See generally* Bundy & Kennedy, *supra* note 169.

[172] As just one example, *see* § 200.608 of the administrative regulations under the Illinois Franchise Disclosure Act. An arbitral forum is different, however.

[173] *Bremen v. Zapata Offshore Co.*, 407 U.S. 1, 10 (1970).

[174] *Ireland v. Compagnie des Banxites,* 456 U.S. 694 (1982).

[175] *See* Bundy & Kennedy, *supra* note 169 at 26.

any kind or nature whatsoever to which they shall or may become liable for, or suffer by reason of any breach, violation or non-performance on the part of the Franchisee or any of its agents, servants or employees of any term or condition of this agreement and from all claims, damages, suits, costs or rights of any persons, firms or corporations arising from the operation of the Franchised Business.

Discussion:

As seen above, indemnification clauses serve the purpose of protecting the franchisor from liability risk related to the franchisee's actions, omissions, or breaches of the franchise agreement. This generally includes third party claims against the franchisee. The franchisor will want the franchisee contractually obligated to indemnify and hold harmless the franchisor from third party claims related to the franchised business, and, often (although not in the sample clause above), also want the franchisee obligated to defend those claims in certain circumstances, at the franchisor's option and at the franchisee's sole expense. By carefully drafting an indemnification clause, the franchisor can help protect itself from the risks associated with vicarious liability claims.[176] From the franchisor's perspective, it is best to be as detailed as possible to make sure the franchisee bears the risk related to third party claims. Drafting should be done with care, however, as courts have generally taken a narrow interpretation of indemnification commitments.[177]

B. No Liability

The Franchisor shall not be responsible or otherwise liable for any injury, loss, or damage resulting from, occasioned to or suffered by any person or persons or to any property because of any products sold or services provided by it to the Franchisee.

Discussion:

The no liability clause is a usual feature of most franchise agreements in some form. The franchisor has little actual control over the daily actions or omissions of the franchisee. As such, the franchisor must safeguard itself, to the extent possible, from being liable for the actions or omissions of its franchisees.[178] The franchisor might also consider drafting a specific disclaimer for liabilities resulting from the actions of the franchisee's employees.[179]

C. Independent Contractor

The parties hereto hereby acknowledge and agree, that, except as expressly provided in this agreement, each is an independent contractor, that no party shall be considered to be the agent, representative, master or servant of any other party hereto for any purpose whatsoever, and that no party has any authority to enter into any contract, assume any obligations or to give any warranties or representations on behalf of any other party hereto. Nothing in this agreement shall be construed to create a relationship of employment partners, joint venturers, fiduciaries, or any other similar relationship among the parties.

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[176] Asbill, Barkoff & Selden, *supra* note 3 at 43.

[177] Perkins, Yatchak & Hadfield, *supra* note 13 at 180.

[178] *See* discussion in Section XVIII.G, immediately below.

[179] Perkins, Yatchak & Hadfield, *supra* note 13 at 181.

Discussion:

It is common for franchise agreements to provide that the franchisee and the franchisor are independent contractors and to disclaim the existence of any employment, agency, partnership, joint venture, or fiduciary relationship between them. The independent contractor relationship is one of the fundamental features of franchising, but this fundamental principle nevertheless has often come under scrutiny by the courts in various scenarios.

In some instances, franchisors may structure their relationship with franchisees in such a way as to provide an opening for claims by franchisees that some other relationship exists, notwithstanding the "franchise" label attached.[180] In other circumstances, court scrutiny focuses not on franchisee claims, but claims by unrelated third parties.

Individuals injured at franchised businesses often seek to recover damages directly from franchisors. Almost invariably, these plaintiffs sue franchisors for negligence, often without regard for or knowledge of the existence of the franchise relationship. A franchise relationship alone is insufficient grounds for franchisor liability for the negligence of its franchisee, however. In fact, one reason to franchise is to allocate the risk of third-party liability to franchisees. Plaintiffs nevertheless claim that franchisees are the actual or apparent agents of their franchisor and that the franchisor should therefore be held vicariously liable for the franchisee's negligence,[181] and/or that the franchisor was negligent in the performance of a duty that it voluntarily assumed.

Oftentimes, neither the plaintiff nor the court clearly differentiates between these different theories of liability. This has resulted in a blurring of the lines between direct and vicarious liability, and occasionally confusion about the theories. However, the key issue under direct and vicarious (actual agency) liability theories is the control exercised by a franchisor over its franchisee's operations.[182]

In analyzing such claims, courts typically examine whether a franchisor controls, or has the right to control, the day-to-day operations of its franchisee. Drafters therefore should be careful that no agency relationship can be implied from the franchise agreement. Although not dispositive of the issue, franchise agreements should include provisions designating franchisees as independent contractors, specifying that neither party is an agent, employee, servant, joint venturer, or other legal representative of the other, and that the franchisee has no power to obligate the franchisor for any purpose whatsoever.[183] In the typical franchise relationship, the

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[180] *See Awuah v. Coverall North America, Inc.*, 2010 WL 1257980 (D. Mass. March 23, 2010) (granting franchisee-plaintiffs motion for partial summary judgment on their claim that they were not independent contractors under Massachusetts law); *see also Employment Dep't v. National Maintenance Contractors of Oregon, Inc.*, Bus. Franchise Guide (CCH) ¶ 14,102 (Or. Ct. App. March 19, 2009) (dispute over franchisee status as employees).

[181] Generally, a principal is responsible for the negligence of its agent. *See, e.g., Little v. Howard Johnson Co.*, 183 Mich. App. 675, 679-80, 455 N.W.2d 390, 393 (Mich. Ct. App. 1990). To establish vicarious liability of a franchisor, a plaintiff must demonstrate that there was a principal-agent relationship between a franchisor and its franchisee at the time of the plaintiff's injury. *See, e.g., Hunter v. Ramada Worldwide, Inc.*, No. 1:04CV00062ERW, 2005 WL 1490053, at *6 (E.D. Mo. June 23, 2005). For a discussion of apparent agency, see Section XI.B, *supra*.

[182] Many courts analyze franchisor vicarious liability cases under traditional notions of agency. Under Section 220 of the Restatement (Second) of Agency, a finding of vicarious liability turns on the "extent of control which, by the agreement, the master may exercise control over the details of the work."

[183] *See, e.g., Allen v. Greenville Hotel Partners, Inc.*, No. C.A.6:04-2327-HMH, C.A.6:04-1260-HMH, C.A.6:04-2328-HMH, 2006 WL 89516, at *4 (D.S.C. Jan. 12 2006) ("[t]he mere designation of [the franchisees] as independent contractors of [the franchisor] is not conclusive as to the nature of their relationship"); *Corrales v. Days Inn Worldwide, Inc.*, Bus. Franchise Guide (CCH) ¶ 13,187 (Dist. Ct. Montrose County Colo. Sept. 23, 2005) (license

franchisee remains solely responsible for hiring, firing, and training employees and for making all day-to-day decisions necessary to run the business, including safety and security measures at the franchised location.

Courts look closely at franchise agreements (and associated operations manuals) because they typically impose detailed quality and operational requirements on the franchisee's operation necessary to ensure uniform customer experiences within the system. Although franchisors retain the right to conduct regular inspections to ensure compliance with system standards, however, the remedy for noncompliance typically is limited to a right to terminate franchisees from the system and collect damages for noncompliance.[184] The "control" exercised by a franchisor generally does not consist (and should not consist) of routine, daily supervision and management of the franchisee's business.

Under the majority approach in the courts, "the standardized provisions commonly included in franchise agreements specifying uniform quality, marketing, and operational requirements and a right of inspection do not establish a franchisor's control or right to control the daily operations of the franchisee sufficient to give rise to vicarious liability for all purposes or as a general matter . . . . [A] franchisor may be held vicariously liable for the tortious conduct of its franchisee only if the franchisor has control or a right of control over the daily operation of the specific aspect of the franchisee's business that is alleged to have caused the harm." [185]

In addition to vicarious liability claims, injured parties may include a claim that the franchisor is directly liable for negligence. To recover under a theory of negligence, a plaintiff must show that the franchisor owed him/her a duty, that the franchisor breached that duty, that the plaintiff suffered injury as a result of that breach, and that the franchisor's breach of duty or negligence was the proximate cause of the injuries.[186] A duty will arise when there is a special relationship or a voluntary undertaking. Because no special relationship exists between a franchisor and the customers of its franchisee, a plaintiff typically argues instead that a franchisor breached a voluntarily assumed duty.[187] A franchisor may be deemed to have

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agreement specified that the franchisee was an independent contractor, was not the franchisor's representative or agent, and had no power to obligate the franchisor for any purpose whatsoever).

[184] *Hayman v. Ramada Inn, Inc.*, 86 N.C. App. 274, 278, 357 S.E.2d 394, 397 (1987) (motel franchisor not vicariously liable under actual agency theory for injuries resulting from franchisee's negligent security because there was "no evidence that [franchisor] retained or exercised the kind of detailed control over the daily operations of the [franchised facility] that would establish a principal-agent relationship").

[185] *Kerl v. Dennis Rasmussen, Inc.*, 273 Wis. 2d 106, 131-32, 682 N.W.2d 328, 341 (Wis. 2004). *See also Schlotzsky's, Inc. v. Hyde*, 245 Ga. App. 888, 890, 538 S.E.2d 561, 563 (Ga. Ct. App. 2000). *Wu v. Dunkin' Donuts, Inc.*, 105 F. Supp. 2d 83, 88 (E.D.N.Y. 2000) ("the franchisor typically is found to be vicariously liable in situations where it exercised considerable control over the franchisee and the specific instrumentality at issue in a given case."); *Allen v. Greenville Hotel Partners, Inc.*, No. C.A.6:04-2327-HMH, C.A.6:04-1260-HMH, C.A.6:04-2328-HMH, 2006 WL 89516, at *7 (D.S.C. Jan. 12 2006) (holding the franchisor "did not control the hotel's daily operations or hotel security and life safety systems," through its agreement and standards "merely maintained uniform service within and public good will toward, the [Choice] system" and, "[a]s such, cannot be liable on a theory of actual agency.")

[186] *See, e.g., Castro v. Brown's Chicken & Pasta, Inc.*, 314 Ill. App. 3d 542, 547, 732 N.E.2d 37, 42, 247 Ill. Dec. 321, 326 (Ill. App. Ct. 2000).

[187] Under the voluntary undertaking theory of liability, "[o]ne who undertakes . . . to render services to another which he should recognize as necessary for the protection of a third person or his things, is subject to liability to the third person for physical harm resulting from his failure to exercise reasonable care to protect his undertaking, if (a) his failure to exercise reasonable care increases the risk of such harm, or (b) he has undertaken to perform a duty owed by the other to the third person, or (c) the harm is suffered because of reliance of the other or the third person upon the undertaking." Restatement (Second) of Torts § 324A (1965). *See also* Section 414: "One who entrusts work to an

voluntarily assumed a duty if it has sufficient actual control or a retained right of control over the daily operations of its franchisee. The scope of liability under the voluntary assumption of duty doctrine is limited to the extent of the undertaking.[188]

The potential for vicarious liability claims underscores the importance of including in the franchise agreement a provision that the franchisor and the franchisee are independent contractors and not agents of one another.[189] Because these clauses are not dispositive, however, it is important to remember that they will not protect a franchisor who goes "over the line" in its relationship with its franchisees.

D. Joint and Several

If two or more individuals, corporations, partnerships or other entities (or any combination of two or more thereof) shall sign or be subject to the terms and conditions of this agreement as the Franchisee or as a Guarantor, the liability of each of them under this agreement shall be deemed to be joint and several.

Discussion:

A joint and several liability clause is a common feature in franchise agreements. For parties subject to joint and several liability, each is individually responsible for the entire obligation, whether it be a non-monetary performance requirement (such as curing a quality default or performing post-termination obligations to de-identify the former franchised location) or a monetary requirement (such as paying outstanding royalties, liquidated damages, infringement damages or attorneys' fees and costs). The obligors, each responsible for the full amount, are left to sort out apportionment between themselves. The clause therefore allows a franchisor, as a matter of standard contract law, to pursue any or all joint and several parties as it chooses, and collect from whomever of them can satisfy any resulting judgment. This provides the franchisor with maximum flexibility to decide, upon breach, which of those parties to press for performance and/or sue, where to sue, and how to enforce and collect, typically with an eye towards which ones are likely to provide the most leverage and liquid assets to the franchisor.

E. Severability

If for any reason whatsoever, any term or condition of this agreement or the application thereof to any party or circumstance shall, to any extent be invalid or unenforceable, all other terms and conditions of this agreement and/or the application of such terms and conditions to parties or circumstances, other than those as to which it is held invalid or unenforceable, shall not be affected thereby and each term and condition of this agreement shall be separately valid and enforceable to the fullest extent permitted by law.

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independent contractor, but who retains the control of any part of the work, is subject to liability for physical harm to others for whose safety the employer owes a duty to exercise reasonable care, which is caused by his failure to exercise his control with reasonable care." Restatement (Second) of Torts § 414 (1965).

[188] *Castro*, 314 Ill.App.3d at 549, 732 N.E.2d at 44, 247 Ill. Dec. at 328.

[189] Perkins, Yatchak & Hadfield, *supra* note 13 at 179.

Discussion:

Most contracts include a severability clause stating that the unenforceability of one clause has no effect on the enforceability of the remaining clauses.[190] This is a typical contract term, and it is important for it to appear in a franchise agreement. It should be noted that an agreement may not be capable of severance depending on the object of the law that is being infringed.[191] Although the clause is typically boilerplate, if there is a particular area of concern with respect to an aspect of an agreement, drafters may review relevant case law in drafting the clause for severability. In some instances, and unlike the sample clause, the franchisor will reserve to itself the right to terminate the agreement if the unenforceable provision is viewed as of such importance that its unenforceability would fundamentally alter the relationship.

F. No Set Off by Franchisee

The Franchisee agrees that it will not, on grounds of the alleged non-performance by the Franchisor of its obligations hereunder, withhold payment of any royalty or other amounts due to the Franchisor or its affiliates, whether on account of goods purchased by the Franchisee or otherwise.

Discussion:

Franchisors include a clause stipulating no set off to ensure that they receive payments at all times. In other words, even if the franchisee alleges that the franchisor has breached a term of the agreement, the franchisee still will be required to pay the franchisor all fees and royalties, as the franchisee's legal remedy is to sue for damages. A franchisor may not be able to control all aspects of its rights to payment if this clause is left ambiguous or is absent.

G. Notices

All notices, consents, approvals, statements, authorizations, documents, or other communications (collectively "notices") required or permitted to be given hereunder shall be in writing, and shall be delivered personally, by facsimile, or mailed by a reputable overnight service, to the said parties at their respective addresses set forth hereunder, namely:

To the Franchisor at:

To the Franchisee at: the Premises

To the Guarantor at: the Premises

or at any such other address or addresses as may be given by any of them to the other in writing from time to time. Such notices, if mailed, shall be deemed to have been given on the second business day (except Saturdays and Sundays) following such mailing, or, if delivered by facsimile or personally, shall be deemed to have been given on the day of delivery, if a business day, or if not a business day, on the business day next following the day of delivery; provided that if such notice shall have been mailed and if regular mail service shall be interrupted by

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[190] C. James Levin & Avery R. Brown, *Severability, in* Negotiating and Drafting Contract Boilerplate 547-49 (Tina L. Stark , ed., ALM Publishing 2003).

[191] *Id*.

strike or other irregularity before the deemed receipt of such Notice as aforesaid, then such Notice shall not be effective unless delivered.

Discussion:

Notice provisions are important, and often an afterthought in most franchise agreements. They can sometimes "trip up" a franchisor who fails to adhere strictly to the agreement's requirements regarding written notice. Strict compliance with the notice provision will be particularly important when a franchisor seeks to default or terminate a franchisee. If a franchisor fails to provide notice in accordance with the terms of the agreement, it invites a court to find that the termination was unlawful. Franchisors also should remember that some state franchise statutes include specific requirements with respect to how particular notices must be provided. (*See, e.g.,* discussion in Section XVII.A, *supra*.) From the franchisor's drafting standpoint, it wants to be able to provide effective notice to the franchisee in the fastest and least cumbersome way possible. Many franchise agreements still do not permit the delivery of official notice by email, but query whether that may change as drafters and parties update their agreements and become comfortable with the idea of using email for this purpose.

H. Headings, Article Numbers

The headings, article numbers and table of contents appearing in this agreement or any schedule hereto are inserted for convenience of reference only and shall not in any way affect the construction or interpretation of this agreement.

Discussion:

The clause regarding headings and article numbers speaks to the general interpretation of the agreement. This clause is drafted so that the user is absolutely clear on the intention behind headings and article numbers. As the headings are often meant as a short form term describing the contents of the section, it is fair to disclaim that they have any contractual weight or authority. The failure to include this type of clause invites a court to interpret the short title as part of its contractual construction and perhaps make a finding that the short title somehow limits rights or obligations under the agreement.

I. Time of the Essence

Time shall be of the essence of this agreement and of each and every part hereof.

Discussion:

It is very common for contracts to stipulate that time is of the essence. This sample clause is bilateral and requires both parties to fulfill their respective obligations in as timely a manner as possible. Some franchise agreements instead may be worded unilaterally, so that time is of the essence with respect to the franchisee's obligations. Typically, the parties can waive time is of the essence under certain circumstances. Often times, such an ability to waive will be drafted into the agreement. The failure to include a provision stating that time is of the essence may bring into question whether a party can rely on the strict time periods specified by the contract.

J. Waiver of Obligations

The Franchisor may by written instrument unilaterally waive any obligation of or restriction upon the Franchisee under this agreement. No acceptance by the Franchisor of any payment by the Franchisee and no failure, refusal or neglect of the Franchisor to exercise any right under this agreement or to insist upon full compliance by the Franchisee with his obligations hereunder, including without limitation, any mandatory specification, standard or operating procedure, shall constitute a waiver of any provision of this agreement.

Discussion:

Drafters include a waiver clause so that the franchisor has the right to waive an obligation at some point during the term of the agreement while still reserving all of its rights. As mentioned throughout this Annotation, it is difficult to predict the future circumstances of the parties' relationship under the agreement. In practice, a franchisor may routinely waive at least some obligation of the franchisee under the franchise agreement. It is important for a franchisor to draft a waiver clause so that it retains flexibility to relieve certain obligations at any point during the term of the agreement without jeopardy to its rights under the agreement. Typically, franchisors will require that any waiver on their part be in writing and signed by an authorized employee to be effective, and include such a requirement either in this provision or elsewhere in the agreement (*see, e.g.,* Section XIX.V below). The above clause goes further than merely stating a right to waive; it stipulates that actions or inactions on the franchisor's part do not constitute waiver. A prudent franchisor will contemplate these circumstances and draft accordingly.

K. Franchisee and Guarantor Defined, Use of Pronoun

The words "Franchisee" and "Guarantor" whenever used in this agreement shall be deemed and taken to mean each and every person or party mentioned as a Franchisee or Guarantor herein, be the same one or more; and if there shall be more than one Franchisee or Guarantor, any notice, consent, approval, statement, authorization, document or other communication required or permitted to be given by the terms or conditions of this agreement may be given by or to any one thereof, and shall have the same force and effect as if given by or to all thereof. The use of the neuter or male or female pronoun to refer to the Franchisee and/or the Guarantor may be an individual (male or female), a partnership, a corporation or another entity or a group of two or more individuals, partnerships, corporations or other entities. The necessary grammatical changes required to make the provisions of this agreement apply in the plural sense, where there is more than one Franchisee or Guarantor and to either individuals (male or female) partnerships, corporations or other entities, shall in all instances be assumed in each case. The words "hereof", "herein", "hereunder" and similar expressions used in any paragraph or subparagraph of this agreement relate to the whole of this agreement (including any Schedules attached hereto) and not to that paragraph or subparagraph only, unless otherwise expressly provided for or the context clearly indicates to the contrary.

Discussion:

It is relatively common to include in the franchise agreement a provision which incorporates certain meaning into frequently used terms. These are classic "boilerplate" provisions in any commercial contract, noted more when they are omitted and a dispute arises than when they are included. However, upon analysis any commercial or transactional lawyer should readily see the importance of deeming that singular use of a term includes the plural,

and that use of the male includes any females. The above provision also deems the franchisor's notice to or other described action toward one of multiple franchisees or guarantors effective as if it were provided to all of them, which is a helpful provision for a franchisor.

L. Cross-Default

In the event that the Franchisee directly or indirectly acquires the right and franchise to operate another or other ● businesses, any default by the Franchisee in the performance or observance of any of the terms and conditions under any one agreement governing the aforesaid right and franchise shall be deemed to be an event of default under all other agreements pursuant to which the Franchisee directly or indirectly owns or operates such a ● business or businesses.

Discussion:

If a franchisee opens more than one franchised business under the franchisor's trademark and system, and defaults on one of the associated franchise agreements for those other sites, then it is common to provide that a default under one agreement will constitute a default under all the franchisee's agreements. From a business perspective, the franchisor wants to ensure that its franchisees are acting responsibly and according to the contractual terms of their franchise agreements, and devoting sufficient resources to all of their franchised businesses. Franchisors consider it a good method by which to motivate a franchisee if that franchisee knows that a default under one agreement can jeopardize all of its agreements. In other words, the franchisor can elicit potentially stricter compliance by having the ability to assert a cross-default and, if necessary, cross-terminations.

M. Set Off by the Franchisor

Notwithstanding anything contained in this agreement, upon the failure of the Franchisee to pay to the Franchisor as and when due, any amounts of money provided for herein, the Franchisor shall have the right at its election, to deduct any and all such amounts remaining unpaid from any monies or credits held by the Franchisor for the account of the Franchisee.

Discussion:

Section XIX.F of this Annotation contained a strict prohibition against the franchisee asserting a right of set off. On the other hand, most franchisors will want an explicit right to set off against monies they owe to the franchisee, from monies owed to them. Even though such a right may be permitted by the common law of contract, this provides the franchisor with that right expressly.

N. Further Assurances

Each of the parties hereto hereby covenants and agrees to execute and deliver such further and other agreements, assurances, undertakings, acknowledgements or documents, cause such meetings to be held, resolutions passed and by-laws enacted, exercise their vote and influence and do and perform and cause to be done and performed any further and other acts and things as may be necessary or desirable in order to give full effect to this agreement and every part hereof.

Discussion:

Any number of provisions in a franchise agreement may contemplate that the parties may be required to enter into some future contract, give some further consent, or execute some further document, to give effect to the intention of the first agreement. The same holds true for most lengthy commercial contracts. Accordingly, it is very common to include a provision that speaks to further assurances, which obligates the parties to sign those further necessary contracts, consents, forms, and so forth. Although it is not a provision that gets attention often, it is certainly noticeable if ever omitted.

O. Successors and Assigns

Subject to the restrictions on assignment herein contained, this agreement shall be to the benefit of and be binding upon the parties hereto and their respective heirs, executors, administrators, successors and assigns.

Discussion:

The provision regarding successors and assigns intends to make clear that the terms of the agreement are binding on the parties and anyone who in the future assumes their respective roles, either by assignment or some other succession mechanism. Of course, it is not meant to override any other provision in the agreement that specifies prior consent is needed to complete an assignment or other transfer.

P. When Agreement Binding on the Franchisor

This agreement is not effective until signed by a corporate officer of the Franchisor. No field representative or salesman is authorized to execute this agreement on behalf of the Franchisor. The Franchisee is advised not to incur any expense or obligation with respect to the proposed Franchised Business until the Franchisee has received a fully executed copy of this agreement from the Franchisor.

Discussion:

It is important to state when an agreement comes into effect. In the above example, the drafters made it clear that execution by a corporate officer was necessary to make the agreement effective. To avoid any unnecessary expense for the franchisee, the franchisor also has clearly instructed the franchisee to refrain from any expenditures until the agreement is in effect. There certainly have been instances where a prospective franchisee argued that it was in fact a franchisee, notwithstanding that the franchisor did not ever sign and deliver to them a franchise agreement, in part because of delivery of a contract and then partial performance of its terms. This clause is intended to counteract that possibility from arising.

Q. Non-Waiver of Rights by the Franchisor

No waiver by the Franchisor of any breach by the Franchisee, nor any delay or failure by the Franchisor to enforce any provision of this agreement, may be deemed to be a waiver of any other or subsequent breach or be deemed an estoppel to enforce the Franchisor's rights with respect to that or any other or subsequent breach.

Discussion:

There are instances every day where and when a franchisee is likely not in strict compliance with the franchise agreement. Some instances are more serious and important than others. Regardless, the franchisor does not want to have waived its contractual rights by virtue of not having acted, or deciding not to act, on an issue. The no-waiver provision therefore provides the franchisor with flexibility; it permits the franchisor to ignore some issues without risking its rights and without having to make every small issue a big one. In disputes, the provision helps protect the franchisor from waiver and estoppel defenses. That being said, it nevertheless is common for a franchisee to counter a default by asserting that the franchisor has acquiesced in prior similar conduct by that franchisee or others.

R. Force Majeure

The Franchisor shall not be liable to the Franchisee for any failure or delay in performing any obligation, in whole or in part, under this agreement if such failure or delay results directly or indirectly from wars (declared or not), insurrections, riots, fires, floods, explosions, earthquakes, accidents, epidemic or quarantine restrictions, acts of God, any act of government or governmental priorities, transportation failures or delays, embargoes, material or parts shortages, strikes, labor trouble causing a cessation or slow down or interruption of work (including labor troubles or other delays at a supplier's facility), events where an export license is refused or withdrawn, or any other cause beyond the Franchisor's reasonable control.

Discussion:

Although it is common for distributor contracts in the product distribution context to include force majeure provisions that temporarily excuse the manufacturer or supplier's obligations during times of some sort of extenuating external circumstance, it is less common to include such clauses in franchise agreements. Franchisors typically either choose not to include such a provision at all (given that franchisors may have few contractual obligations to the franchisee aside from providing a license to use the system and trademarks) or limit the clause in favor of the franchisor, particularly if the franchisor supplies products to the franchisee (for example, gasoline or cars). From the franchisor's perspective, it typically is not helpful to include a force majeure clause that applies to the franchisee's obligations, as that opens the door for a non-performing franchisee to cite external circumstances as the reason for its non-performance in a host of areas, including quality assurance. In the litigation context, such defenses ultimately may not carry the day, but they very well may raise factual issues that would be subject to discovery and could survive dispositive motion practice. If a franchisor does wish to include a bilateral clause, the agreement should expressly require the franchisee to make all payments notwithstanding, and make plain that the franchisee's economic hardship, whatever its cause or seriousness, is not force majeure.[192]

S. Waiver of Jury Trial

With respect to any proceeding not subject to arbitration, the parties hereby agree to waive trial by jury in any action, proceeding or counterclaim, whether at law or equity, regardless of which party brings suit. This waiver will apply to any matter whatsoever between the parties hereto which arises out of or is related in any way to this agreement, the performance of either

[192] *See generally* 30 Williston on Contracts § 77:31 (4th ed.) (discussing force majeure clauses and defenses).

party, and/or the Franchisee's purchase from the Franchisor of the franchise and/or any goods or services.

Discussion:

A party's right to a jury trial, guaranteed by the Seventh Amendment to the U.S. Constitution, may be contractually waived in franchise agreements in some jurisdictions. Franchisors often wish to include in the franchise agreement a contractual jury waiver to eliminate the uncertainty that jury verdicts inject into what otherwise may be, from a franchisor's perspective, a desirable judicial forum.

In the majority of U.S. jurisdictions that allow contractual jury waivers, a party's waiver of the right to a jury must be "knowing, willing and intelligent," and courts have developed various factors to determine if, in particular circumstances, that standard has been met.[193] A common element among those factors is that the contractual jury waiver must be conspicuous and prominent, leading drafters to consider where to place such provisions in the contract and to emphasize them through bold-faced type, capital letters, larger font, underscoring or some combination.[194]

In some jurisdictions, however, all jury waivers in franchise agreements are prohibited as a matter of state statutory franchise law.[195] Other jurisdictions may not uphold jury waivers based on their courts' views of franchise public policy, even without a specific statutory prohibition on such waivers.[196] Aside from that, depending on the facts, courts may not uphold jury waivers if, in applying their jurisdiction's particular jury waiver test, they determine that the agreement was not negotiated and/or that the parties' bargaining power was significantly unequal -- circumstances that often exist in franchising. In view of the differences in state law and individual facts, enforceability is not certain.[197]

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[193] *See, e.g., Aetna Insurance Co. v. Kennedy,* 301 U.S. 389, 393 (1937) ("[T]he right of jury trial is fundamental, [and] courts [must] indulge every reasonable presumption against waiver"); *Samica Enters., LLC v. MailBoxes Etc. USA, Inc.,* Bus. Franchise Guide (CCH) ¶ 13985 (C.D. Cal. July 17, 2008) (outlining and analyzing factors in jurisdiction).

[194] *See, e.g., Cottman Transmission Sys. v. Kevin McEneany*, 2007 WL 119956 (E.D. Pa. Jan. 4, 2007) (conspicuous waiver provision upheld); *see also* Fittante & Wieczorek, *supra* note 16; Kenneth A. Adam, A Manual of Style for Contract Drafting 351(2d ed. ABA 2008).

[195] *See., e.g.,* Minn. R. 2860.4400(J) ("It shall be unfair and inequitable for any person to . . . . require a Franchisee to waive his or her rights to a jury trial . . ."); *Carrel v. George Weston Bakeries Distribution, Inc.,* 2006 WL 2524124 *2 (S.D. Ind. 2006) (contractual jury waivers violate Indiana Deceptive Practices Act § 23-2-2.7-1(10), which prohibits franchise agreements from including terms that limit "litigation brought for breach of the agreement in any manner whatsoever"). For a discussion of jury waivers in California, *see* W. Andrew Scott & R. Samuel Snider, *California Populism, Contract Interpretation, and Franchise Agreements*, 24-Spg Franchise L.J. 248, 255 (2005).

[196] *See, e.g., Goodyear Tire & Rubber co. v. Tualatin Tire & Auto, Inc.*, 908 P.2d 300, Bus. Franchise Guide (CCH) 10,838 (Or. 1995) (public policy underlying franchise act rendered jury waiver unenforceable even in absence of statutory provision concerning jury right or waiver).

[197] *See, e.g*, *Too Tall, Inc. v. Sara Lee Bakery Group, Inc.,* Bus. Franchise Guide (CCH) ¶ 13954 (D.N.M. July 17, 2008) (contractual jury waiver not "voluntarily made" where unequal bargaining power existed and there was a lack of negotiations); *Samica Enters., LLC,* Bus. Franchise Guide (CCH) at ¶ 13985 (holding jury waiver unenforceable after analyzing test factors, including conspicuousness, bargaining power and negotiatability); *Cottman Transmission Sys.*, 2007 WL 119956 at *1 (upholding conspicuous jury waiver clause on basis that it was voluntary, knowing and intentional despite Franchisee's contentions of unequal bargaining power and lack of ability to negotiate). *See also* Dunham, *supra* note 159 at 95-97, and cases cited therein.

As a result, those who draft franchise agreements, as well as those who counsel franchisors and franchisees about them, should review and understand the applicable law and trends with respect to jury waivers in all relevant jurisdictions, both with respect to drafting requirements and other elements of enforceability. If appropriate, franchisors may choose to include a general jury waiver in their standard franchise agreement and then handle jurisdictional and situational differences through state-specific addenda or negotiated changes.

T. Damages Waiver

The Franchisee hereby waives to the fullest extent permitted by law, any right to or claim for any punitive, exemplary, incidental, indirect, special or consequential damages (including, without limitation, lost profits) against the Franchisor arising out of any cause whatsoever (whether such cause be based in contract, negligence, strict liability, other tort or otherwise) and agrees that in the event of a dispute, the Franchisee's recovery is limited to actual damages. If any other term of this agreement is found or determined to be unconscionable or unenforceable for any reason, the foregoing provisions will continue in full force and effect, including, without limitation, the waiver of any right to claim any consequential damages.

Discussion:

Franchisors often include some variety of a damages waiver or "damages cap" provision in an attempt to manage risk, whether in a judicial or arbitral forum. The sample clause above is such an example of a franchisor's attempt to limit damages exposure at the outset of the franchise relationship.[198] Damages caps, however, are not consistently enforceable and may be void under statutory or common law, either in their entirety or in part, depending on the jurisdiction.[199]

U. Reasonable Business Judgment

Whenever the Franchisor reserves discretion in a particular area or where the Franchisor agrees to exercise its rights reasonably or in good faith, the Franchisor will satisfy its obligations whenever it exercises Reasonable Business Judgment in making a decision or exercising a right. The Franchisor's decisions or actions will be deemed to be the result of Reasonable Business Judgment, even if other reasonable or even arguably preferable alternatives are available, if the Franchisor's decisions or actions are intended, in whole or significant part, to promote or benefit the System generally even if the decision or action also promotes Franchisor's financial or other individual interests. Examples of items that will promote or benefit the System include, without limitation, enhancing the value of the Trademarks, improving customer service and satisfaction, improving product quality, improving uniformity, enhancing or encouraging modernization and improving the competitive position of the System.

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[198] Fittante & Wieczorek, *supra* note 16 at 25.

[199] For a discussion of the enforceability of caps in the franchise context, *see* Dunham, *supra* note 159 at 97 ("Because many legislatures and courts are so concerned about the bargaining power of franchisees, and troubled by franchisor attempts to plate themselves with nonnegotiable contract terms, damages caps are likely on par with forum selection clauses and jury trial waivers: they are probably never enforceable in certain jurisdictions, and elsewhere their fate will often depend on an unpredictable, case-by-case analysis.")

Discussion:

As discussed in Section V.A, drafters increasingly have begun to avoid the word "discretion" in franchise agreements. This is mostly because that term has become a red flag for courts that may expose the franchisor to claims under the common law covenant of good faith and fair dealing over the franchisor's exercise of such discretion. To address this problem, some drafters have begun using the phrase "reasonable business judgment."[200] The purpose of that phrase is to give the franchisor some flexibility in its decision-making abilities under the agreement without facing judicial scrutiny of that decision making. More specifically, the franchisor reserves the right to use reasonable business judgment in making decisions that affect the franchisees. Some drafters go even further to disclaim any harm the franchisor's reasonable business judgment might cause.

V. Entire Agreement, Modifications and No Reliance

Except for any written promissory notes, this agreement contains the entire agreement between the parties hereto as it relates to the franchising of the Franchised Business at the Premises, and there are no representations, inducements, promises, agreements, arrangements or undertakings, oral or written, between the parties relating to the franchising of the Franchised Business at the Premises other than those set forth herein and in any promissory notes, and no party has relied on any representation, inducement, promise, agreement, arrangement, undertaking, of any type or form, that is not set forth in this agreement or any promissory note. No agreement of any kind relating to the matters covered by this agreement shall be binding upon either party unless and until the same has been made in writing and executed by all interested parties. This provision is not intended to disclaim the representations the Franchisor made solely in the franchise disclosure document that the Franchisor furnished to the Franchisee.

This agreement may not be amended, modified or rescinded, or any performance requirement waived, except by a written document signed by the Franchisee and an authorized representative of the Franchisor. This provision does not apply to changes in the Manual, which the Franchisor may modify unilaterally. The parties expressly agree that this agreement may not be amended or modified, or any performance standard changed, by course of dealing, by special indulgences or benefits the Franchisor bestows on the Franchisee, or by inference from a party's conduct.

Discussion:

Integration, no-reliance and no unwritten modifications clauses are among the most important "boilerplate" clauses in any commercial contract, and are of utmost importance in franchise agreements, where disputes over what the parties promised each other are common. The purpose of the integration clause is to capture the parties' contractual acknowledgment that the only understanding and promises between them are those appearing within the "four corners" of the written franchise agreement, and that the rights and obligations as written in the franchise agreement supersede any prior agreements, discussions or representations of any kind. The requirement that all amendments and modifications be in an authorized, signed writing, rather than orally or by conduct, serves a similar purpose. These provisions are important not only so that the parties each understand the bounds of their contractual

[200] Asbill, Barkoff & Selden, *supra* note 3 at 13-14.

responsibilities and rights during the regular course, but also as a matter of contract interpretation and construction if a dispute ends up in litigation or arbitration.

In very simple terms, the integration clause and modifications language affect whether extrinsic evidence may be introduced in a dispute. Particularly from the franchisor's perspective, the clause's aim is to demonstrate to a court (and, before that, to counsel contemplating a claim) that the parties plainly intended that anything outside the written document does not and cannot form the basis for any contractual duty or right and, therefore, cannot support any claim of breach. As a broad generalization, franchisors typically seek to rely on integration clauses in franchise contract disputes while franchisees very often seek to convince a court that the parties' contract encompassed more than what appears in the written agreement provisions, based on alleged oral statements, correspondence, marketing materials or other evidence. Courts' receptiveness to integration clauses in general, and those in franchise agreements in particular, varies by jurisdiction and depends largely on the law, facts, conduct and equities in any particular case.[201]

Drafters often intend that an integration clause also bar fraud claims based on representations outside the written agreement, but in some jurisdictions an integration clause alone is not sufficient for that purpose. Accordingly, franchise agreements should contain separate no-reliance language that makes plain that no party relied on anything that is not set forth within the four corners of the agreement. Many franchise agreements call out no-reliance provisions separately from the integration clause, sometimes in bolded or otherwise emphasized form. (In this Annotation, see Exhibit B, the Acknowledgment Addendum, which includes more specific no-reliance provisions.) The purpose of no-reliance language is to derail a plaintiff's ability to prove an essential element of a fraud claim – reasonable reliance on an alleged representation. A party cannot reasonably rely on a representation, the argument goes, if he or she has disclaimed reliance in the contract. Again, however, courts take different views of no-reliance clauses in fraud cases depending on the applicable state law and the facts with which they are presented. Thus, drafters must use much care in crafting integration, modifications and no reliance clauses, and should counsel their clients that such clauses do not inoculate against all claims or improper conduct.

EXHIBIT A: GUARANTY AND INDEMNIFICATION AGREEMENT

(Franchise Agreement)

The Undersigned, for and in consideration of, and as an inducement to, the grant by ● ("Franchisor") of franchise rights to _____ ("Franchisee") for the development, establishment, and operation of a Franchised Business as described in that certain Franchise Agreement dated _____, between the Franchisor and the Franchisee ("Franchise Agreement") establishing said rights, and other good and valuable consideration, receipt and sufficiency of which are hereby acknowledged, hereby jointly and severally guaranty timely and full payment of any and all indebtedness and full performance of any and all obligations for which the Franchisee is now or may hereafter become responsible. This Guaranty shall include, without limitation, any sum owed by the Franchisee under the agreement which the Franchisee is not able to pay or remit to the Franchisor due to currency restrictions imposed by any government authority having jurisdiction in any country in which the Franchisee is operating

[201] For a thorough discussion of integration clauses in franchise law, *see generally* Deborah S. Coldwell, Mario L. Herman & John D. Holland, *Litigating "the Contract": The Evolution of the Integration Clause and the Parol Evidence Rule in Franchise and Distribution Cases*, A.B.A. 28th Annual Forum on Franchising (2005) at W17.

under the Franchise Agreement; provided, however, that the Franchisee shall be entitled to a credit under the agreement for any such amount paid by the Undersigned on its behalf.

The Undersigned hereby agree to defend, indemnify, and hold the Franchisor harmless against any and all losses, damages, liabilities, costs, and expenses (including, but not limited to, reasonable attorneys' fees, reasonable costs of investigation, court costs, and arbitration fees and expenses) resulting from, consisting of, or arising out of or in connection with any failure by the Franchisee to make any payment required of the Franchisee under the Franchise Agreement or to perform any obligation of the Franchisee under the Franchise Agreement, including any amendments, or any other agreement executed by the Franchisee referred to in the Franchise Agreement.

The Undersigned hereby agree to be bound jointly and severally with the Franchisee for any such indebtedness and obligations to the Franchisor arising under the Franchise Agreement; and the Undersigned hereby waives (a) acceptance and notice of the acceptance of this guaranty ("Guaranty"); (b) notice of any and all indebtedness and obligations of the Franchisee to the Franchisor, now existing or which may hereafter exist; (c) notice of default of payment, demand and diligence, and all other notices of any kind whatsoever; (d) any right to require the Franchisor to (1) proceed against the Franchisee for any payment required under the Franchise Agreement; (2) proceed against or exhaust any security from the Franchisee; or (3) pursue or exhaust any remedy, including any legal or equitable relief, against the Franchisee; and (e) all legal and equitable defenses to which it may be entitled under the Franchise Agreement or under this Guaranty. The Undersigned further waives notice of amendment of the Franchise Agreement and agrees to be bound by any and all such amendments and changes to the Franchise Agreement.

The Undersigned acknowledge that, during the effective period of this Guaranty, the Franchisor may look first to the Undersigned for any nonpayment or unperformed obligations, without being required to first seek recourse or exhaust all remedies against the Franchisee. Without affecting the obligations of the Undersigned under this Guaranty, the Franchisor may, without notice to the Undersigned, extend, modify, or release any indebtedness or obligation of the Franchisee, or settle, adjust, or compromise any claims against the Franchisee.

The Undersigned also agree that the written acknowledgement of the Franchisee or the judgment of any arbitration panel or court establishing the amount due from the Franchisee shall be conclusive and binding on the Undersigned, and their successors and assigns, and that any extension of time for payment shall not affect the Undersigned's liability thereunder.

This Guaranty shall terminate upon the termination or expiration of the Franchise Agreement, except that all obligations and liabilities of the Undersigned which arose from events which occurred on or before the effective date of such termination shall remain in full force and effect until satisfied or discharged by the Undersigned, and all obligations which by their terms continue in force after the expiration or termination of the Franchise Agreement shall remain in force according to their terms. Upon the death of an individual guarantor, the estate of such guarantor shall be bound by this Guaranty, but only for defaults and obligations hereunder existing at the time of death; and the obligations of the other guarantors will continue in full force and effect.

The Undersigned agree to pay to the Franchisor its reasonable attorney's fees and all costs incurred by the Franchisor in attempting to collect, or in collecting, any sums owed by the Franchisee, as described in the Franchise Agreement (unless attorney's fees and costs are

included in the indebtedness of the Franchisee for which the Undersigned is liable thereunder), or owed by the Undersigned as a result of, or in connection with, this Guaranty.

The Undersigned hereby subordinate their claims to repayment of loans made by the Undersigned to the Franchisee, or any claims associated therewith, to the rights or claims of the Franchisor, whether now existing or hereafter arising while this Guaranty is in effect.

This Guaranty is for the benefit of the Franchisor, which may, without any notice whatsoever to anyone, sell, assign, or transfer any part of the indebtedness guaranteed herein, and in that event, each and every successive assignee, transferee, or holder of all or any part of the indebtedness shall have the right to enforce this Guaranty, by suit or otherwise, for the benefit of such assignee, transferee or holder, as fully as if such assignee, transferee or holder were herein by name given such rights, powers, and benefits; but the Franchisor shall have an unimpaired right, prior and superior to that of any such assignee, transferee or holder, to enforce this Guaranty for its benefit as to so much of said indebtedness that it has not sold, assigned or transferred.

The Undersigned understand that this Guaranty is independent of any and all other guaranties that may be made by any other parties with respect to the indebtedness or obligations covered hereby. Notices under this Guaranty shall be furnished to the Undersigned at the addresses given below in accordance with the Franchise Agreement. This Guaranty shall be interpreted and construed in accordance with the applicable law and dispute resolution provisions of the Franchise Agreement. This Guaranty is the entire agreement affecting the Undersigned's liability for the obligations described herein. Unless specifically stated otherwise, the terms used in this Guaranty shall have the same meaning as in the Franchise Agreement.

EXECUTED in multiple originals this day of _____, 201_.

GUARANTORS:

_____

*Address:*_____

_____

*Address:*_____

Discussion:

Requiring that the owners of the franchisee entity sign a personal guaranty is standard practice. The personal guaranty is drafted such that the owners must personally guaranty the franchisee's payment and performance obligations under the franchise agreement. A well drafted guaranty also binds the owner to key covenants in the franchise agreement, such as confidentiality and noncompetition. Franchisees may resist signing a personal guaranty, particularly high net worth franchisees, and franchisors may need to be flexible and willing to

negotiate alternative language. However, a personal guaranty (or some other alternative of personal commitment) is important to ensure compliance with the franchise agreement and to demonstrate personal commitment and accountability to the franchise endeavor. A guaranty also becomes very important if a dispute between the parties develops. Among other things, the potential for personal liability against the guarantors affects the parties' respective strategies with respect to compromise, litigation and collectability.

A guaranty provides the franchisor with some assurance that there will be a source of funds in times when the franchisee is experiencing lower cash flows or financial troubles. The role of the guarantor can vary from responsibility to cover smaller liabilities like royalty payments to much more burdensome obligations like personal responsibility for third-party claims and damages.[202] In most instances, however, the guarantor(s) are obligated to provide an unlimited, joint and several, and irrevocable guaranty of payment and performance of all obligations of the named franchisee under the franchise agreement and any related agreements. Anything less is a substantial compromise by the franchisor and should be considered unusual. It is up to each individual franchisor to determine whether it wants to require the individual, corporate or other owners of a franchisee to offer a personal guaranty. In making this decision, franchisors should consider the legal and commercial interests that might persuade for or against a personal guaranty requirement.[203] For instance, if a franchisor is trying to attract new franchisees, it may consider alleviating the requirement for a personal guaranty. Alternatively, if the franchisor sees that this individual has little net worth to support a personal guaranty, the franchisor may decide that it is not useful or applicable in that situation or it may require that a non-owner family member provide the guaranty. Where the franchisee is large, which is becoming more common, dispensing with personal guaranties is becoming itself more common, with other forms of security being considered, such as corporate guaranties or letters of credit. The debate over whether or not personal guaranties are useful is widespread, and it is ultimately up to the franchisor to decide what is best for it in its own particular circumstances.

EXHIBIT B: ACKNOWLEDGMENT ADDENDUM TO THE ● FRANCHISE AGREEMENT

As you know, you and we are entering into a Franchise Agreement for the operation of a ● franchise. The purpose of this Acknowledgment Addendum is to determine whether any statements or promises were made to you that we have not authorized or that may be untrue, inaccurate or misleading, and to be certain that you understand the limitations on claims that may be made by you by reason of the offer and sale of the franchise and operation of your business. Please review each of the following questions carefully and provide honest responses to each question.

Acknowledgments and Representations.*

Did you receive a copy of our Disclosure Document (and all exhibits and attachments) at least (a) fourteen (14) calendar days prior to signing the Franchise Agreement, or (b) if you are a resident of Iowa, Maryland, New York, Oklahoma or Rhode Island, at the earlier or the first personal meeting or ten (10) business days before the execution of the franchise or other agreement or payment of any consideration, or (c) if you are a resident of Michigan, Oregon,

[202] Rupert M. Barkoff, *Traditional and Avant-Garde Uses of Personal Guarantees in Franchise Relationships*, 23-WTR Franchise L.J. 137 (2004).

[203] Andrew C. Selden, *What Do Personal Guaranties Offer the Franchisor? Be Careful What You Wish For*, 23-WTR Franchise L.J. 138 (2004).

Washington or Wisconsin, at the earlier of ten (10) business days before the execution of any binding agreement or payment of any consideration? Check one: ☐ Yes. ☐ No.

Have you studied and reviewed carefully our Disclosure Document and Franchise Agreement? Check one: ☐ Yes. ☐ No.

Is the name, address and phone number of any broker and each of our employees or representatives who was involved in offering you this franchise listed on the Disclosure Document receipt you signed (or on any updated receipt we provided to you)? Check one: ☐ Yes. ☐ No.

Do you understand that the Franchise Agreement contains the entire agreement between you and us concerning the franchise, meaning that any prior oral or written statements not included in the Franchise Agreement or our Disclosure Document will not be binding? Check one: ☐ Yes. ☐ No.

Do you understand that the success or failure of your business will depend in large part on your skills and experience, your business acumen, your location, the local market for products, interest rates, the economy, inflation, the number of employees you hire and their compensation, competition and other economic and business factors? Check one: ☐ Yes. ☐ No.

Do you understand that the franchise granted is for the right to operate a ● Franchised Business at the authorized location only and includes no exclusive area or protected territory, and that we and our affiliates have the right to issue franchises or operate competing businesses for or at locations, as we determine, near your authorized location? Check one: ☐ Yes. ☐ No.

Do you understand that you are bound by the non-compete covenants (both in-term and post-term) listed in Section XIV and that an injunction is an appropriate remedy to protect the interests of the ● system if you violate the covenant(s)? Further, do you understand that the term "you" for purposes of the non-compete covenants is defined broadly such that any actions in violation of the covenants by those holding any interest in the Franchisee entity may result in an injunction, default and termination of the Franchise Agreement?

Do you understand that the current economic crisis and financial situation could have a negative impact on the franchise industry, the ● franchise system and your business? Do you also understand that the economic situation may worsen? Check one: ☐ Yes. ☐ No.

If you answered "No" to questions 1-8, please explain (attached additional sheets if necessary): _____

_____

_____

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Was any oral, written or visual claim or representation made to you which contradicted the disclosures in the Disclosure Document? Check one: ☐ Yes. ☐ No.

Was any oral, written or visual claim or representation made to you which stated, suggested, predicated or projected your sales, income or profit levels? Check one: ☐ Yes. ☐ No.

Did any employee or other person speaking on our behalf make any statement or promise regarding the costs involved in operating a franchise that is not contained in the Disclosure Document or that is contrary to or different from the information in the Disclosure Document? Check one: ☐ Yes. ☐ No.

If you answered "Yes" to questions 9-11, please explain in detail the claim, representation or statement (attached additional sheets if necessary): _____

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YOU UNDERSTAND THAT YOUR ANSWERS ARE IMPORTANT TO US AND THAT WE WILL RELY ON THEM. BY SIGNING THIS ADDENDUM, YOU ARE REPRESENTING THAT YOU HAVE CONSIDERED EACH QUESTION CAREFULLY AND RESPONDED TRUTHFULLY TO THE ABOVE QUESTIONS. IF MORE SPACE IS NEEDED FOR ANY ANSWER, CONTINUE ON A SEPARATE SHEET AND ATTACH.

NOTE: IF THE RECIPIENT IS A CORPORATION, PARTNERSHIP, LIMITED LIABILITY COMPANY OR OTHER ENTITY, EACH OF ITS PRINCIPAL OWNERS MUST EXECUTE THIS ACKNOWLEDGMENT.

Signed: _____ *Signed:* _____

Print Name: _____ *Print Name:* _____

Date: _____ *Date:* _____

APPROVED ON BEHALF OF ●

Signed: _____

By: _____

Print Name: _____ *Title:* _____

Date: _____ *Date:* _____

**Such representations are not intended to nor shall they act as a release, estoppels or waiver of any liability incurred under the Illinois Franchise Disclosure Act or under the Maryland Franchise Registration and Disclosure Law.*

Discussion:

The Acknowledgment Addendum (also known as a closing checklist) is a tool for the franchisor to ensure that the franchisee understood key terms in the franchise agreement, including terms that often become the subject of disputes. It is also a way to attempt to foreclose, at the time of contracting, franchisee reliance on representations outside of the documents (or, if the franchisee believes such representations exist, to deal with and resolve them before the contract is signed). Putting key terms and representations in a separate document and in a question and answer format, is a good way to disarm any claims that something was "hidden" within the text of the franchise agreement.[204] As discussed in Section XIX.V above, these types of "no reliance" acknowledgments can be of critical importance in any later dispute proceeding. It is intended that the parties sign this Addendum concurrently with the franchise agreement.

Conclusion

The sample agreement in this Annotation does not represent a "correct" or ideal version of a franchise agreement. However, it does illustrate what is often included, why those clauses are meaningful, and what attorneys should consider while drafting. This particular agreement was relatively long; if the users of the agreement explicitly request a simple and shorter agreement, parties could place some content into collateral documents. Collateral documents might include agreements regarding leases, confidentiality, equipment or fee financing, security, and other pre-opening issues.[205]

One lesson to be learned from examination of the Annotation is that drafters must think critically, even when it comes to "standard" language, and take all relevant business and legal realities into consideration when constructing franchise agreements. They should look at the particular financial and market realities of the franchisor's industry and avoid the temptation simply to borrow clauses from boilerplate agreements without understanding their meaning or impact.[206] In the end, creativity and critical analysis will be essential tools in drafting a superior franchise agreement, and in adding value to your client's enterprise.

An equally important lesson is that, even after the ink is dry, franchisors and franchisees, as well as their business and litigation counsel, must truly understand how the written reflection of the parties' rights and duties actually affects the parties' rights and duties under the law, so that they can govern themselves accordingly both during cooperative periods and when disputes arise.

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[204] *See Healy v. Carlson Travel Network Associates, Inc.*, 227 F.Supp.2d 1080 (D. Minn. 2002) (summary judgment entered against franchisee on fraud claim for various reasons; among those reasons, court noted that at the outset of the relationship, the franchisee had completed and initialed a "closing checklist" in which he had acknowledged that he had independently investigated the franchise and not been given, nor relied on, particular representations that were now part of his fraud claim).

[205] Asbill, Barkoff & Selden, *supra* note 3 at 11.

[206] Sherman, s*upra* note 15 at 105.

Author Biographies

Kerry Olson

Kerry Olson is Vice President and Assistant General Counsel for International Dairy Queen, Inc., based in Minneapolis, Minnesota. Before joining Dairy Queen, Kerry was Associate General Counsel at Buffalo Wild Wings, Inc., for two years and in private practice for over four years at the Minneapolis law firm of Gray Plant Mooty. Kerry is a frequent speaker locally and nationally on topics related to franchising and is a member of the American Bar Association's Forum on Franchising. She also is an active member of the International Franchise Association, serving as Chair of the Women's Franchise Committee, a member of the Nominating Committee, as a past co-chair of the Minneapolis chapter of the Women's Franchise Network and as past chair of the Legal Legislative Committee. She also served on the Task Force for the 2007 and 2008 IFA Legal Symposia. Kerry was named a "Rising Star" of Minnesota lawyers for 2006, 2007, 2008 and 2009 by *Minnesota Law and Politics* magazine and listed as a "Legal Eagle" by *Franchise Times* in 2006, 2007 and 2008. Recently, *Franchise Times* named Kerry as one of "20 to Watch" in 2010. Kerry graduated summa cum laude, Phi Beta Kappa, from St. Olaf College in 1997. She earned her law degree, magna cum laude, from the University of Minnesota Law School in 2000, where she was awarded membership in Order of the Coif.

Robin M. Spencer

Robin M. Spencer is a partner in Schiff Hardin's litigation group. She concentrates her practice in the arbitration and litigation of complex commercial litigation, including franchise, distribution and antitrust matters involving manufacturers, suppliers, distributors and dealers, as well as franchisors and franchisees in a variety of service, hotel and food systems. In addition to her litigation practice, Ms. Spencer advises suppliers, manufacturers and franchisors with respect to their supply/distribution arrangements, programs and plans. Significant matters in which Ms. Spencer has been involved include the prosecution and defense of trademark and trade secret cases, antitrust tying, price discrimination, price-fixing, and attempted monopolization claims, as well as issues arising under the franchise and dealership laws.

Ms. Spencer is a member of the editorial board of the American Bar Association *Franchise Law Journal* and also has served on the Steering Committee of the Litigation and Dispute Resolution Division of the American Bar Association Forum on Franchising and on the Franchising Forum's Publications Committee and Technology Committee. She is a frequent speaker and writer on franchise, distribution and litigation topics. Ms. Spencer also serves as a faculty member for the National Institute for Trial Advocacy, and has been selected as a Leading Lawyer in Franchise and Dealership Law. She received her law degree (J.D., 1994) from the University of Virginia School of Law.

Larry Weinberg

Larry is a partner at the Toronto law firm of Cassels Brock & Blackwell LLP, and head of the firm's franchise law practice group. He has a practice that specializes in franchise law and providing all necessary legal services to franchisors. He is Vice-Chair of the Ontario Bar Association's Franchise Law Section, and was the founder of, and to date has organized and chaired four Ontario Bar Association annual franchise law conferences. He is a member of the American Bar Association's Forum on Franchising, and in 2006, he was the first Canadian lawyer to be appointed Director of the ABA Forum's International Division and to a leadership role on its Governing Committee. In 2009 he had the honor of being Co-chair of the 32nd Annual

Forum on Franchising annual conference. In addition, he is a member of the International Bar Association, the International Franchise Association, and the Canadian Franchise Association. In 2004 he acted as co-editor of the ABA Forum on Franchising's book entitled *Fundamentals of Franchising-Canada*. As well he was co-editor and co-author of the Canadian Franchise Association's first and only official book publication entitled, *How To Franchise Your Business*. He is a co-author and the regional editor of the chapter on Canada for the ABA Forum's book entitled *International Franchise Sales Laws*. In 2004, 2005, 2009 and 2010 Larry was named by Franchise Times to their "Legal Eagles" list of the top 100 franchise lawyers in the United States and Canada. He and Cassels Brock are each listed in the *Lexpert*® Canadian legal directory as being among the leaders in Canada in franchise law. Larry was called to the Bar of the Province of Ontario in 1989.