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DUELING PERSPECTIVES ON SELECTED FRANCHISE AGREEMENT PROVISIONS

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I. INTRODUCTION

In the world of franchise lawyers, nothing is more contentious nor more likely to incite a bout of fisticuffs than a debate over the necessity or reasonableness of language in franchise agreements. The age-old schism between franchisee and franchisor about what constitutes a reasonable division of responsibility between the parties is a quagmire; the Afghanistan of franchising.[1]

At its core, the franchise relationship is a symbiotic one. Regardless of the specific strengths a franchisor may bring to a franchise system, it can only thrive if its franchisees succeed. Some franchisees believe that franchise agreements are often characterized by unfair contract terms, and apart from their unfairness, these terms can sometimes seem unnecessary. Just as employers have increasingly found it necessary to compete for a diminishing supply of qualified employees by offering improved working conditions, franchisors who insist on outmoded policies and contract terms may find themselves at a competitive disadvantage if others modernize their documents by eliminating unreasonable or unnecessary provisions. Only through debate over the necessity, propriety, and reasonableness of the provisions governing the parties' relationships can we assess what amounts to an equitable division of responsibility and obligation.

The intent of this paper and presentation is to evaluate this very question: Whether or not common, uncommon, and truly radical provisions in franchise agreements are reasonable, necessary, and likely to achieve the collective goal of system success. In order to address this question with any degree of impartiality, the authors have excerpted the original language from a wide variety of franchise agreements and provided insight and discussion as to whether these provisions are likely to lead to system success, or instead, intractable disputes and unconscionable overreach. The paper is the joint effort of attorneys with dueling perspectives on the answers to these questions, and not all of us agree with our (sometimes) conflicting analysis and conclusions. As such, each author's opinion is their own and not every position taken in this paper is a group consensus.

Nonetheless, the authors have found areas of agreement, and at the conclusion of this paper the authors propose compromise language for provisions that are often disputed. The authors believe that there are always grounds for reasonable debate and discussion, and that compromise is not synonymous with concession. The authors hope that this paper promotes thoughtful internal discussions about ways of avoiding disputes through good drafting of good agreements, and look forward to a healthy, respectful debate in the years to come.

II. GENERAL CONTRACTUAL RIGHTS

Franchise lawyers are accustomed to discussing whether or not a contract provision is enforceable. Non-compete agreements are generally enforceable, for example, but courts can sometimes decline to enforce them if they exceed reasonable bounds. In other instances, franchise agreement terms can be attacked on different grounds, such as unconscionability. While this paper may occasionally touch on such matters, it is not the primary intent. Rather, the

[1] *See, e.g.,* Alexander the Great, the Mongolian Empire, the British Empire, the Soviet Union, and the United States.

authors acknowledge that courts are generally inclined to enforce the "agreement of the parties." Nonetheless, simply because an agreement is enforceable does not mean that it is inherently fair or reasonable, or good for business.[2] Our intent is instead to consider the fairness of certain actual franchise agreement terms.

A. General Contractual Rights and Restrictions

1. Territories

Franchise agreements frequently limit the franchisee's rights to a specific territory, but the nature of these limitations varies greatly depending on the kind of the business. Some businesses tend to draw customers from only a limited geographic area, and can therefore get by with only a small territory, while others need a larger territory to succeed. Some franchises may be operated without a physical facility, and may be able to offer their services over the internet, or by delivering products or services directly to customers. The differences between types of franchises make it difficult to generalize about territory clauses in franchise agreements. Nonetheless, some themes recur frequently.

Where a franchise system has many units operating in close proximity to each other, franchise agreements are sometimes written without any exclusive territory, or with only a very small exclusive territory. Even where larger exclusive territories are provided, franchisors typically reserve to themselves numerous exceptions, such as (1) the right to place a competing unit in a non-traditional site, and (2) the right to sell the same products under the marks through non-traditional methods of distribution. The exception for internet sales, in particular, can be a problem for the franchisee. Customers can be attracted by advertising to the franchisee's location, can consult about the products with the franchisee's employees, but can then sometimes purchase the same products online from the franchisor or another franchisee at a better price.

Some franchise agreements use the threat of losing some of the designated exclusive territory as a lever against franchisees who do not achieve the franchisor's minimum expectation for franchisee unit sales. Indeed, some franchise systems go even further. For example, in one system, the franchise agreement contains three minimum performance standards, and failure to achieve any one of them can result in a reduction of the franchisee's exclusive territory, or even termination of the franchise.[3] A franchisee can suffer these adverse consequences if he (1) fails to achieve certain minimum revenues, (2) falls in the bottom quarter of all franchisees in customer satisfaction, or (3) falls in the bottom quarter of all franchisees in sales.[4] And from the franchisee's

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[2] Courts regularly side with legislative history in concluding that most of the bargaining power in franchise relationships is held by franchisors. California law treats contracts of adhesion, or at least terms over which a party of lesser bargaining power had no opportunity to negotiate, as procedurally unconscionable to at least some degree. Armendariz v. Found. Health Psychcare Servs., Inc., 99 Cal. Rptr. 2d 745, 6 P.3d 669, 690 (2000). Indeed, "California courts have long recognized that franchise agreements have some characteristics of contracts of adhesion because of the 'vastly superior bargaining strength' of the franchisor." Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 1282 (9th Cir. 2006); *see also* Bridge Fund Capital Corp. v. Fastbucks Franchise Corp., 622 F.3d 996, 1004 (9th Cir. 2010). Franchisors of course dispute this contention, arguing that control over the system is necessary to ensure broad conformity and consistency across the brand; otherwise you have the inmates running the asylum. As the reader can imagine, these starkly conflicting viewpoints undoubtedly lead to strife and disagreements. *See* William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case For a More Balanced View of the Franchisor-Franchisee Relationship*, 28 FRANCHISE L.J. 23 (2008).

[3] *See, e.g.,* i9 Franchise Disclosure Document at 125 (issued Mar. 26, 2020).

[4] *Id.*

perspective, two of the performance standards seem unreasonable on their face. Since twenty-five percent of all franchisees will necessarily fall in the bottom quarter of any ranking on any parameter, and it's likely that even more will fall in the bottom quartile on one of two parameters, this essentially guarantees that at any given time a substantial percentage of franchisees will find themselves at risk for reduction of their exclusive territory or termination.

Franchisors on the other hand take the position that they need to balance the system and the competing demands of their franchisee constituents. Granting large exclusive territories and prohibiting sales through other channels of trade may limit system growth if the territories are operated by stagnating or unsuccessful franchisees, and reward unproductive franchisees at the expense of others in the system that are more efficient and willing to grow the business and the brand. In a middle ground approach, a system would still impose exclusive territories and offer sales through channels of trade, but not impose mandatory restrictions that implicate large percentages of the franchise system.

a. Exclusive/Nonexclusive

The scope and nature of the territorial rights to be granted to franchisees is determined by a franchisor for its system based on a number of factors, as discussed above. In a typical bricks-and-mortar franchise system that operates from fixed locations, a franchisee will typically be granted an exclusive territory, within which the franchisor will not establish another franchised outlet, or itself operate or authorize anyone else to operate a similar establishment using the same trade name. Regardless of any grant of exclusivity, franchisors typically reserve various potentially conflicting rights to themselves, such as (1) the right to operate or franchise a competing outlet using the same trade name in a non-traditional site, such as a shopping center, airport or university,[5] (2) the right to operate or franchise a competing outlet inside the territory under a different trade name,[6] or (3) the right to sell the same products or services inside the territory through other channels of distribution, such as by selling to grocery stores, or over the internet.[7]

Even where a franchise system employs a bricks-and-mortar model, exclusive territories can sometimes be very small, and some franchise systems offer no exclusive territory at all.[8] Franchisees will typically be required to promote the brand, and in many cases will want assurances of exclusivity to insure that other businesses identified with the same mark do not reap the benefits of their promotional activities. Where competing franchises exist in close proximity to each other, this concern is typically addressed by maintaining co-op advertising programs where advertising is conducted as a group with shared expense.[9]

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[5] Franchise agreements sometimes provide the franchisee with assurances they will be offered the right to own and operate such a unit if the franchisor proposes to establish it.

[6] This protects the franchisor against potential conflicts if it subsequently acquires a competing brand, or is itself acquired by a competing brand, or allows it to start up a competing brand if it feels like it.

[7] Internet sales, in particular, are becoming increasingly problematic. In some cases, dual distribution systems have operated for decades without serious harm to franchisees, but are now becoming increasingly damaging for franchisees.

[8] *See, e.g.,* Scheck v. Burger King Corp., 798 F. Supp. 692 (S.D. Fla. 1992).

[9] Another compromise provision that may make this more palatable to franchisees is transparency over how the franchisor spends advertising funds. Many agreements require disclosure (upon request) by the franchisor of its

b. Determination of Territory

Where franchisors grant exclusive territories, the boundaries of the territory can be determined in various ways. For example, some agreements use geographical borders (such as zip codes), or by attaching a map indicating the boundaries.[10] Frequently the size of the territory is determined by an area's population. In some cases, the exclusive territory is based on the agreed location of the franchised unit (for example, a five-mile radius). Where a map or geographical description is used to describe a territory, a franchisee may face competition from another unit if she locates her franchise near the perimeter of the territory. Determination of the proper scope of a territory varies from system-to-system, and the reasonableness of a territorial restriction may similarly vary as a result. For example, a territory that is based upon a geographic description that is limited to remote rural regions may be unreasonable if it is a high volume business requiring many customers to remain profitable (e.g., windshield replacement, large hotel, etc.). The goal should be territories which are large enough for the franchisee to operate profitably but limited enough to allow the sale of additional franchises where the market can support them.

2. Term Length

Most franchise agreements specify a fixed initial term typically between five[11] and twenty[12] years, and provide for the possibility of one or more successor[13] terms. The length of the initial term will vary with the type of franchise and other factors. For example, a major hotel chain franchise or a well-established national fast food franchise might appropriately specify a longer term, while some new systems without an established track record of success may warrant a shorter initial term. Newer systems often have a higher risk of franchisee failure, and a longer term in such circumstances might put the franchisee at risk of not only losing his investment, but also remaining liable to the franchisor under the Franchise Agreement for the remainder of the term.

Franchisors, on the other hand, may want a longer initial term to lock franchisees in and guarantee revenue sources. This may even be beneficial to some franchisees who wish to take advantage of initial purchase deals made available to new franchisees that are not provided to existing franchisees on renewal. The longer the term, the longer the franchisee can take advantage of the introductory initial deal benefits that are not made available to renewing franchisees. Moreover, franchisees commonly contend that the term of the agreement is too short, and given upfront fees and capital investments, does not provide sufficient runway to receive a return on their investment. Franchisors typically address this concern by including renewal terms in their agreements to extend the length of the parties' relationships, although renewal fees and required refurbishment or remodeling can also change the return on investment

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advertising expenditures. Transparency in decision-making often builds trust in the system and a sense of unity in promoting the brand.

[10] 1-800-Got-Junk? Franchise Disclosure Document at 63, 109 (issued Apr. 23, 2020).

[11] ServPro Franchise Disclosure Document at 88 (issued May 15, 2020).

[12] Staybridge Suites Franchise Disclosure Document at 134 (issued Apr. 30, 2020) (amended May 14, 2020).

[13] The term "renewal" is often used, but franchise agreements rarely offer renewal of the same agreement. Instead, the norm is requiring the franchisee to accept the terms of the "then-current form of agreement."

calculation. Moreover, many state laws are specifically crafted to prevent non-renewal of franchise relationships in instances where the initial term length was insufficient to allow the franchisee to recoup its investment in the business.[14] Other states have adopted equitable recoupment doctrines which similarly protect franchisees from short-duration agreements that do not provide sufficient time to recoup the initial investment.[15]

Despite all of these factors, the initial term of the franchise agreement is rarely negotiated between the parties. This is undoubtedly the case because whether a term should more appropriately be longer or shorter is in many senses in the eye of the beholder. But ultimately, franchisees who are concerned that the term is too long because the business is untested, or too short because they will have difficulty recouping their investment, should be wary of signing on the dotted line of the franchise agreement. Only if they are satisfied with their own due diligence of the business should they proceed if there are any concerns about the length of the term.

3. <u>Renewal</u>

Franchise agreements generally provide options for one, two or an unlimited number of successor terms, each usually for the same duration as the initial term. Exercise of an option to renew is typically subject to numerous conditions, for example (1) payment of a renewal fee, usually in an amount significantly less than an initial franchise fee, (2) timely notice of option exercise (typically during a window, such as six to twelve months before term expiration), (3) the franchisee being in full compliance with the agreement, (4) the franchisee signing a release of any prior claims, (5) the franchisee agreeing to remodel or refurbish his facility (potentially at considerable expense), and (6) the franchisee agreeing to the terms of the franchisor's then-current agreement.[16] Franchisees often contend that these restrictions on renewal are unreasonable; the franchisee is required to agree at the inception of the relationship that the term can only continue if the franchisee agrees to sign on to the new form of agreement, which for all it knows will provide for increased royalties or advertising expenditures, and may also require significant changes in the nature of the franchisee's business.[17] All of these factors, as well as the magnitude of potential new investments in remodeling and refurbishing facilities, are unknown and indeed unknowable at the time the franchisee signs the original agreement.[18] Thus, the

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[14] Arkansas (ARK. CODE ANN. § 4-72-204); California (CAL. BUS. & PROF. CODE §§ 20025-20026); Connecticut (CONN. GEN. STAT. § 42-133f); Delaware (DEL. CODE ANN. tit. 6, § 2552(b)); Hawaii (HAW. REV. STAT. § 482E-6); Illinois (815 ILL. COMP. STAT. 705/20); Indiana (IND. CODE § 23-2-2.7-1(8)); Iowa (IOWA CODE § 523H.8, IOWA CODE § 523A.10(8)); Michigan (MICH. COMP. LAWS § 445.1527); Minnesota (MINN. STAT. § 80C.14(4)); Mississippi (MISS. CODE ANN. § 75-24-53); Missouri (MO. REV. STAT. § 407.405); Nebraska (NEB. REV. STAT. § 87-404); New Jersey (N.J. STAT. ANN. § 56:10-5); Puerto Rico (P.R. LAWS ANN. tit. 10, § 278a); the Virgin Islands (V.I. CODE ANN. tit. 12A §§ 131-132); Washington (WASH. REV. CODE § 19.100.180(2)(i)); and Wisconsin (WIS. STAT. § 135.03).

[15] *See, e.g.,* Armstrong Bus. Servs. Inc. v. H & R Block, 96 S.W.3d 867, 868 (Mo. Ct. App. 2002) ("Missouri courts apply the recoupment doctrine to protect franchisees.").

[16] *See generally* Papa John's Franchise Disclosure Document at 129−130 (Issued Apr. 15, 2020).

[17] *See, e.g.,* Beilowitz v. General Motors Corp., 233 F. Supp. 2d 631 (D.N.J. 2002) (holding that General Motors likely violated the New Jersey Franchise Practices Act by imposing new terms on a proposed renewal of the franchised business that required the franchisee to sacrifice $1 Million in sales and incur new operating costs of between $1 Million and $1.6 Million over the first three years of the renewed agreement).

[18] For example, the authors are aware of at least one system that significantly changed available terms over the last twenty years. In approximately 2000, the franchise agreement contained a twenty-year initial term, with two five year

franchisee needs to be satisfied that the initial term will be long enough for it to recoup its investment in the business, as it has no advance assurance that it will receive a second term without having to accept potentially onerous additional conditions which may also affect the franchisee's return on investment.

For example, several years ago, a national dog kennel franchise operated by Camp Bow Wow Franchising determined to add services to its franchise system, and to require all franchisees to provide them. The franchisees each operated kennels (called "camps") to care for pets during the day, as well as providing overnight kennel services.[19] The franchisor decided to require franchisees to also (1) offer dog grooming at the owner's home, and (2) dog training services at the kennel.[20] Rather than impose these changes through revisions to the Operating Manual, the franchisor decided to change its agreement for new franchisees, and to require that renewing franchisees sign this new agreement and begin to offer these services. The franchisees hated this idea and pushed back by coming together to form a franchisee association to oppose it. Eventually the franchisor dropped the idea.

From the franchisor's perspective, systems change over time, and that requires that franchisees change along with them.[21] And beyond the system, markets and consumer preferences change, and businesses must remain flexible if they are to remain relevant and profitable.[22] Franchisees need to understand that when they enter into their first agreement with the franchisor. If the franchisee refuses to agree to the changes to bring it into alignment with the rest of the system as it evolves, franchisors believe they are justified in refusing to renew an agreement.[23] This is generally permissible in most states.[24] Nonetheless, in some states, if the

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renewals and no cross-default provisions. That term was reduced to ten years by 2005, with one ten year renewal and no-cross default provisions. By 2011, the agreement changed again with the addition of cross-default provisions.

[19] Camp Bow Wow Franchise Disclosure Document at 106 (issued Mar. 30, 2015).

[20] *Id.*

[21] Edward Wood Dunham & Kimberly S. Toomey, *The Evolution of the Species: Successfully Managing Franchise System Change*, 24 FRANCHISE L.J. 231, 231 (2005) ("To prosper long-term, franchisors must adapt to changing demographics, consumer preferences, competitors, and technology by modifying their business concepts, operating procedures, products, and services."). As a result, "successful franchisors have no choice but to continually adapt their systems to evolving circumstances." *Id.*

[22] William L. Killion, *Putting Critical Decision Making Where it Belongs: Scouring the Franchise Agreement of the 'D' Word*, 24 FRANCHISE L.J. 228 (2005) ("The direction of a franchise system comes essentially in two forms—the model that the franchisor initially chooses to franchise to third parties and the model that morphs over time. . . A perfect example of system change is the McDonald's system. The McDonald's model was built initially around a limited menu of a few products sold at a cheap price. Because of system change, the present-day McDonald's restaurant, thankfully for both franchisor and franchisee alike, bears little resemblance to the walk up hamburger stand concept that Ray Kroc inherited from the McDonald brothers."); *see also* Gary R. Batenhorst, Nicole Liguori Micklich & Les Warton, *As My Franchisor Lay Dying—Franchisee and Franchisor Options in a Struggling System*, ABA 40TH ANNUAL FORUM ON FRANCHISING W-13, at 17 (2017) (discussing Mrs. Fields, Blockbuster Video, and other chains struggling with changing market conditions). Nobody wants to be the next Kodak film or Blockbuster Video.

[23] Batenhorst, et al., supra note 22.

[24] *See* Daniel J. Oates & David M. Byers, *Is this Really the End? Dealing with Renewal and Nonrenewal of Franchise Relationships*, INT'L FRANCHISE ASS'N 48TH ANNUAL LEGAL SYMPOSIUM at 33−34 (May 2015). Under Wisconsin law, franchisors are prohibited from "substantially chang[ing] the competitive circumstances of a dealership agreement without good cause." WIS. STAT. § 135.03. It is unclear to what extent this prohibits requiring franchisees to sign the new form of franchise agreement in order to renew, but cases seem to suggest that it is still proper so long as the

terms are sufficiently onerous that the franchisee has no real choice in the matter, it may amount to constructive nonrenewal of the franchise agreement.[25]

While there are stark contrasts in whether and under what conditions renewal is permissible, one potential issue that could give rise to compromise is what happens when neither party acts to formally renew an otherwise expiring franchise agreement. Often, due to course of dealing or sloppy business practices, the parties do not timely execute a renewal of the franchise agreement. Later on, the authors propose that a compromise provision in franchise agreements would deal with this type of situation while preserving the parties' rights.[26] While not a total panacea for disputes over the propriety of renewal conditions and requirements, it may offer some additional certainty and de-escalate some disputes so the parties have time to negotiate an amicable resolution.

4. <u>Transfer and Assignment of the Franchise Agreement</u>

Franchise agreements, like employment agreements, are typically treated as personal in nature. An employee cannot assign his employment agreement to someone else and require the employer to employ the substitute. Franchise agreements are analogous (although not identical—an employee can quit, a franchisee cannot), but their prohibition on assignment coexists with the understanding that the franchised businesses may sometimes be sold or otherwise transferred, and that this will necessitate assignment of the relationship to the transferee. Franchise agreements typically devote several pages to addressing these conflicting goals. This language usually follows the form of (1) a prohibition on assignment, except as specifically permitted, (2) a prohibition on sale or transfer of the franchise, except with franchisor's approval and the franchisee's compliance with various conditions, and (3) a right of first refusal or option to purchase given to the franchisor in connection with the proposed transfer. Some agreements also contain options for franchisor to purchase the business or specific assets following termination or expiration, and most agreements also give the franchisor an option to assume any real estate lease under the same circumstances. A full discussion of these provisions is beyond the scope of this paper, but selective points are addressed below.

a. <u>Transfers</u>

Where a franchisee wishes to sell the business, agreements typically impose various conditions on the sale, such as (in decreasing order of reasonableness) (1) the proposed assignee being acceptable to the franchisor,[27] (2) the payment of a transfer fee, usually a fixed

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proposed new requirements are applied in a non-discriminatory manner, and are based on legitimate business decisions. *See* Wis. Music Network, Inc. v. Muzak L.P., 5 F.3d 218 (7th Cir. 1993).

[25] *See* Petereit v. S.B. Thomas, Inc., 63 F.3d 1169, 1182 (2d Cir. 1995) (applying constructive nonrenewal theory under Connecticut law); Kirkwood Kin Corp. v. Dunkin' Donuts, Inc., No. 94C-03-189-WTQ, 1997 WL 529587, at *9 (Del. Super. Ct. Jan. 29, 1997) (Delaware); Bell v. Bimbo Foods Bakeries Distribution, Inc., No. 11 C 03343, 2012 WL 2565849, at *3 (N.D. Ill. July 2, 2012) (Illinois); Am. Bus. Interiors, Inc. v. Haworth, Inc., 798 F.2d 1135, 1141 (8th Cir. 1986) (Missouri); Maintainco, Inc. v. Mitsubishi Caterpillar Forklift Am., Inc., 408 N.J. Super. 461, 481, 975 A.2d 510 (App. Div. 2009) (New Jersey); Girl Scouts of Manitou Council, Inc. v. Girl Scouts of U.S. of Am., Inc., 646 F.3d 983, 989 (7th Cir. 2011) (Wisconsin).

[26] *See infra* Section VI.A.

[27] *See, e.g.,* Mathnasium Franchise Disclosure Document at 127 (issued Mar. 4, 2020); Camp Bow Wow Franchise Disclosure Document (issued Mar. 23, 2020) (franchise agreement at § 14.5(h)).

amount, but sometimes a percentage of the sale price,[28] (3) the franchisee signing a release of any prior claims,[29] and (4) the transferee signing a new agreement for a full term, which will potentially include higher royalties and other fees. Agreements often state that the franchisor "will not unreasonably withhold consent" to an assignment if the stated conditions are met.[30] One condition sometimes seen is the franchisor's approval of the substantive terms of sale, primarily that the price is not too high, and that the buyer will not be taking on an amount of debt the franchisor deems excessive.[31] This condition can be seen as problematic by franchisees, particularly in circumstances where the franchisor is also given a right of first refusal. If the franchisor forces the deal terms to be revised to a lower price level, and then buys the business itself based on a right of first refusal, franchisees may have a claim for breach of the duty of good faith and fair dealing.

Sometimes franchisors prohibit the franchisee or any broker from advertising the business for sale, begging the question of how the franchisee is supposed to identify potential candidates to purchase the business. In some cases, the franchisor may propose candidates, and may expect to receive an additional payment like a brokerage fee for this. In instances where the franchisee is prohibited from advertising the sale, it would be reasonable to expect franchisors not to charge a fee for identifying candidates for the transfer.[32]

b. <u>Rights of First Refusal</u>

If a franchisee proposes to sell his business to a third party, the franchise agreement often gives the franchisor additional rights, beyond the right of approval. Often the agreement contains a right of first refusal, requiring the franchisee to first obtain a binding written offer to purchase from a buyer, but then to submit the offer to the franchisor before the franchisee accepts.[33] The franchisor is then given a specified period, perhaps thirty days, to decide whether the franchisor will itself purchase the franchise on more or less the same terms.[34]

In practice, franchisees often find these provisions objectionable for a number of reasons. First, while the franchisee-seller should generally not care who buys his business, the fact that

[28] Jimmy John's Franchise Disclosure Document at 158 (issued Apr. 24, 2020); Camp Bow Wow Franchise Disclosure Document (issued Mar. 23, 2020) (franchise agreement at § 14.5(b)).

[29] Jimmy John's Franchise Disclosure Document at 158 (issued Apr. 24, 2020); Camp Bow Wow Franchise Disclosure Document (issued Mar. 23, 2020) (franchise agreement at § 14.5(c)).

[30] Jimmy John's Franchise Disclosure Document at 164 (issued Apr. 24, 2020); Camp Bow Wow Franchise Disclosure Document (issued Mar. 23, 2020) (franchise agreement at § 14.5(b)).

[31] Camp Bow Wow Franchise Disclosure Document (issued Mar. 23, 2020) (franchise agreement at § 14.5(d)).

[32] That is, of course, unless the business is operated in a highly competitive marketplace in jurisdictions where there are limitations on noncompetition covenants. The advertising of a prospective sale could prompt unfair competition from competitors that seek to undermine the franchised business and take market share from the franchisor. For example, in the real estate industry where much of the business is based on commission sales to brokers who are free to change allegiances at any time, the marketing and sale of a franchised real estate brokerage could prompt a feeding frenzy by competitors who seek to poach lucrative brokers. So as with virtually every example in this paper, there are exceptions depending on the context.

[33] Jimmy John's Franchise Disclosure Document at 161 (issued Apr. 24, 2020).

[34] For example, the franchisor may reserve the right to substitute cash for payment terms.

any proposed sale will be subject to this procedure after the terms of sale have been negotiated can make it more difficult to find buyers.[35] Prospective purchasers are less likely to engage in lengthy due diligence and negotiation of a purchase and sale agreement if they know that the process could be for naught if the franchisor exercises its right of first refusal. Second, even if the potential purchase opportunity is exciting enough to entice buyers to make an offer, the lengthy review period afforded the franchisor can operate to drag the process out and make financing or other purchase terms untenable or less valuable. Ultimately, these factors tend to decrease the likelihood that the franchisee can sell its business to a third party for the highest value, resulting in the franchisor appropriating some of the value the franchisee had created by operating the business.

From the franchisor's perspective, a right of first refusal is a critical component of its ability to ensure brand consistency and quality.[36] Sometimes the franchisor would like to reserve the right to prevent an otherwise technically eligible buyer from joining the system for legitimate business reasons. The right of first refusal is the last line of defense in this regard, because if the franchisor does not have an otherwise defensible reason for refusing to allow a transfer,[37] the right of first refusal at least allows it to prevent the sale by purchasing the business itself on the same terms offered by the buyer.

Once the franchisor declines to exercise its right of first refusal, the franchisee is typically given some further period of thirty to sixty days to complete the transaction.[38] But if the terms change, or the time period is exceeded, the franchisee is required to submit the offer again to the franchisor for possible purchase by franchisor.[39] Franchisees again contend that these types of terms reduce the overall sale value of the business. A compromise solution might be for franchisors to have a right of first offer: When a franchisee wants to sell, before putting the franchise on the market it would give notice to the franchisor which would have thirty days to make an offer to purchase. The franchisee could either accept the offer or find a qualified buyer who will pay more.

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[35] While the diminution in the purchase price is not easy to ascertain (how can one quantify the loss of prospective purchasers that are not interested in investing the time to purchase a business only to have their best offer be supplanted by an equal offer by the franchisor?), it is likely real. Keith J. Kanouse & H. Stephen Brown, *AAFD's 'Fair Franchising Standards': The Case For*, 16 FRANCHISE L.J. 59, 64 (1996) ("While, on its face, a right of first refusal to purchase a franchisee's business is reasonable, particularly if the decision has to be made in thirty days or less, this right has been known to have been abused, deflating the true fair market value of the franchised business and causing a third party buyer to get 'cold feet' waiting for the franchisor to make a decision.").

[36] THE ANNOTATED FRANCHISE AGREEMENT at § XXV(D) (Nina Greene, Dawn Newton & Kerry Olson, eds. 2018) ("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.").

[37] The discretion to decline proposed transferees is not unbounded. While there is no bright-line test for when a franchisor may properly reject a transferee, "it is important for a franchisor to be prepared, prior to litigation, to set forth legitimate business reasons for refusing a proposed transfer." Joel D. Siegel & Glenn J. Plattner, *Saying No: Franchisor Exposure for Franchisee Transfer Restrictions*, 16 FRANCHISE L.J. 131, 135 (1997).

[38] Jimmy John's Franchise Disclosure Document at 163 (issued Apr. 24, 2020).

[39] *Id.*

B. Franchisor Reservation of Rights/Step In Rights

Franchise agreements routinely seek to preserve for the franchisor the benefit of any goodwill associated with the business after the termination of a franchisee's rights. This can take the form of granting the franchisor an option to assume any real estate lease, an assignment of rights to telephone numbers and email addresses, assumption of websites and social networking accounts, and even an option to purchase key physical assets. Sometimes the franchisor requires that any real estate lease include an amendment by which the landlord agrees to recognize the franchisor's rights to assume the lease under certain conditions.[40]

Provisions of this sort illustrate the tension between trademark goodwill and local and locational goodwill, discussed more fully below.[41] Where a location has become identified with a mark, as for example, when it has been operated for twenty years as a McDonald's unit, the goodwill associated with the business might be regarded as primarily attributable to the mark, and therefore appropriately reserved for the franchisor upon termination. At the other extreme, for example, a franchisee may have been operated in a location where no other units of the franchise existed, and may argue that the goodwill associated with the business was created instead by personal identification with the franchisee and his or her personal efforts.[42] Imagine, for example, a business that was previously operated as family-owned diner and the only sit down restaurant in a small town. The owner agreed to sign on as a franchisee of a national pizza chain, but the franchise term has now expired, and the owner wants to revert to his former mode of operation. Assuming the former franchisee complies with his or her non-compete (such as by offering a different type of restaurant or business as permitted by the franchise agreement), should the franchisor be permitted to control this restaurant location after the agreement expires? Not every franchise system conveys the name recognition of McDonald's, and "step-in" rights like these should not be standard fare for every franchise agreement, particularly where the franchisee had a business that predated the franchise, and thus brought its own goodwill to the relationship.[43]

C. Asset Purchase Options

Franchise agreements may also include outright options to purchase the franchise or selected assets under certain circumstances. These options are most often seen in connection with franchisor's right to terminate after the franchisee's breach or when the agreement expires. However, some agreements also provide these options in connection with the franchisee's proposed sale of the franchise, and occasionally an agreement gives the franchisor the right to buy back the franchise at any time, without any cause.[44]

These options to purchase are typically couched in language allowing for third-party review or determination of any proposed price, but they typically also specify that the valuation will be determined "without including good will" or "without any going concern value." Business

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[40] A franchisor's rights to assume the franchisee's lease can go awry in cases where the franchisee acquires ownership of the site.

[41] *See* discussion of Goodwill *infra* section IV.C.2.

[42] *See, e.g.,* Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168 (Tex. 1987) (suggesting that franchisees develop some degree of goodwill on their own based on their own personal efforts, traits, and characteristics).

[43] This is common in the hotel industry, where hotels frequently rebrand at the conclusion of the term.

[44] Juice It Up Franchise Agreement, § 9.9(b) 2015.

valuations typically consider a number of methods, primarily (1) the value of the tangible assets, such as furniture and equipment, and (2) a valuation based on the historical stream of income generated by the business. A profitable pizza franchise may generate earnings before interest, taxes, depreciation and amortization ("EBITDA") of $300,000, which might justify a purchase price of $1 million or more, but the same franchise might generate a purchase price of only $30,000 to $50,000 if its earnings potential is disregarded and the business is valued only on the basis of the resale price of its used furniture and equipment. Franchisees complain that inclusion of this phrase in the valuation mechanism essentially assures that a business will be valued based solely on the value of its tangible assets, rather than its earnings history. Franchisees therefore believe that although a valuation mechanism of this sort might sometimes be appropriate for a failed business, it should not be used to determine value where the agreement gives the franchisor an option to buy a successful operating unit.

Conversely, franchisors expressly reject any inclusion of goodwill in the value of the business arguing that the goodwill associated with the business is derived from the trademark, not from the franchisee's efforts,[45] and that the franchisees ultimately directly benefited from their association with the franchisor by being able to hold themselves out as a franchised business.[46] Franchisees disagree, since they purchased that benefit through their royalty payments, and because in a sale to anyone but the franchisor they would be entitled to ask for fair market value.

Ultimately, there is likely some middle ground. There is probably room to discuss when the franchisor has the right to exercise its asset purchase option, or simply by excluding the concept of goodwill from the transfer related portions of the document. In addition, while the concept of an option is probably appropriate on termination or transfer, it seems that unfettered options to purchase at any time, for any reason, are not necessary, and franchisees believe they are neither fair nor appropriate.

III. ALLOCATION OF RISK

Allocation of risk is almost as fundamental to franchising as trademarks. From a reductionist perspective, franchising is another way to use other peoples' money to pay for brand expansion, an alternative to borrowing funds or selling shares. Unlike borrowing, which obliges the borrower to pay the lender back with interest, or selling shares, which limits the shareholders' investment (and liability) to the purchase price, the sale of a franchise imposes no inherent obligation to pay back the buyer who instead takes on potentially limitless liability in exchange for the purchase. The franchisee, like an independent business owner, takes on the risks of the failure of their business, but unlike the owner of an independent business, accepts that the operation of the business will be constrained by the model, the brand, and the system provided by the franchisor. The franchisor is relieved of the need to risk its own capital, and of potential direct liability for business operations, but in doing so cedes hands-on control over operations to a third

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[45] Which, as previously discussed, is generally considered the case absent extreme circumstances. *See, e.g.,* Benjamin A. Levin & Richard C. Morrison, *Who Owns the Goodwill at the Franchised Location?*, 18 FRANCHISE L.J. 85, 116 (1999) ("This view, which implies that all of the customer goodwill associated with a particular franchised business establishment is derived from and ultimately inheres in the franchisor's trademark, is grounded on settled principles of trademark law.").

[46] *Id.* at 85 ("[T]he primary characteristic of a franchise is the license given to the franchisee to trade upon and exploit the franchisor's goodwill during the course of the franchise relationship.") (citing Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc., 834 F. Supp. 683, 691 (D.N.J. 1993)).

party who may at times have different concerns, priorities, or incentives.[47] This section looks at four ways in which most franchise agreements apportion the business risks between the parties.

A. **Indemnity**

An indemnity provision found in almost every franchise agreement requires the franchisee to "indemnify, defend, and hold [the Franchisor] harmless against any and all Damages arising directly or indirectly from" the franchise. Third parties can be harmed by a franchise system in numerous ways, and as a result of actions or decisions taken at various levels of the system. Nonetheless, these provisions shift the risk of legal actions for harms to third parties caused by the franchise business operations entirely onto the franchisees.

Conversely, in a standard contract for the purchase and sale of a business, there are reciprocal indemnity provisions. The seller agrees to indemnify the buyer against claims arising from the business prior to the closing date, and the buyer agrees to indemnify the seller against claims arising from the business following the closing date. In other words, risk is allocated based on fault: Harm caused when the seller was operating the business, which the Buyer had no ability to prevent, is the seller's responsibility.

With a limited exception for trademark related claims, franchise agreements do not generally work this way.[48] The franchisor's trademark, the fundamental object in a franchise agreement,[49] is entirely under the franchisor's control. Most franchise agreements recognize that a franchisee who is sued for trademark infringement based on its use of the licensed mark in compliance with the franchisor's system is not objectively at fault. These agreements provide that the franchisor will defend and indemnify the franchisee.

The liability for injuries to third parties caused by the franchised business, however, is shifted entirely onto the franchisee. Franchisees argue that the manner in which franchisees conduct their business is often organized pursuant to their franchisor's requirements. Business format franchises, in particular, require strict compliance with the Operating Manuals and other franchisor directives;[50] failure to comply is a default (often specifically listed) and ground for

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[47] Nonetheless, franchisors retain ultimate control through their power to define the system through the operating manual and to terminate franchisees who fail to follow the manual's dictates.

[48] The authors have encountered only three examples of franchise agreements which provide that the franchisor will indemnify the franchisee for non-trademark related claims. *See, e.g.,* Am. Poolplayers Ass'n Franchise Disclosure Document at 108 (issued Mar. 25, 2020) ("[Franchisor] agrees to indemnify, defend and hold [franchisee]. . . from and against all damages, liabilities, losses, taxes, penalties, fines, debts, costs and expenses. . . incurred by Indemnities in investigating, preparing for, bringing, defending, settling or satisfying any third party claim, demand, suit or proceeding, arising solely out of conduct of APA adjudged to be wrongful or any breach of this Agreement by APA."); Once Upon a Child Franchise Disclosure Document at 115 (issued Mar. 16, 2020); Snap-on Tools Franchise Disclosure Document at 316 (issued Feb. 14, 2020). While franchisors rarely agree to provide any indemnity to the franchisee beyond for use of the trademark, several of the franchise agreements we reviewed did not impose an affirmative duty on the franchisee to defend and indemnify the franchisor in situations where the franchisor was negligent or breached the franchise agreement in some way.

[49] The definitions of "franchise" under the FTC Rule and most state franchise laws include or require some degree of association of the franchisee's business with the franchisor's trademark or tradename.

[50] The following language is representative of that found in most franchise agreements: "You agree that: (i) every component of the System is vital to us, to your Franchised Business, and to the Businesses our other franchisees operate; and (ii) your compliance with the System is of the essence to this Agreement. You therefore agree that you will conduct all activities and operations of your Franchised Business in strict compliance with the System, including

termination.[51] It is certainly conceivable that a franchisee's careful compliance with the Operating Manual could result in injury to a customer or other third party.

Consider a customer who is injured in a franchise where the franchisee scrupulously follows the franchisor's mandated procedures: A sandwhich franchisee who is required to stick a logo'd toothpick into each half of a sandwhich, and a customer swallows one; a hamburger franchisee who serves coffee at the temperature specified by the franchisor but which scalds a clumsy customer; or a donut hole franchise where the donut holes are exactly the right size to choke a child. The employee who prepared the sandwich, the coffee or the donut hole pursuant to the employer's direction would be at worst jointly liable with the employer under agency principles, and covered by the employer's liability insurance. In terms of the injurious act, the employee is in the same relationship to the employer as the franchisee is to the franchisor: Each of them is contractually obligated to perform as directed or risk the other terminating the relationship (termination of employment or franchise agreement). Indeed, the franchisee's motivation to follow directions is arguably stronger; employees generally neither pay to be hired, nor face a suit from their employer for lost future payments if they are fired. Nonetheless, as an "independent contractor," a franchisee is not entitled to defense by the franchisor or the more dubious benefits of comparative fault or joint and several liability. Rather, under a strictly drafted provision, it is obligated to defend and indemnify the franchisor.

From the franchisee perspective, a fair franchise agreement, like a business purchase agreement, would include reciprocal indemnity provisions aligning liability with fault. Conversely, franchisors believe that operations are necessarily under the control of the franchisee, and liability should remain with the franchisee for injuries that arise out of the operations of the business. Allowing reciprocal indemnity provisions could open a Pandora's box of new claims arising out of negligent or even intentional wrongdoing by the franchisee. As discussed in more detail later, the authors believe that there may be some middle ground for third-party claims that arise expressly as a result of franchisor-imposed standards, specifications, and requirements.[52]

B. <u>Discretion</u>

As a type of trademark license, a franchise agreement must give the franchisor enough control over the franchisees' operations to ensure the consistent quality of the goods or services they provide in order that the franchisor not be found to have abandoned the mark.[53] Both the franchisor and its franchisees benefit from strong, protectable trademarks. And, because franchise agreements create relationships intended to persist into an uncertain future, the franchisor needs to preserve some degree of flexibility in order to deal with economic or

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the Standards and the Manuals, as though specifically stated in this Agreement." 2016 Jamba Juice franchise agreement, § 8.2.

[51] *E.g.*, 2017 Modern Acupuncture franchise agreement, § 15 ("We have the right to terminate this Agreement effective immediately upon delivery of notice of termination to you, if: . . . (r) you or any of your Principal Owners fail to comply with any other provision of this Agreement or any mandatory specification, requirement, standard, or operating procedure, including those in our Operations Manual, and you fail to make the required changes or to comply with such provision, specification, requirement, standard or operating procedure, within thirty (30) days after written notice of your failure to comply is given to you.").

[52] *See infra* section VI.D.

[53] *See, e.g.,* discussions on abandonment of and quality control in THE INTELLECTUAL PROPERTY HANDBOOK at 35−40 (Bussert and Sims, eds., 2d. ed. 2016).

technological changes during their terms.[54] Part of the solution to these problems is for the franchise agreement to give the franchisor the ability to take certain potentially necessary but originally unidentifiable actions. The emergence of a significant new competitor, game changing technological development, or sea-change in consumer preferences are the types of challenges a franchisor must be able to respond to.

In many franchise agreements, however, the franchisor gives itself discretion in areas beyond those necessary to maintain the trademarks or respond to existential crises. Rather, "discretion" and "sole discretion" are peppered throughout franchise agreements, and franchisees complain that the language is not used for the benefit of the system, but rather to minimize franchisor's obligations and insulate them from franchisees' complaints of mismanagement or breach of contract.

A review of five essentially randomly selected franchise agreements found thirty-six different grants of discretion to the franchisor, the majority of them common to multiple agreements.[55] The most common, present in all or all but one of the agreements, were:

Discretion to change the operating manual or system;

Discretion to deal with infringement of or challenges to the trademarks;

Discretion regarding evaluation of franchisee's compliance;

Discretion to create an advertising fund;

Discretion to approve or disapprove franchisee's advertising; and

Discretion to approve, disapprove or impose conditions on transfers.

Other areas where at least three agreements granted the franchisor discretion include whether to provide operating assistance or continuing services or advice to franchisees; approval of suppliers; designation of products or services franchisees offer; reduce the scope of covenants; and change the marks. And, in addition to all the specific grants of discretion, four of the six agreements also included a catchall provision granting the franchisor discretion regarding all decisions or approvals it was authorized to make. The only grant of "discretion" solely to franchisees in any of the agreements was the power to set their own prices.

It bears noting here that these thirty-six are neither an exhaustive list nor unique. Franchise agreements effectively grant franchisors the power to decide many more issues, these are merely examples where the drafter chose to use the term "discretion" rather than "may," "can," "judgment," or another conditional formulation. In any franchise agreement, the section setting out the franchisee's obligations is lengthy and detailed, and the common verbs are "shall," "will" and "required." The section setting out the franchisor's obligations provides that the franchisor

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[54] Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927 (1990).

[55] The five, Rita's Water Ice, 2016; Row House, 2018; Servepro, 2017; Vitality Bowls, 2016; and Yoga Six, 2019, were selected from among numerous agreements already in the authors' possession, but the selection was not based on their contents.

"will" provide training and a copy of the operating manual, and then lists the services it "may" provide and the decisions it has the discretion to make.

All the states recognize some form of the implied covenant of good faith and fair dealing. A common formulation is that "[t]he covenant of good faith requires that a party vested with contractual discretion exercise that discretion reasonably, not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectation of the parties."[56] Many courts, however, based on the tenet that the covenant of good faith cannot contradict express terms also recognize that a contract may grant one party essentially unfettered discretion, effectively precluding a disgruntled party's recourse to the covenant of good faith.[57] This seeming contradiction, eliminating a rule designed to impose restrictions on discretion by making the grant of discretion more forceful, may result in franchisors untethered from the obligation to act in good faith.[58] Franchisees thus can expect to receive only the minimum services franchisors agree they "will" provide, despite the numerous listed services franchisors "may" provide.

The scope of discretion is not necessarily limited only to the common law duty of good faith. In many instances, other laws impose an obligation to act consistent with the terms of the contract in ways that are objectively measurable.[59] As a result, franchisees' contention that franchisors have unbounded discretion to do whatever they please may on occasion be overblown.

Nonetheless, franchisees believe that franchisors' discretion should be limited to responding to unforeseen market changes and challenges, and ensuring that the trademarks remain strong and protected. Drafting with these lofty goals may not be as simple as it sounds. To limit disputes, franchisors should attempt to spell out the specific support services they will provide, and where possible, allow franchisees to source non-proprietary supplies from qualified suppliers. And to eliminate concerns about discretionary overreach, agreements should make clear that the franchisor will not discriminate or act arbitrarily in the course of the performance of its contractual obligations. These seemingly minor changes would grant some assurances that

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[56] Goldberg v. 401 N. Wabash Venture LLC, 755 F.3d 456, 462 (7th Cir. 2014).

[57] *See, e.g.,* Clark v. Am.'s Favorite Chicken Co., 110 F.3d 295, 298 (5th Cir. 1997); *see also* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005).

[58] Increasingly, franchise agreements specifically impose a duty of good faith and honesty on franchisees in their dealings with everyone including their franchisor, but do not impose the reciprocal duty on the franchisor. *E.g.,* "You agree that in all dealings with us and any of our affiliates, other franchisees, your customers, your suppliers, and public officials, you will adhere to all manner of code, regulation and law and the highest standards of honesty, integrity, fair dealing and ethical conduct." 2017 Modern Acupuncture Franchise Agreement, § 10.6.

[59] For example, under the Uniform Commercial Code, a long term contract can grant one party the right to vary pricing on the contract over time. But the party must set the price in good faith. U.C.C. § 2-305. Unlike the more nebulous good faith described by general contract law principles, however, good faith under the UCC is defined more narrowly, and the majority of courts have construed it as being a price that is commercially reasonable. Capital Equip., Inc. v. CNH Am. L.L.C., No. 4:04CV00381GTE, 2004 WL 3406091 (E.D. Ark. Sept. 27, 2004); Vt. Morgan Corp. v. Ringer Enters. Inc., 461 N.Y.S.2d 446 (N.Y. App. Div. 1983). This can be determined with relation to objective facts, rather than the subjective intent of the party exercising discretion. *See generally* Douglas C. Berry, et al., *Open Price Agreements: Good Faith Pricing in the Franchise Relationship*, 27 FRANCHISE L.J. 45 (2007); *see also* Casserlie v. Shell Oil Co., 121 Ohio St. 3d 55, 902 N.E.2d 1 (2009) (applying standard of commercial reasonability with reference to objective pricing decisions in the industry rather than subjective analysis of intent of the party exercising discretion). Obviously, the UCC does not apply to all transactions or franchise systems, but it provides a useful guidepost on how systems might be designed to avoid these problems.

the franchisor is not intent upon enriching itself through its own interference with the success of its franchisees.

C. <u>Guarantees</u>

When a business fails, the owners lose their investment—the money, time and energy they have put into the business. Creditors who advanced money, products, or services to the business may lose to the extent the business lacks the ability to pay them. Statutes and economics encourage people to take the risk of going into business by permitting, even encouraging the use of limited liability entities, which allow owners and investors to decide how much of their personal wealth they want to risk on the business. Franchisors are almost uniformly corporations or limited liability companies for these reasons.[60] Logically, franchisees should be as well. However, franchisors who are willing to enter into a franchise agreement with a limited liability entity generally require that the owners personally guarantee their entity's performance of the franchise agreement:

> Concurrently, with the signing of this Agreement, Franchisee must execute a personal guaranty in the form attached hereto as Exhibit 4 ("Personal Guaranty"). In the event Franchisee is a legal entity having more than one owner, all owners, shareholders, partners, joint venturers, and any other person who directly or indirectly owns a 10% or greater interest in Franchisee (the "Owners") must execute the Personal Guaranty. Any person or entity that at any time after the date of this Agreement becomes an Owner, pursuant to Section 14 or otherwise, shall, as a condition of becoming an Owner, execute Franchisor's then-current form of Personal Guaranty.[61]

In contrast, franchisors often expressly refuse to guarantee anything:

> FRANCHISOR EXPRESSLY DISCLAIMS THE MAKING OF, AND FRANCHISEE ACKNOWLEDGES THAT IT HAS NOT RECEIVED, ANY WARRANTY OR GUARANTEE, EXPRESS OR IMPLIED, THAT FRANCHISEE WILL BE SUCCESSFUL IN THIS VENTURE OR THAT THE BUSINESS WILL ATTAIN ANY LEVEL OF SALES VOLUME, PROFITS, OR SUCCESS.[62]

* * *

> These figures are estimates, and we cannot guarantee that you will not have additional expenses starting the Restaurant.[63]

* * *

[60] Indeed, many franchisors are separated from their ultimate owners by multiple levels of entities, and they are often structured so that the intellectual property is not owned by the franchising entity.

[61] Row House 2018 franchise agreement § 2.2(b).

[62] Row House 2018 franchise agreement § 18.

[63] Vitality Bowls Franchise Disclosure Document at 17−20 (issued Apr. 19, 2016).

> We do not promise that you will benefit directly or proportionately from any Marketing Programs.[64]
>
> *   *   *
>
> We do not guarantee that advertising expenditures from the Brand Fund will benefit you or any other franchisee directly, on a pro rata basis, or at all.[65]
>
> *   *   *
>
> You acknowledge and agree that our approval of a site does not constitute a representation or warranty of any kind, express or implied, as to the suitability of the site for a Restaurant or for any other purpose.[66]
>
> *   *   *
>
> If you choose to offer any items at a price we recommended, you understand and acknowledge that we do not represent, warranty, or guarantee that you will earn any level of sales or profitability.[67]
>
> *   *   *
>
> You acknowledge that you have not received or relied upon any warranty or guarantee, express or implied, as to the potential revenues, income, profits, volume, or success of the business venture contemplated by this Franchise Agreement…We expressly disclaim the making of any warranty, guarantee, or representations of this type.[68]

In addition, the required guarantees generally provide that the entity's owners:

> [J]ointly and severally, hereby unconditionally guarantee to Franchisor and its successors and assigns the full and timely performance by Franchisee of each

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[64] *Id.* at 85.

[65] *Id.* at 24−33.

[66] *Id.* at 71.

[67] *Id.* at 84.

[68] *Id.* at 111. In further contrast, many franchise agreements contain provisions intended to reinforce the effect of the franchisor's limited liability:

> No Person who is not a Contracting Party, including without limitation any director, officer, employee, incorporator, member, partner, manager, stockholder, affiliate, agent, attorney, or representative of, and any financial advisor or lender to, any of the foregoing ("Nonparty Affiliates"), shall have any liability (whether in contract or in tort, in law or in equity, or granted by statute) for any claims, causes of action, obligations, or liabilities arising under, out of, in connection with, or related in any manner to this Agreement or based on, in respect of, or by reason of this Agreement or its negotiation, execution, performance, or breach….

Row House Franchise Agreement at § 17.6; *see also* Club Pilates 2019 Franchise Agreement at § 17.36. Personal guarantors are, of course, an exception.

obligation undertaken by Franchisee under the terms of the Franchise Agreement, including all of Franchisee's monetary obligations arising under or by virtue of the Franchise Agreement.[69]

Taken together, on one hand these provisions enhance the franchisor's ability to collect, while on the other they may limit the franchisee's recourse for harm the franchisor may cause, and indeed reduce the franchisor's obligation to provide benefits to the franchisee. They are tilted in favor of franchisors, not only because they impose a greater risk burden on franchisees, but also because the risks are unequal to begin with. A franchisor's financial life is rarely ever tied to the fate of a single franchise, but a franchisee's success often is.[70]

Franchisees contend that guarantees exacerbate franchisees' problems in at least two ways. First, the nature of the guarantees, specifically requiring guarantees from all investors and imposing joint and several liability on all the guarantors, arguably increases the risk of failure. Friends or family members who might be willing to invest in the franchised business must risk not only their investment but also becoming liable for the franchisees' total obligations under the agreement. This is a disincentive, and likely results in the approved sales of franchises to franchisees with fewer resources to support their franchise. Franchisors that are not selective about their franchisees run the risk of bringing on under-capitalized owners if they allow franchisees to go "all-in" to simply acquire their business. These franchisees will likely be less able to weather a bad patch and prevent failure, or to avoid financial ruin due to the one-two punch of failure of the business and the franchisor's claims under the guarantee.

With respect to this first contention, franchisors would dispute that there is likely to be greater investment in the brand in the absence of guaranties. Moreover, as it relates to undercapitalization, no franchisor is excited about the prospect of having a new, undercapitalized franchisee; it is a recipe for failure. While franchisors prefer guarantees, this could be remedied by being more selective in choosing new franchisees.

Second, franchisees argue that the "harm" personal guarantees purport to protect franchisors from is at best overstated. Franchisees receive a limited, temporary trademark license and access to one or more of the following: An exclusive territory, specific products, specialized training or knowledge, the details of a system developed by the franchisor, or purchasing efficiencies for advertising or products arranged by the franchisor. In most franchises the franchisee pays an initial fee and makes ongoing payments to the franchisor, either in the form of royalties on sales or of premiums on the price of goods or services purchased from the franchisor. Consequently, franchisees frequently contend that the failure of any one franchisee is immaterial to the franchisor; it simply represents a loss in revenue for one location. There is no serious "harm" that comes from the loss.[71]

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[69] Vitality Bowls 2016 Personal Guaranty.

[70] The counterargument is that franchisors are almost invariably on a more stable financial footing than franchisees, so the likelihood that a claim brought by a franchisee against a franchisor is uncollectable is slim. Moreover, franchisors provide financial statements as part of their franchise disclosure document at the time of the sale, so the franchisee has at least a snapshot of the franchisor's financial situation; conversely the franchisor is often gambling on the franchisee's success because it has no prior track record, and many franchisees finance their initial obligations with debt.

[71] Under this line of thinking, the franchisor has been compensated up front for the license and the training or transfer of knowledge (if any) by the initial franchise fee. In addition, during the franchisee's pre-failure performance, the

This second contention, however fails to take into consideration franchisors' concerns that the failure of a location reflects poorly on the brand and the system as a whole, and potentially creates an irreparable injury in the eyes of the consumer and prospective franchisees.[72] Often a location that fails financially is also underperforming in compliance and quality control before failure, further diminishing and tarnishing the brand and the trademark in the eyes of the public. While under performing in this manner is generally the franchisee's doing, franchisees argue that allowing it to continue so long that it harms the brand is the franchisor's fault. Moreover, franchisors worry that in jurisdictions that limit enforcement of post-term noncompetition covenants, the end of the relationship with a successful franchisee could create an instant new competitor with an intimate knowledge of the marketplace and local goodwill to boot.[73]

In any event, what is certain is that the failure of a franchised business is a loss to both parties. Franchisors see guarantees as the backstop for failure. Even if they are unwilling to entirely give them up, there is room for compromise, such as in limitations imposed on requiring guarantees for minor investors in the business, capping the guarantors' potential liability, or agreeing to release guarantees after a specified number of years of compliant operation.

D. <u>Disclaimers</u>

Legislatures and the Federal Trade Commission enacted franchise disclosure laws in response to perceived widespread fraud in the industry.[74] The statutes' disclosure requirements and anti-fraud provisions have increased franchisors' wariness of fraud claims, and resulted in the proliferation of prophylactic waivers and disclaimers of pre-sale representations and promises

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franchisor continued to receive compensation (royalties, fees or premiums). But, by granting a license to a franchisee the franchisor has not appreciably reduced its ability to use and exploit its trademarks and system. Unlike selling or renting physical property—a car, a house or a piece of machinery—intellectual property can be licensed many times and simultaneously. And, when the license expires or is terminated, the "repossessed" trademark (including any associated system) is no worse for wear. It can be, or already has been, sold again and again. The loss of the performance of a licensee, who stops using the franchisor's property and stops paying for its use, causes minimal harm. The franchisor's property has not been stolen, damaged or diminished. The franchisor has merely lost an income stream which can be, or may already have been, replaced. It even has a claim against the franchisee for breach of contract.

[72] Eric Goldberg & Justin Csik, *Unintended Legal and Business Consequences of Termination of a Franchisee*, 34 FRANCHISE L.J. 53, 70 (2014) ("Not only is it more difficult to sell a franchise if the franchisor's reputation/perception is negative, but it can be very difficult to repair a bad perception once created. A bad reputation will leave a franchisor with less qualified prospective franchisees from which to choose, which could lead to a vicious circle for the franchisor. . . .").

[73] Of course, without non-compete provisions franchisors can still prevent the misappropriation of their intellectual property.

[74] "Based upon the original rulemaking record, the Commission found widespread deception in the sale of franchises and business opportunities through both material misrepresentations and nondisclosures of material facts." Statement of Basis and Purpose, 72 Fed. Reg. 15,444 (Mar. 30, 2007). *See also, e.g.,* CAL. CORP. CODE § 31001 ("California franchisees have suffered substantial losses where the franchisor or his or her representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between franchisor and franchisee, and the prior business experience of the franchisor. It is the intent of this law to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered. Further, it is the intent of this law to prohibit the sale of franchises where the sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled, and to protect the franchisor and franchisee by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship."); 815 ILL. COMP. STAT. 705/2; MD CODE ANN., BUS. REG. § 14-202; N.Y. GEN. BUS. L. §680.1.

in franchise agreements. Indeed, the FTC found it necessary to specifically provide that it is a violation of the Rule to “require a prospective franchisee to waive reliance on any representation made in the disclosure document…”[75]

Franchisees however are regularly required to waive reliance on everything else. Such waivers seek to shift all the risks associated with misunderstandings and misbehavior onto the franchisee. These disclaimers are intended as defense evidence against a franchisee’s claim that it was misled with regard to specific information material to the decision to purchase the franchise. Franchisors clearly perceive claims of fraud in the inducement to be a significant risk. Practically speaking the franchisor can address these fraud concerns in two (nonexclusive) ways. First, the franchisor can design the franchise sales process so that it provides prospective franchisees with sufficient factual information that allows them to clearly understand both the benefits the franchise system offers and the risks of making the investment. Second, they can populate the franchise agreement with widespread disclaimers on reliance. Objectively doing both is the most prudent and cautious way for the franchisor to protect itself from a claim. Franchisees complain that instead many franchisors use only disclaimers, and proceed to use sales techniques to gain the prospect’s trust and paint the rosiest possible picture of the franchise, the system, and a franchisee’s likelihood of success.

What actually happens in any given situation depends on the system and the prospect. But practically speaking, nobody buys a franchise in a vacuum. They typically do so after being convinced of the attractiveness of the brand, the strength and utility of the franchisor’s system, the support they will receive from the franchisor, and the enthusiasm they encountered at Discovery Day. None of these factors are the result of reading an FDD. Consequently, franchisees contend that the very thing that prompts franchisees to purchase their franchised business is likely to be what is broadly disclaimed in most franchise agreements. Some courts accept such disclaimers at face value:

> Ordinarily under New York law, where a party specifically disclaims reliance upon a particular representation in a contract, that party cannot, in a subsequent action for common law fraud, claim it was fraudulently induced to enter into the contract by the very representation it has disclaimed reliance upon.[76]

As a result, clauses like the following are increasingly popular:

> You acknowledge that the success of the business venture contemplated under this Agreement is speculative and depends, to a large extent, upon your ability as an independent businessperson, your active participation in the daily affairs of the business, market conditions, area competition, availability of product, quality of services provided as well as other factors. We do not make any representation or

[75] 16 C.F.R. § 436.9(h).

[76] Governara v. 7-Eleven, Inc., No. 13-CV-6094 (LAP), 2014 WL 4476534, at *5 (S.D.N.Y. Aug. 20, 2014) (citations and internal quotation marks omitted). Other courts have questioned the motive for such disclaimers or limited their effect. *See, e.g.,* Martrano v. Quizno's Franchise Co., LLC, Civil Action No. 08-0932, 2009 WL 1704469, at *15 (W.D. Pa., June 15, 2009); Coraud LLC v. Kidville Franchise Co., LLC, No. 14-cv-9105 (JSR), 2015 WL 3651423 (S.D.N.Y., June 12, 2015).

> warranty express or implied as to the potential success of the business venture contemplated hereby.[77]

What franchisees read when they see this language is "if what we sold you doesn't work, don't blame us."

Franchisees believe that courts' validation of such disclaimers is bad for franchisees and franchisors. By allowing franchisors to disclaim away misrepresentation and fraud, courts tacitly encourage them. This harms franchisees who purchase franchises they should not, but also responsible franchisors who either lose sales to less responsible ones, or end up with inappropriate or disgruntled franchisees. Reduced reliance on disclaimers would encourage franchisors to improve the sales process so that prospective franchisees better understand the system, and where appropriate, to improve their systems to reduce the potential for franchisee failure. The risk to franchisors of fraud claims would be reduced not because they are made harder to win, but because there would be fewer reasons to bring them.

Many franchisors argue that disclaimers need to be included because they believe there is a subset of franchisees that will seek to find any excuse for backing out of a franchise system when they find that the system is not for them, or they are not prepared to operate a business. Courts have referred to this practice a "heads we win, tails you lose"[78] approach, where franchisees attempt to evaluate the system to see if they will succeed, and then subsequently sue using alleged oral statements outside the FDD to justify their decision to leave the system. Franchisees obviously dispute that this is in any way common, and in fact argue that the vast majority of franchisees that seek legal assistance worked diligently to make their business a success, albeit unsuccessfully. Regardless of which side is right, both sides commonly ignore untrue or exaggerated representations if the franchisee succeeds, but these same representations will get scrutinized very closely if there is litigation. And practically speaking, these claims are very difficult for franchisors to defend, because they require a weighing of credibility from the witnesses that generally requires trial on the merits; an expensive proposition. Accordingly, the prominence of disclaimers in franchise agreements is largely traceable to a minor subset of disgruntled franchisees that try to take advantage of the system. Nonetheless, this should not stop franchisors from implementing a transparent and open sales process as a means of reducing claims and avoiding the need to argue about disclaimers in court.

IV. COMPETITION

The current topic de jour in franchising is whether franchisors are "employers" of a franchisees' employees. While that debate is a story for another time, franchise agreements do undoubtedly contain provisions that are in some respects akin to employment agreements (which explains the courts' continued confusion and debate about the subject). Among other things, this includes disputes over franchisees' obligations to comply with system standards and rules, including in the operations manual. This also includes provisions in franchise agreements that relate to competition between the franchisor and the franchisee, and the franchisee's principals and owners; or, more specifically, prohibitions on competition between the franchisor and franchisee, and a delineation of the rights of the parties. It also relates to the ownership and use of the trademark and other intellectual property of the parties. Unsurprisingly, these sections have

[77] Dog Haus Franchise Agreement (2014).

[78] *See* Layton v. AAMCO Transmissions, Inc., 717 F. Supp. 368, 372 (D. Md. 1989).

the potential to create disagreement between the parties, both during their relationship and long after it has concluded.

A. Restraints on Franchisees

1. Operations Manuals

The following language is commonly contained in franchise agreements: "Franchisee's right to use the Trademarks is limited to the operation of the franchise and as expressly provided in this Agreement and the Operations Manual."[79] On the surface, this seemingly innocuous language merely acknowledges the controlling documents in the relationship. Upon closer inspection, it operates as a substantial constraint on franchisees' operations and rights. If the franchise agreement is the visible tip of the iceberg poking out of the calm seas, the operations manual is the hulking behemoth beneath the waves. Operations manuals can be hundreds of pages long, prescribe in intricate detail the manner in which the franchise system is implemented, and in many cases, can be amended without the franchisee's consent.[80] These amendments may even require substantial additional capital investments by the franchisee.[81]

The tension this creates can be significant. From the franchisor's perspective, the power to amend the operations manual is needed to create sufficient flexibility for the system to adapt to changing circumstances.[82] For example, franchisors in the restaurant industry need the flexibility to change menu offerings and prices without having to amend the franchise agreement.[83] The flexibility may be bounded by the terms of the franchise agreement, which cannot be modified by changes to the operations manual.[84] For franchisees, this limitation is insufficient protection. Their surrender of control over their business can feel nearly complete; anything can change

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[79] Snap-on Tools Franchise Disclosure Document at 305 (issued Feb. 14, 2020).

[80] ServPro Franchise Disclosure Document at 113 (issued May 15, 2020) ("FRANCHISOR has the right to periodically modify the Manuals as FRANCHISOR deems necessary or appropriate, in its sole discretion, and the OPERATOR agrees to comply with each new or changed standard. . . .").*See also* Bores v. Domino's Pizza LLC, 530 F.3d 671 (8th Cir. 2008); Nat'l Franchisee Ass'n v. Burger King Corp., 715 F. Supp. 2d 1232 (S.D. Fla. 2010); La Quinta Corp. v. Heartland Props., LLC, 603 F.3d 327 (6th Cir. 2010); Remus v. Amoco Oil Co., 794 F.2d 1238 (7th Cir. 1986); Trail Burger King, Inc. v. Burger King of Miami, Inc., 187 So. 2d 55 (Fla. Dist. Ct. App. 1966).

[81] Peter C. Lagarias & Edward Kushell, *Fair Franchise Agreements from the Franchisee Perspective*, 33 FRANCHISE L.J. 3, 16 (2013) ("Franchisees may be required to replace costly initial investments, purchase new equipment, remodel stores, provide new product lines, or use new more expensive vendors. Such changes may alter the economic model of the business from profitable to breakeven, or take a losing or breakeven business into substantial monthly losses.").

[82] Robin Day Glenn, *Drafting Franchise Agreements in California* ¶ 2.18, CAL. FRANCHISE L. & PRAC. (David E. Holmes ed., 2009); THE ANNOTATED FRANCHISE AGREEMENT *supra* note 36 at § XIX(A) ("The manual is at the heart of an effectively run system. It contains key information about how to operate the business and protect the goodwill of the brand.").

[83] THE ANNOTATED FRANCHISE AGREEMENT *supra* note 36 at § XIX(A)(i) ("Particularly with a new and growing business, revisions will be necessary as the franchisor responds to changes in processes, customers' needs, and demands dictated by the market and competition. Failing to include language to reserve rights to change the manual will make it difficult, if not impossible, to effectively run a franchise system.").

[84] THE ANNOTATED FRANCHISE AGREEMENT *supra* note 36 at § XIX(A)(i) ("franchisees looking to curtail the extent to which a change in the manual can impact the system may negotiate a clause such as. . .: Franchisor agrees that although such modifications to the Manual may be material in that they may have an effect on the operation of the Franchised Business, they may not conflict with or materially alter the terms of this Agreement.").

without their consent, and they may be forced to change their business model entirely.[85] At least one commentator has suggested that the franchisor's authority should, at minimum, be limited to changes that do not result in a "significant economic detriment" to the franchisee.[86] Alternatively, franchisors could allow franchisees to operate under the old system through the remainder of their term, or simply decide to exit the system amicably without converting to the new standards.

2. <u>System Competition</u>

While franchisees are limited by restrictions on rights to use marks and other system programs except in strict compliance with operations manuals, many franchise agreements explicitly make clear that the franchisor is under no such restrictions. Indeed, many franchise agreements expressly permit the use of the marks and the system to compete directly with the franchisee, either by the franchisor, its affiliates, or other franchisees.[87] In the absence of a thoroughly protected territory, in most jurisdictions this is permissible.[88] While there is some case law that suggests that the duty of good faith and fair dealing prohibits franchisors from improperly competing with franchisees, most of it is outdated[89] or outlying.[90] The vast majority of recent cases permit system competition if expressly allowed by the franchise agreement.[91]

These provisions are likely not negotiable in most systems. Either the franchisor has a system with protected territories, or it does not. Prospective franchisees with concerns about intra-brand competition, or competition in different channels of trade, should stay away from these systems. Similarly, franchisors that have difficulty selling franchises because they refuse to grant any protections against competition may need to change their agreements to afford greater protection to prospective franchisees. Otherwise, they may lose franchise sales, or the ability to charge larger and more lucrative initial fees.

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[85] *See, e.g.,* Lagarias & Kushell, *supra* note 81 at 15−16.

[86] *See, e.g.,* Lagarias & Kushell, *supra* note 81 at 16.

[87] GNC Live Well Franchise Disclosure Document at 12 (issued May 13, 2020) ("In our Franchise Agreement, we reserve the right to sell products under the same or similar brand that you sell, including GNC Brand Supplements, via other channels of distribution."); Gymboree Franchise Disclosure Document at 33 (issued Aug. 30, 2019) ("You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control."); H&R Block Franchise Disclosure Document at 40 (issued July 29, 2019) ("You will not receive an exclusive Franchise Territory. You may face competition from other franchisees or H&R Block tax businesses that we or our affiliates franchise or own and that operate at traditional sites outside your Franchise Territory. You may also face competition from other offices that we franchise or own, or that are franchised or owned by our Parent or affiliates, or from other channels of distribution or competitive brands we control.").

[88] Charles S. Marion, Daniel J. Oates & Ari N. Stern, *Stepping on Toes: Territorial Rights and Encroachment*, ABA 42ND ANNUAL FORUM ON FRANCHISING W-14, at 2–8 (2019).

[89] Scheck v. Burger King, 756 F. Supp. 543 (S.D. Fla. 1991); In re Vylene Enters., Inc., 90 F.3d 1472 (9th Cir. 1996).

[90] Bryman v. El Pollo Loco, Inc., Case No. MC026045 (Cal. Super. Ct. Los Angeles Cnty. Aug. 1, 2018) (*appeal docketed, Handlers-Bryman v. El Pollo Loco*, Case No. B292585 (Cal. Ct. App. Feb. 5, 2019)).

[91] Cohn v. Taco Bell, No. 92 C 5852, 1994 WL 13769 (N.D. Ill. Jan. 14, 1994); Barnes v. Burger King Corp., 932 F. Supp. 1420 (S.D. Fla. 1996); Burger King Corp. v. Agad, 941 F. Supp. 1217 (N.D. Ga. 1996); Clark v. Am.'s Favorite Chicken Co., 110 F.3d 295 (5th Cir. 1997); Cook v. Little Caesar Enters., Inc., 972 F. Supp. 400 (E.D. Mich. 1997); Payne v. McDonald's Corp., 957 F. Supp. 749 (D. Md. 1997); Davis v. McDonald's Corp., 44 F. Supp. 2d 1251 (N.D. Fla. 1998); Camp Creek Hosp. Inns, Inc. v. Sheraton Franchise Corp., 139 F.3d 1396 (11th Cir. 1998); Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir. 1999).

B. Non-Compete Provisions

Covenants against competition are creatures of state law. In some states, noncompetes are generally unenforceable.[92] In most states, a noncompete is enforceable if it is intended to promote a legitimate business interest, and it is reasonable in duration and scope.[93] With respect to the legitimate business interest, the justification is often that the franchisee has in its possession valuable intellectual property of the franchisor that it can use to compete unfairly. However, the application of this standard is by no means consistent: Reasonable duration and scope have ranged from six months to five years, and distances of up to 100 miles.[94] Similarly, based on court rulings, legitimate business purposes may include "(1) protecting a franchisor's trade secrets and proprietary information, (2) preserving goodwill and avoiding customer confusion, (3) refranchising, and (4) sending a message to the system and discouraging 'breakaway' franchisees."[95]

Of course, due to the variation in state laws, it is apparent that covenants against competition are not strictly necessary to preserve the franchisor's business. While many states ban the practice in some contexts, there are entire jurisdictions where franchise systems grow and thrive without the standard restrictions on competition.[96] As a result, the inclusion of these provisions is certain to cause friction and disputes because, from the franchisee perspective, it smacks of overreach and unequal bargaining power,[97] and from the franchisor's perspective, it is an essential element to protect the entire system from collapse.

1. In-Term Noncompete Provisions

Unlike post-term covenants against competition, courts are typically less concerned about enforcing in-term covenants, especially in franchise agreements, because they are limited to the term of the agreement, and they are designed to protect the fruits of the contract for both parties (and in franchise systems, other franchisees).[98] "Moreover, courts have noted that striking an in-

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[92] *See, e.g.,* CAL. BUS. & PROF. CODE § 16600; N.D. CENT. CODE § 9-08-06. "California's antipathy toward covenants not to compete is longstanding." Theo S. Arnold, *Try Poking it With a Stick: Post-Term Noncompetes in California Certainly Look Dead*, 38 FRANCHISE L.J. 55, 56 (2018).

[93] Jess A. Dance & William W. Sentell, *Turning an (Occasional) Blind Eye: Selective Enforcement of Franchisee Post-Termination Non-Compete Covenants*, 37 FRANCHISE L.J. 245, 246 (2017).

[94] *Id.*

[95] *Id.*

[96] "California banned noncompetes almost entirely in 1872." Arnold, *supra* note 92 at 56; *but see* Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc., 834 F. Supp. 683, 691 (D.N.J. 1993) ("One can view a franchise agreement, in part, as a conveyance of the franchisor's good will to the franchisee for the length of the franchise. When the franchise terminates, the good will is, metaphysically, reconveyed to the franchisor. A restrictive covenant, reasonably crafted, is necessary to protect the good will after that reconveyance.").

[97] As some commentators have noted, many franchisees are individuals, and their franchise is not only their business but their job. Lagarias & Kushell, *supra* note 81 at 20−21. As a result, they contend that any noncompete is in essence a prohibition on their ability to perform their chosen profession, and should be deleted from any franchise agreement. *Id.*

[98] Peter J. Klarfeld & Mark S. VanderBroek, *Law on Covenants Against Competition Shifts Toward Greater Enforceability by Franchisors*, 31 FRANCHISE L.J. 76, 79 (2011).

term covenant alters the parties' bargain by allowing a franchisee to continue to benefit from most provisions of the franchise agreement without having to comply with other obligations of the agreement, specifically the in-term covenant."[99] Even in California, notorious for its disdain for noncompetes, there is a track record of courts enforcing in-term franchise noncompetes.[100]

The devil, of course, is in the details. Whether the scope of an agreement is reasonable is inherently fact specific, and therefore likely to give rise to difficult-to-resolve disputes. Moreover, despite the typical review of the geographic and temporal scope of the competition restriction, many franchise agreements include a broad list of nonsignatories who are purportedly also bound by the scope of the provision, including spouses, guarantors, affiliates, and "immediate family members."[101] Agreements also commonly restrict franchisee principals not only from owning competing businesses, but also from acting in other capacities (such as director, manager, employee, consultant, representative, agent, etc.).[102] They also can restrict what types of action franchisees can take, such as providing services to a competing business.[103]

And finally, the agreement's definition of what constitutes a "competitive business" with the franchise system can lead to titanic struggles. Some are crafted broadly to prohibit any activity that is "the same or similar" to those provided by the franchisor.[104] Others are much more narrowly tailored to prohibit only specific actions like offering specific types of products ("hero sandwiches")[105] or services ("indoor or outdoor boot camp style fitness program").[106] Undoubtedly, greater degree of specificity as to what is, and is not, prohibited is a fairer way of approaching the drafting of these provisions. By knowing the rules of the road before agreeing to

[99] *Id.* While inarguably true that courts do this, the logic is somewhat circular. Whether an in-term covenant or a post-term covenant, the provision is part of the parties' bargain.

[100] Comedy Club, Inc. v. Improv Assocs., 553 F.3d 1277 (9th Cir. 2009); Dayton Time Lock Serv., Inc. v. Silent Watchman Corp., 52 Cal. App. 3d 1, 6 (1975) (upholding a noncompete against a franchisee/dealer for the duration of the franchise period, but not for the 10 year post-term period). *See also* Ixchel Pharma, LLC v. Biogen, Inc., 5 Cal. 5th 1130, 2020 WL 4432623 (Cal. Aug. 3, 2020) (holding that in-term non-compete covenants are analyzed under the rule of reason).

[101] Novus Glass Repair & Replacement Franchise Disclosure Document at 166 (issued Apr. 28, 2020).

[102] Face Foundrie Franchise Disclosure Document at 80 (issued May 15, 2020); Novus Glass Repair & Replacement Franchise Disclosure Document at 166 (issued Apr. 28, 2020).

[103] They also can be much broader. The Papa John's noncompete, for example, prohibits franchisees from "indirectly . . . working in concert with any person. . . that owns, operates, manages or licenses any business that. . . sells pizza. . . ." Papa John's Franchise Disclosure Document at 229 (Issued Apr. 15, 2020). One wonders what conduct could be construed as falling within a prohibition on "indirectly working in concert" with a third party. This language is probably unnecessarily overbroad, and more likely to result in disputes and potential invalidation of the provision (especially in jurisdictions without a blue pencil rule), than it is to accomplish the provision's intended purpose. A recent California case found that including and seeking to enforce a statutorily unenforceable non-compete provision was an unfair business practice. Robinson v. U-Haul Co. of California, 4 Cal. App. 5th 304 (2016).

[104] Blo Blow Dry Franchise Disclosure Document at 74 (Issued July 10, 2017).

[105] Jimmy John's Franchise Disclosure Document at 141 (issued Apr. 24, 2020) ("[A]ny restaurant or other food-service business that derives more than ten percent (10%) of its revenue from selling submarine, hero-type, deli-style, pita and/or wrapped or rolled sandwiches. . .").

[106] Orange Theory Franchise Disclosure Document at 117 (issued May 15, 2020).

the franchise system, the franchisee is in a better position to understand what is being agreed to.[107]

From the franchisor's perspective these restrictions can be critical to ensuring that the franchisee does not use the franchisor's intellectual property, trade secrets, and training to compete with the franchise system. Otherwise, there is nothing to prevent the unscrupulous franchisee from learning the "secret sauce" of the system, and then converting to an unbranded business that pays no royalties for the know-how and business acumen learned from the franchisor. At minimum, the in-term covenant operates to prevent franchisees that are nearing the end of their term from soliciting customers to a new unbranded location that the franchisee intends to open and operate at the expiration of the term. From the franchisor's perspective this places the franchisor and franchisee on equal footing (competitively) at the end of the franchise term. The breathing room afforded by an in-term noncompete allows the franchisor to resell the territory during the window of time between learning that the franchisee has decided not to renew, and the end of that franchisee's term.

Franchisees have a harder time disputing the propriety of in-term noncompetition provisions; the risks of abuse are just too significant, particularly where trade secrets and other intellectual property rights are at stake.[108] That said, many franchise agreements go overboard in their definitions and extension of restrictions to nonsignatories and passive actions by the franchisee. For example, if a sandwich shop franchisee employs the franchisee's family members, how is that franchisee to stop their immediate family members (children, siblings, etc.) from opening their own sandwich shops? If the franchisee can provide reasonable assurances that they have not shared proprietary or sensitive business information with the breakaway family member, and reasonably enforce any confidentiality agreement with them, the franchisor should not have grounds to terminate such an agreement. While there is certainly a potential for abuse, there are also matters outside the franchisee's control that should not rise to the level of breach of a franchise agreement except in the most egregious situations, such as where the franchisee refuses to cooperate or otherwise satisfactorily demonstrate that it has no control over the actions of the third party, and is not participating in or aiding competition.

2. <u>Post-Term Noncompete Provisions</u>

Unlike in-term covenants not to compete, post-term covenants are more heavily scrutinized by courts for reasonableness.[109] The rationale for a post-term covenant is not as strong as for an in-term covenant because a post-term covenant is a more direct restraint on trade and competition. It is, in effect, a franchisor carving out a right to be free from competition for a

[107] This is, of course, an optimistic gloss. There are countless examples of seemingly specific contract terms that are maddeningly unspecific when applied to a specific fact pattern. For example, is a wrap a "sandwich?" How about a hamburger? None of these myriad disagreements are likely to be discussed or understood at the time the parties execute the agreement.

[108] Franchisees would argue that even in-term noncompetition covenants are unnecessary to protect intellectual property, however, as there are separate statutory protections for misuse of intellectual property.

[109] Klarfeld & VanderBroek, *supra* note 98 ("Both in-term and post-term covenants against competition must be 'reasonable' to be enforceable, but courts generally have applied less scrutiny in evaluating the reasonableness of in-term covenants.").

specified period in a specified area.[110] As a result, the states that restrict or prohibit covenants against competition tend to focus on post-term covenants.

As with in-term covenants, post-term covenants have the same definitional issues that can lead to disputes: Who is covered, what is covered, and what is "competition." From the franchisee's perspective, however, the bargaining power gained by the very existence of a post-term noncompete is unnecessarily large. This is because the remedy for the violation of a noncompete can be draconian: An injunction prohibiting all business activities during the pendency of the dispute. At the expiration of the franchise, the mere threat of an injunction by the franchisor may be sufficient to scare the franchisee into operating a different business. The cost of litigating an injunction, coupled with the consequence of losing (and essentially having to shutter a business indefinitely and lose the capital invested in establishing it) are risks that are often simply too much to bear, even if the franchisee believes itself to be in the right. Franchisors view this as a necessity, however, as it preserves their ability to protect market share and retain as much of the franchise's goodwill as it can, and provide additional contractual rights to protect its trade secrets.

One other common franchisee complaint about post-termination noncompetes is that franchisors engage in selective enforcement of the provisions.[111] Most courts addressing the issue have held that a franchisor owes no obligation to existing franchisees to enforce post-termination noncompete clauses.[112] But the fact remains, where the agreement contains a post-termination noncompete, if the franchisor does not regularly enforce that provision following termination, the provision's very existence can cause conflict with remaining franchisees who believe they are injured by a terminated franchisee's competition. Moreover, some jurisdictions prohibit discrimination between franchisees in the application of the franchisor's discretion under the franchise agreements, which can also lead to disputes.[113]

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[110] The franchisor would argue that this is not the case; to the contrary, anyone in the world other than the expiring franchisee is capable of competing after the expiration of the term. A post-term covenant is intended to prevent the franchisee from converting the local good will gained through the operation of the franchised business and the locational good will which has attached to the premises (which the franchisor wants for itself) to his or her personal benefit. That risk is diminished or extinguished when the franchisor has been given the opportunity to resell the territory to a new franchisee. For a further discussion of locational goodwill and the parties' ownership rights to it, *see infra* section IV.C.2.

[111] Dance & Sentell, *supra* note 93.

[112] Craig Tractenberg, Jean-Philippe Turgeon & Stéphanie Destrempes, *The Franchisor's Duty to Police the Franchise System*, 36 FRANCHISE L.J. 87 (2016); Canha v. LaRoche, No. CA 955110, 1996 WL 1186959 (Mass. Sup. Ct. Aug. 12, 1996); Shoney's, Inc. v. Morris, 100 F. Supp. 2d 769 (M.D. Tenn. 1999).

[113] *See, e.g.,* WASH. REV. CODE § 19.100.180(2)(c) (making it an unfair or deceptive act or practice for a franchisor to "discriminate between franchisees . . . in any other business dealing. . ."). While a franchisor can escape liability by showing that the discrimination is not between franchisees that compete for the same customers, that can become problematic if the specific issue is related to competition, and leads to litigation. *See generally* Douglas C. Berry, David M. Byers & Daniel J. Oates, *State Regulation of Franchising: The Washington Experience Revisited*, 32 SEATTLE U. L. REV. 831, 879−80 (2009) (discussing scope and limitations on Washington's anti-discrimination protections contained in the Franchise Investment Protection Act); *see also* Armstrong v. Taco Time Int'l, Inc., 30 Wash. App. 538, 635 P.2d 1114 (1981) (holding that franchisor did not violate anti-discrimination provision in enforcement of noncompetition covenant because covenants were executed during different time periods and was otherwise reasonable); Precision Enters., Inc. v. Precision Tune, Inc., Bus. Franchise Guide (CCH) ¶ 10,472 (W.D. Wash. Oct. 4, 1993) (holding that selective enforcement of noncompete provision was based on rational business decisions and thus not discriminatory); *see also* Deutchland Enters., Ltd. v. Burger King Corp., 957 F.2d 449 (7th Cir. 1992).

3. Geographic/Temporal Scope of Non-competes

Putting aside the definitional difficulties with franchise agreement noncompetes, most court cases analyzing the reasonableness of a noncompete focus on two other issues: the geographic and temporal scopes of the provision.

While the reasonableness (and by extension enforceability) of the geographic scope of a restriction may depend on whether it is an in-term or post-term covenant,[114] one thing is certain, the broader the scope, the less likely the provision is to be enforceable. As a result, many franchisors have begun to limit the geographic range of the provision to increase the likelihood of enforcement. Some agreements merely prohibit competition in the franchisee's former territory.[115] Others prohibit competition only within certain states, territories, or countries.[116] Still others impose a limitation on any competition within a specified radius around any franchised location of the franchisor.[117] And some continue to take the position that the noncompete can be applied anywhere, regardless of location.[118] Presumably the latter provision is intended to apply worldwide, even in territories where the franchisor does not do business. This may seem like an obvious overreach, but even seemingly more restricted definitions can have wide ranging application. For example, in franchised systems with thousands (if not tens of thousands) of outlets, requiring a location that is more than ten miles away from an existing franchised business may be difficult outside of remote unpopulated areas like the South Georgian Islands or Siberia, and effectively mean there are no financially viable alternative locations where a business can operate. Franchisors that wish to enforce these provisions should take care not to demand too much, as a court's invalidation of a noncompete (especially in jurisdictions that do not have the blue pencil rule)[119] would remove all restrictions on competition, including core protections which might have survived by themselves.

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[114] Comedy Club, Inc. v. Improv Assocs., 553 F.3d 1277 (9th Cir. 2009) (upholding noncompete provision in part, to the extent it applied during the term of the agreement, and only for those counties in which the franchisor operated a competing location, not nationwide); Dayton Time Lock Serv., Inc. v. Silent Watchman Corp., 52 Cal. App. 3d 1, 6 (1975) (upholding a noncompete against a franchisee/dealer for the duration of the franchise period, but not for the ten year post-term period); *see also* Steamatic Franchise Disclosure Document at 123−24 (July 13, 2017) (imposing noncompete in the entire United States during term of the franchise agreement, while restricting noncompete to the former franchised territory for the post-term noncompete).

[115] Steamatic Franchise Disclosure Document at 124 (July 13, 2017).

[116] Steamatic Franchise Disclosure Document at 123−24 (July 13, 2017).

[117] Novus Glass Repair & Replacement Franchise Disclosure Document at 166 (issued Apr. 28, 2020) (restricting competition within ten miles of any existing franchised location within the United States); Hertz Franchise Disclosure Document at 187 (issued Mar. 31, 2020) (restricting competition within ten miles of any existing franchised location anywhere, or locations operated by Hertz or its affiliates).

[118] Face Foundrie Franchise Disclosure Document at 80 (issued May 15, 2020) (preventing owning or participating in a competitive business during the term of the franchise agreement "regardless of location.").

[119] The "Blue Pencil" doctrine is a legal principle sometimes employed by the courts to revise otherwise overly broad restrictive covenants to make them enforceable. Barbara A. Bagdon & Mary M. Kellerman, *When Will Courts Issue Preliminary Injunctions to Enforce Restrictive Covenants in Franchise Agreements?*, 28 FRANCHISE L.J. 141, 147 (2009). Most states allow courts to modify restrictive covenants in this way. *Id.* at 147 n.89 (identifying the following states as those that allow for blue penciling of otherwise overly broad restrictive covenants: Alabama, Alaska, Delaware, District of Columbia, Florida, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, New Hampshire, New Jersey, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Washington, West Virginia, Wisconsin, and Wyoming). Other states construe restrictive

Courts also heavily scrutinize the temporal limitations of post-term noncompetes, perhaps even more so than geographic limitations. Historically, post-term noncompetes often extended for many years, if not decades, as franchisors tried to maximize their ability to protect the franchise system from former franchisees. Courts have not been kind to these overbroad restrictions.[120] Perhaps based on these adverse court rulings, in the authors' review of recent FDDs, those restrictions have been reined in substantially. Most franchise agreements apply only a one to two year limitation on post-term noncompetes.[121]

C. <u>Intellectual Property</u>

The temporary transfer of intellectual property is a fundamental aspect of franchising. Franchisors have a clear interest in preserving the value of their intellectual property, and in keeping the transfer temporary. Some intellectual property rights are protected by statutes, such as the Lanham Act and state trade secret laws, but others are mainly protected contractually. This section discusses franchise agreements' treatment of intellectual property.

1. <u>Trade secrets and Confidential or Proprietary Information</u>

In addition to a license to use the franchisor's trademarks, most franchises also offer access to information or a system developed by the franchisor which provides more or less guidance for operating the franchised business. Franchise agreements generally refer to this as "confidential information" and define it broadly:

> "Confidential Information" means any non-public information related to the System or information that, by its nature, would reasonably be expected to be held in confidence or kept secret. Without limiting the definition of "Confidential Information," all the following will be conclusively presumed to be Confidential Information whether or not we designate them as such: (i) the Standards and Manuals; (ii) pricing information and models; (iii) materials describing our franchise network and System; (iv) plans, layouts, designs and specifications for a prototypical Business; (v) our methods of preparing and serving Approved Products, including Recipes; (vi) our sources (or prospective sources) of supply and all our Approved Suppliers; (vii) our training materials; (viii) our marketing plans and development strategies; (ix) this Agreement and any related schedules, exhibits, attachments, or addenda and all items contained therein; (x) Customer

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covenants more strictly, either only allowing specific language to be stricken, or otherwise simply refusing to enforce overbroad provisions. Bagdon & Kellerman, *supra* at 147.

[120] Darton Envtl., Inc. v. FJUVO Collections, LLC, 332 F. Supp. 3d 1022, 1029 (W.D. Va. 2018) ("The non-compete purports to be in effect for ten years. . . Plaintiff points to no contracts of this length that have been upheld."); Pure Power Boot Camp, Inc. v. Warrior Fitness Boot Camp, LLC, 813 F. Supp. 2d 489, 507 (S.D.N.Y. 2011) ("Courts have consistently held non-compete provisions of this duration [ten years] unreasonable and, therefore, unenforceable.").

[121] Steamatic Franchise Disclosure Document at 124 (July 13, 2017) (two years); Novus Glass Repair & Replacement Franchise Disclosure Document at 166 (issued Apr. 28, 2020) (two years); Comfort Keepers Franchise Disclosure Document at 221 (issued Nov. 27, 2019) (two years); Crawlspace Ninja Franchise Disclosure Document at 91 (issued Mar. 5, 2020) (two years); Gymboree Franchise Disclosure Document at 134 (issued Aug. 30, 2019) (two years); H&R Block Franchise Disclosure Document at 232 (issued July 29, 2019) (two years); Hertz Franchise Disclosure Document at 187 (issued Mar. 31, 2020) (one year); Great Clips Franchise Disclosure Document at 208 (Mar. 30, 2020) (one year).

> Information (as defined in Section 15.3 (Customer Information), whether collected by you, us or our affiliates, or a third party; and (xi) other information we give you, except where such information is a Trade Secret (defined below).[122]

Many franchise agreements do not, as this example does, treat trade secrets as a distinct category. The Uniform Trade Secrets Act, currently adopted by forty-seven states, defines trade secret as:

> [I]nformation, including a formula, pattern, compilation, program, device, method, technique, or process, that:
>
> (1) Derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and
>
> (2) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[123]

The federal Defend Trade Secrets Act's definition is similar.[124]

As acknowledged by the sample provision above, most franchise systems include information which does not satisfy all the elements of trade secrets. Such information clearly exists along a continuum ranging from information which "might" qualify as trade secret through information which is confidential but has no objective economic value or which is neither secret nor widely known to information which is widely available. The further from *trade secret* along the continuum the information sits the more its "protection" depends on its having been defined as "confidential." Overbroad definitions of confidential information begin to foster restraints of trade rather than protection of property.

The definitions of confidential information in franchise agreements could be narrowed without harming the franchisor or the system, and should be. First, some states will only enforce confidentiality provisions as applied to trade secrets. Others will protect non-trade secret confidential information to varying degrees. Writing to the strictest states' standards would provide for more uniform treatment of franchisees and ex-franchisees. And, the inclusion of information which is obviously not secret within the definition of confidential information may weaken the arguments for enforcement. The example above defines the franchise agreement itself and "other information we give you" as confidential. The inclusion of similarly non-secret information, such as "any information" learned as a result of the defendant's employment, can render the definition overbroad and "makes the confidentiality covenant unenforceable."[125] A carefully tailored confidentiality provision should seek to protect only that information which is actually secret and has demonstrable economic value, and was developed by the franchisor. Such a provision will be fairer to former franchisees and more likely to be enforced if violated.

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[122] Jamba Juice 2019 franchise agreement, § 15.1.

[123] *See, e.g.,* CAL. CIV. CODE § 3426.1.

[124] 18 U.S.C. § 1839(3).

[125] Orca Commc'ns Unlimited, LLC v. Noder, 233 Ariz. 411, 417 (Ct. App. 2013), decision aff'd and ordered depublished, 236 Ariz. 180 (2014) [quoted section not depublished].

In addition, franchisees argue that designation of information the franchisee learns or creates through its efforts operating the business as the franchisor's confidential information or property is unfair. Much in the same way that parties dispute the ownership of locational goodwill, customer information gathered during interactions with individual customers is not inherently the franchisor's exclusive property. It is often developed due to a combination of the franchisor's system or trademarks and the franchisee's work, personality, and individual contributions to the business. Franchisees therefore contend that such information should not be appropriated by the franchisor without compensation. A reasonable compromise might provide that customer information derived from the franchisee's interaction with the customers is the joint property of both parties.

2. <u>Goodwill</u>

Goodwill has been succinctly defined as "the sum total of those imponderable qualities which attract the custom of a business, what brings patronage to the business."[126] A business's goodwill includes its trademark, in addition to other intangibles.[127] The goodwill associated with a trademark is thus the trademark's power to bring patronage to the business. Franchisors own the trademarks, and the goodwill which is inseparable from the trademarks, and retain that package when franchise agreements end. But that does not include all the goodwill associated with the franchisee's business.

There are types of goodwill which are not inseparable from the trademarks which many franchise agreements seek to appropriate for the franchisor. The trademark's inseparable goodwill can be defined as the custom the trademark attracts to a new location, or as the reduction in business when a former franchisee remains in a competing business under different marks. "The franchisee—by investing his or her time, effort and capital—generates local goodwill, further bolstering the reputation of the national product or service."[128] At least one court has pointed out that state franchise relationship statutes are an attempt to prevent franchisors from unfairly appropriating franchisees' local goodwill without compensation.[129] In addition, some franchise agreements presume the existence of locational goodwill, which remains attached to the specific address which had been associated with a trademark after the association ends. Through non-compete provisions and conditional lease assignments franchisors try to appropriate these types of goodwill which are not inherently tied to the trademark. One way of avoiding this problem—and separating out the goodwill of the mark from the location, might be the elimination of post-term

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[126] Boe v. Comm'r, 307 F.2d 339, 343 (9th Cir. 1962).

[127] Philip Morris Inc. & Consol. Subsidiaries v. C.I.R., 96 T.C. 606, 634 (1991), *aff'd sub nom.* Philip Morris Inc. v. Comm'r, 970 F.2d 897 (2d Cir. 1992). *See also* Nestle Holdings, Inc. v. Comm'r, 70 T.C.M. (CCH) 682 (T.C. 1995), *aff'd in part, rev'd in part,* 152 F.3d 83 (2d Cir. 1998), and *supplemented,* 80 T.C.M. (CCH) 829 (T.C. 2000) ("[T]rademark-associated goodwill [does not encompass] the entire goodwill of a company.").

[128] LaGuardia Assocs. v. Holiday Hosp. Franchising, Inc., 92 F. Supp. 2d 119, 125 (E.D.N.Y. 2000). *See also* E.S. Bills, Inc. v. Tzucanow, 38 Cal. 3d 824, 835 (1985) (holding that"[t]he franchisee, as it has been recognized, develops goodwill for the franchise through the investment of his time, labor, and money."). *See also*, Milsen Co. v. Southland Corp., 454 F.2d 363, 366 (7th Cir.1971). Not surprisingly then, the franchisee's interest in the goodwill of its franchise in its own locality has achieved recognition under the common law. *See, e.g.,* Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598, 601–602 (1973) cert. den. 415 U.S. 920 (1974). Similarly, some statutes provide protection. *See, e.g.,* CAL. BUS. & PROF. CODE § 20000 et seq.; CAL. CORP. CODE §§ 31101, 31119, 31125.

[129] *LaGuardia Assocs.,* 92 F. Supp.2d at 125−26.

noncompetes. Franchisees argue that competition by an ex-franchisee not using the franchisor's trademarks, trade secrets, or confidential information developed by the franchisor does not deprive either party of the goodwill it created.

Ultimately, however, the fact that locational goodwill is not a protectable aspect of a trademark is clear: Without a conditional lease assignment or other contractual right, the trademark owner cannot prevent the operation of a competing business in a location previously associated with its trademark. Similarly, without an enforceable non-compete agreement, a franchisor cannot prevent a former franchisee from remaining in a competing business which does not use the franchisor's trademarks or protectable intellectual property.

Franchise agreements consistently differentiate between the franchisor and the franchisee: Franchisees and franchisors are independent entities,[130] who have their own employees, and make their own decisions. Franchisees cannot enter into agreements on behalf of, or otherwise obligate their franchisor.[131] And a franchisee must typically acknowledge that its success will mainly be due to its own efforts.[132] Nonetheless, by defining goodwill over broadly, franchisors may be able to practically appropriate the benefits of the franchisees' investment. This is because at the end of a franchise relationship, the franchisor retains exclusive ownership of the trademarks, including the benefit of any additional attractiveness to consumers—goodwill—the franchisee's labor and investment has contributed. The franchisor is free to use or license the trademark anywhere, and benefit from its goodwill. The franchisee receives no compensation for the value it has added—it ceases benefitting from a trademark when it loses the right to use it. The personal relationships which are separable from the trademark—local goodwill—are not transferable to the franchisor. They must either be used by the former franchisee or their value is lost. Franchisees believe that franchisors' efforts to prohibit former franchisees from using this value is punitive and unfair. At the end of a franchise relationship, franchisees should either be fairly compensated for the local goodwill their efforts have created or permitted to continue to benefit from it.

Franchisors obviously will balk at the payment of anything for goodwill that they believe is generated by their brand. And anything more than the likely *de minimus* payments that might be offered will prompt disputes. But there may be a compromise solution. Some state laws require payment for locational goodwill upon nonrenewal of a franchise relationship, if the franchisee has not been provided sufficient advance notice to sell or wind-down the business.[133] By eliminating post-term noncompete provisions, relying on legal protection of trademarks and trade secrets, and drafting clear renewal provisions that give ample notice at the end of the term, the parties would be able to set expectations and provide compensation.

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[130] "You and we understand and agree that this Agreement does not create a fiduciary relationship between you and us. You have no authority, express or implied, to act as agent of us or any of our affiliates for any purpose. You are, and shall remain, an independent business owner responsible for all obligations and liabilities of your Business and for all claims or demands . . . resulting from the operation of your Business." Massage Envy Franchise Agreement 2016.

[131] "You have no authority, express or implied, to act as agent of us or any of our affiliates for any purpose. You are, and shall remain, an independent business owner responsible for all obligations and liabilities of your Business and for all claims or demands based on injury, illness or death of any person or persons, directly or indirectly, resulting from the operation of your Business." Jamba Juice Franchise Agreement 2019.

[132] *See, e.g.*, acknowledgment quoted *supra* Section III.D; *see also supra* note 78.

[133] WASH. REV. CODE § 19.100.180(2)(i); *see also* CAL. BUS. & PROF. CODE § 20025(a).

V. DISPUTES

No dispute is as juicy as a dispute over the dispute resolution terms of a franchise agreement. Parties that are spoiling for a fight are quick to fight over the terms of the engagement. Often the *way* the battle lines are drawn is just as decisive of the outcome as the way the battle ultimately unfolds. So parties to the franchise agreement should take care in the manner in which they draft the way they plan on resolving disputes. By investing time in advance of executing the agreement, the parties are best positioned to reach a reasonable resolution that fairly adjudicates disputes.

A. Arbitration

Federal and state laws establish the primacy of arbitration over traditional litigation, in cases where the franchise agreement requires arbitration. Among franchise lawyers, many support arbitration, and a goodly number dislike the device. As a general rule, franchisee lawyers more often dislike arbitration: their reasons include the significant up-front costs to file, the lack of a jury, and franchisors' perceived "repeat player" advantage. Franchisors have sometimes written their arbitration clauses in ways calculated to raise these barriers and thereby deter claims.

In *Rodriguez v. Tropical Smoothie*,[134] an Ohio man, Rodriguez, bought a Tropical Smoothie franchise from a Florida franchisor. The sale was induced by the fraudulent representations of another Ohio franchisee, who was paid a brokerage fee in connection with the sale. The business failed and Rodriguez filed suit in Ohio for violation of the Ohio Business Opportunity Act. The franchisor moved for dismissal because the agreement required that disputes be arbitrated in Atlanta. In his defense, Rodriguez argued that the arbitration clause was unconscionable, because it required three arbitrators, that the process occur in a distant location, and most importantly, that the contract required Rodriguez to pay the full initial cost of the proceeding up front, with the understanding the franchisor would reimburse it half if Rodriguez prevailed. Rodriguez was insolvent, and had only managed to obtain counsel on the basis of a contingency fee. Rodriguez argued that the requirement to pay 100% of the cost of the arbitration would essentially require him to pay about $50,000 to initiate his claim, and that this was grossly unfair.

The district court decided it was necessary to prove both substantive and procedural unconscionability to invalidate the arbitration clause. The court agreed that the arbitration clause satisfied the requirement of substantive unconscionability, because it required Rodriguez to pay 100% of the arbitration costs as a condition of his bringing suit. But despite Rodriguez' arguments about the unfairness of the signing process, as necessary to establish procedural unconscionability, the court ruled that procedural unconscionability could never be established where the franchisee did not hire an attorney, and admitted he did not read the arbitration clause before purchasing the franchise. Despite arguments that many people sign contracts without reading them (e.g., software license agreements, insurance contracts, cellphone contracts), the court stated that franchise agreements were different, and would be held to a higher standard. The Sixth Circuit Court of Appeals subsequently affirmed without an opinion.

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[134] Rodriguez v. Tropical Smoothie Dev. Corp., 3:11-cv-359, 2012 U.S. Dist. LEXIS 750 (2012). Stanley M. Dub represented the plaintiff in the *Rodriguez* case.

The *Rodriguez* rationale can be extended beyond arbitration arguments, to cases seeking to avoid any franchise agreement term as unconscionable. The court did not cite any support for its decision to hold franchise agreements to a higher standard than other agreements, and as many as half of all franchise buyers are believed to sign their agreements without consulting an attorney. These circumstances support the need for franchisors and their attorneys to self-regulate and strive to eliminate unreasonable provisions from their agreements.

As noted below, different factors can be used to raise barriers to bringing claims, beyond just mandating that claims be arbitrated. But opportunities of this sort also arise within the arbitration requirements themselves. Arbitration clauses sometimes require use of a panel of several arbitrators, typically three, and may also impose mandatory qualifications on the arbitrators themselves, for example, that they be experienced franchise lawyers. These requirements may seem reasonable and even appropriate on their face. But they have the potential to drive up the cost of the procedure, or even diminish the ability to locate qualifying arbitrator candidates.

To start an arbitration procedure, it is necessary to first contact the administering agency, often the American Arbitration Association, and pay the administrative fee associated with bringing the claim. In a typically-sized franchise dispute, that might come to $3,000. The administrator then provides the parties with CVs for the arbitrator candidates it suggests, each of which lists the arbitrator's hourly rate. Once the arbitrators are selected, the administrator asks how long the parties think the procedure will run, and how much arbitrator time will be required. If there is an imbalance between the parties in terms of financial resources, the party with deeper pockets may use this opportunity to drive up costs by exaggerating the time it expects will be required. Assuming three arbitrators at an average hourly rate of $300/hr, the expected cost for only the arbitrators and the administrator would be $21,000 if the proceeding required twenty hours of arbitrator time, but would be $75,000 if the proceeding was said to require eighty hours of arbitrator time. Typically, each party would be required to pay half of this estimate in advance, as a condition of scheduling the procedure.[135] Imposing mandatory qualifications on the arbitrators could drive the cost of arbitration even higher, by limiting the pool of qualified arbitrators.

The authors believe that neither side in a franchise dispute is interested in the extensive costs associated with multiple arbitrators at far-flung jurisdictions. Accordingly, there is likely grounds for compromise on a reasonable arbitration provision, as discussed more below.[136]

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[135] *See, e.g.,* JAMS Comprehensive Arbitration Rule 31(a) ("Each party shall pay its *pro rata* share of JAMS fees and expenses as set forth in the JAMS fee schedule in effect at the time of the commencement of the Arbitration. . . The non-payment of fees may result in an administrative suspension of the case in accordance with Rule 6(c)."), https://www.jamsadr.com/rules-comprehensive-arbitration/#Rule-31. It is not unusual that the franchisee fails and refuses to make the required payment, and as a result, franchisors are frequently required to pay both halves of the arbitration fees in order for the proceeding to move forward. Consequently, the requirement that the franchisee pay half the arbitration costs is not always the burden claimed by franchisees in cases initiated by the franchisor. That is, until the franchisor prevails. *See, e.g., id.* at 31(c) ("In the event that one Party has paid more than its share of such fees. . . the Arbitrator may award against any other Party any such fees. . . that such Party owes with respect to the Arbitration."). That does not, however, eliminate concerns about the cost of proceeding with arbitration in matters initiated by the franchisee.

[136] *See* discussion *infra* section VI.B.

B. Liquidated Damages

A significant proportion of franchise agreements contain liquidated damages provisions.[137] Generally, a liquidated damages provision will be enforceable if (1) it appears that the parties intended to liquidate damages; (2) at the time of contracting, the amount of damages specified was a reasonable estimate of the presumed actual damages that would result from a breach; and (3) at the time of contracting, it was difficult to ascertain the amount of damages that would result from a breach of the agreement.[138] Liquidated damages provisions are more likely to be considered reasonable if damages would be more difficult to ascertain.[139] But in any case, the amount of the damages must be reasonably proportional to the amount of probable damage from the breach.[140] In the event that the liquidated damages set in the agreement are not reasonably proportionate to the probable damages from the breach, the court may well deem the provision to be an unenforceable penalty.[141]

As a result of these rules[142] the language in franchise agreements is often tailored to address these concerns. A review of various FDDs reveals that franchisors take into consideration factors such as (1) when the provisions apply; (2) how the damages will be calculated; and (3) for what period of time. Due to the vagueness of these considerations, there is a wide breadth of permutations of these factors.

For example, with respect to the question of "when" these provisions apply, some franchise agreements impose them on early termination by either party, some only following termination by the franchisor, and some only on termination for cause. As to how the damages are calculated, that also varies significantly. Some liquidated damages are calculated based upon average monthly royalties over the past twelve to twenty-four months, or if no operations during

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[137] Based on the authors' review of dozens of FDDs and Franchise Agreements in connection with the drafting of this paper (admittedly unscientific and anecdotal), about half or fewer franchisors seem to have a provision in their agreements providing for the award of liquidated damages under some circumstances.

[138] Deborah S. Coldwell, Altresha Q. Burchett-Williams & Melissa L. Celeste, *Liquidated Damages*, 29 FRANCHISE L.J. 211 (2010).

[139] Benjamin B. Reed, *Liquidated Damages Provisions: Strategic Drafting and Enforcement Issues*, 37 FRANCHISE L.J. 523, 524 (2018).

[140] *Id.* (citing Meyer Ventures, Inc. v. Barnak, No. Civ A. No. 11502, 1990 WL 172648, at *5 (Del. Ch. Nov. 2, 1990)).

[141] State law varies on whether and to what extent a liquidated damages provision is an unenforceable penalty. *See, e.g.,* Reed, *supra* note 139 at 524. Generally, factors that are considered include (1) whether liquidated damages provisions are presumptively enforceable or unenforceable; (2) whether the reasonableness of the estimate of damages is judged based on reasonableness at the time of contracting or at the time the provision is to be enforced; (3) the role actual damages play in determining the reasonableness of the estimate; and (4) what factors courts will consider in deciding whether or not the provision constitutes an unenforceable penalty. *Id.* at 524−25.

[142] To be clear, there is no one set of rules for the enforcement of liquidated damages provisions. The rules vary substantially by jurisdiction, and liquidated damage provisions are unenforceable in some states. *See, e.g.,* Reed, *supra* note 139 at 547 n.103; *see also* THE ANNOTATED FRANCHISE AGREEMENT *supra* note 36 at § XXVII(B) (noting that liquidated damages provisions are unenforceable in Minnesota and North Dakota).

that entire span, during the period the franchisee actually operated. And as for what time period, the franchise agreements typically apply the average royalty payment over a set period of time (twelve months, twenty-four months, or thirty-six months) or a lesser period if the remaining term is less than the set term. The amount calculated based on the time period is usually then due in full in a specified period of time (30-180 days following termination).

As a practical matter, liquidated damages provisions in franchise agreements need to be flexible and tailored to the specific franchise system in question.[143] Accordingly, deciding what constitutes a reasonable liquidated damages provision will vary from system to system, based on franchisee operations and the likelihood of the estimate representing a reasonable forecast of harm. Franchisees regularly complain that liquidated damages provisions are rarely negotiated and one-sided.[144] As such, the *reasonable estimate* is often if not exclusively the franchisor's calculation of damages. In the event of a dispute, if the estimate included in the agreement is not based on some actual data or information that supports the conclusion that the harm is likely to occur and cause injury, then the franchisee will be in the position to contend that the provision is not a reasonable estimate of loss, and instead an unenforceable penalty.

Similarly franchisees also often contend that the very concept of a liquidated damages provision is improper in most franchise systems, as most established franchisors have access to a wealth of data about franchisee business operations and revenue. Thus, the idea that damages in the event of breach will be difficult to calculate is not supported by the reality of the parties' relationship. Furthermore, most liquidated damages call for the payment of lost revenue rather than lost profits, which franchisees contend is the more appropriate measure of damages. A counter to this argument is that the higher amount includes compensation for the intangible injury to the mark caused by an early termination and (if applicable) the vacancy in a territory for the brand. But in reviewing franchise agreements, the authors found that most liquidated damages provisions do not calculate loss based on perceived injury to the mark; rather, they focus their calculations on lost royalties, which are much simpler to calculate. Better drafting of these provisions to tie the intangible and difficult-to-calculate loss to the liquidated damages amount might better avoid these arguments.

With one exception,[145] all of franchise agreements reviewed by the authors that had liquidated damages provisions called for payment of average monthly gross royalties for a period of less than thirty-six months following termination. Most provisions referred to liquidated damages equal to the average monthly royalty (calculated based on the trailing twelve or twenty-four months, or whatever operational time existed) for less than thirty-six months, with most being

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[143] "What constitutes reasonable compensation for one system will differ for another." THE ANNOTATED FRANCHISE AGREEMENT *supra* note 36 at § XXVII(B).

[144] Franchisors have the right to elect their chosen remedy. Should liquidated damages be insufficient to remedy the harm caused by the franchisee's conduct, there is nothing that prevents a franchisor from seeking the full measure of its damages. And franchisors often choose to do so where the harm is provable. *See, e.g.,* Findings of Fact and Conclusions of Law, Alpha Omega Home Health Care, Inc. v. Nurse Next Door Home Healthcare Servs. (USA), Inc., No. 16-2-07685-8, No. 78, (Wash. King Cnty. Sup. Ct. Oct. 12, 2017) (awarding franchisor contract damages following bench trial instead of liquidated damages based on evidence submitted at trial supporting larger damages award). Be careful what you wish for. Daniel J. Oates of Miller Nash Graham & Dunn, LLP represented Nurse Next Door in this case.

[145] *See* Burgerim Franchise Disclosure Document at 166 (issued Apr. 19, 2019) (calling for payment of liquidated damages throughout the remainder of the franchise term, which could be as long as ten years).

in the range of twelve to twenty-four months. This likely is (and should be) a reflection of the different time periods that the franchisor anticipates it will take to sell a new franchise in the terminated territory or region. To avoid disputes, the cautious franchisor should explain to prospective franchisees up front why the liquidated damages provision is necessary and why it represents a reasonable estimate of loss given all of the foregoing factors. In most instances, however, due to information imbalances and franchisors' *take it or leave it* posture, this provision is rarely, if ever, discussed or negotiated.

C. Damages Limits

The converse of liquidated damages are the damage limits by which franchisors try to protect themselves and limit their potential liability under the franchise agreement. Sometimes those limits are directed at preventing claims by third parties based on the franchisee's conduct.[146] Other times those limits are designed to reduce direct claims by the franchisee against the franchisor, by prohibiting or limiting the amount of claims for punitive,[147] exemplary, consequential,[148] or incidental[149] damages. More specifically, franchise agreements sometimes have waivers of damages arising out of the franchisee's use of products or software required for the system.[150] In general, these limitations are enforceable.[151]

Franchisees contend that these provisions are one-sided, and focused only on the kind of (mis)conduct by the franchisor that could give rise to substantial claims (fraud, etc.). To underscore the disparity in the provisions, it is not uncommon for franchisors to carve out trademark claims from the exemplary damages prohibition, thereby preserving their right to seek treble damages under the Lanham Act for franchisees' misuse of the marks.[152] While franchisees would prefer to have these provisions removed from franchise agreements in their entirety,[153]

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[146] Am. Poolplayers Ass'n Franchise Disclosure Document at 107 (issued Mar. 25, 2020) ("You acknowledge and agree neither APA nor any Sponsor will be liable for any debt, obligation, or damages to person or property directly or indirectly arising out of your operation of the Franchised League, whether caused by your negligent or willful action, failure to act or otherwise.").

[147] *Id.* at 127; *see also* Once Upon a Child Franchise Disclosure Document at 122 (issued Mar. 16, 2020).

[148] Papa Murphy's Franchise Disclosure Document at 277 (issued Mar. 27, 2020) ("The parties hereto and each of them EXPRESSLY WAIVE(S) ANY CLAIM FOR PUNITIVE, MULTIPLE, CONSEQUENTIAL AND/OR EXEMPLARY DAMAGES. . .").

[149] Playa Bowls Franchise Disclosure Document at 132 (issued Apr. 13, 2020).

[150] Once Upon a Child Franchise Disclosure Document at 131 (issued Mar. 16, 2020) (waiving consequential and incidental damages arising out of franchisee's use of software).

[151] W. MICHAEL GARNER, FRANCHISE & DISTRIBUTION L. & PRAC. § 356 (1990); Choice Hotels Int'l, Inc. v. Chewl's Hospitality, Bus. Franchise Guide (CCH) ¶ 12,271 (4th Cir. 2003); TES Franchising LLC v. Feldman, 943 A.2d 406 (Conn. 2008); Stanley A. Klopp, Inc. v. John Deere Co., 510 F. Supp. 807 (E.D. Pa. 1981).

[152] Papa Murphy's Franchise Disclosure Document at 277 (issued Mar. 27, 2020) (noting after the carve out that "except that we shall be free to bring an action for willful trademark infringement, and if successful, to receive an award of multiple damages as permitted by law.").

[153] *See, e.g.,* Lagarias & Kushell, *supra* note 81.

given the court's willingness to enforce them,[154] it is unlikely that franchisors are inclined to ever give up on liability limitations in franchise agreements.

D. <u>Contractual Statutes of Limitations</u>

Many franchise agreements contain contractual statutes of limitations which shorten the amount of time within which a party (one or both, depending on how the provision is drafted) may bring a claim against the other.[155] Courts generally enforce these provisions, so long as they are reasonable.[156] A very basic contractual limitation is as follows:

> Neither party may bring an action or maintain an arbitration against the other party unless the party files the action or arbitration within one year after the event complained of occurs.[157]

The foregoing provision would prevent any claim, regardless of the claimant's knowledge of the facts giving rise to the claim, if the action is not initiated within one year. This language would prevent many fraud claims to the extent they remain hidden or unknown, but it provides absolute certainty as to the time limit for bring claims. It also may leave the franchisor open to an argument that it is imposing unreasonable and unfair terms, particularly in the context of a fraud claim where the facts giving rise to the claim are hidden from the franchisee. Another example of a simple provision that addresses the overreach concern is as follows:

> <u>Limitations of Claims</u>. Any and all claims arising out of or relating to this Agreement or the relationship among the parties will be barred unless a proceeding for relief is commenced within one (1) year from the date on which the party asserting such claim knew or should have known of the facts giving rise to such claims.[158]

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[154] In many instances, the scope of these provisions may be limited in any event by state law limitations on waiver of franchisee rights under state franchise laws. *See, e.g.,* CAL. CORP. CODE § 31512; CAL. BUS. & PROF. CODE § 20010; MINN. STAT. § 80C.21; WASH. REV. CODE § 19.100.220(2).

[155] Scott G. McLester, Sandy T. Tucker & William Killion, *Statutory and Contract Limitations of Action in Franchising,* INT'L FRANCHISE ASS'N 36TH ANNUAL LEGAL SYMPOSIUM 19 (2003) (noting that out of ninety of the top 100 franchise systems in the U.S. surveyed, thirty-three franchise agreements contained a contractual limitations period); Sandy T. Tucker, *Contractual Limitations of Action Periods in Franchise Agreements*, 24 FRANCHISE L.J. 18 (2004).

[156] B.H. Glenn, Annotation, *Validity of Contractual Time Period, Shorter Than Statute of Limitations, for Bringing Action*, 6 A.L.R. 3d 1197 (1966); Universal Windows & Door, Inc. v. Eagle Window & Door, Inc., 689 N.E.2d 56 (Ohio Ct. App, 1996); Thabet v. Mobil Corp., Bus. Franchise Guide (CCH) ¶ 12,612 (Cal. Ct. App. July 22, 2003); D&K Foods, Inc. v. Bruegger's Corp., Bus. Franchise Guide (CCH) ¶ 11,506 (D. Md. Sept. 30, 1998); Reynolds Indus., Inc. v. Mobil Corp., 618 F. Supp. 419 (D. Mass. 1985). Some states, however, invalidate any provision that purports to limit or modify the statute of limitations. Tucker, *supra* note 155 at 18 n.5 (identifying the following states: Alabama (Ala. Code § 6-2-15); Florida (FLA. STAT. § 95.03); Idaho (IDAHO CODE § 29-110); Mississippi (MISS. CODE ANN. § 15-1-5); Missouri (MO. REV. STAT. § 431.030); Montana (MONT. CODE ANN. §§ 18.1-403, 28-2-708); North Dakota (N.D. CENT. CODE § 9-08-05); Oklahoma (OKLA. STAT. tit. 15, § 215); South Carolina (S.C. CODE. ANN. § 15-3-140); South Dakota (S.D. CODIFIED LAWS § 53-9-6); and Texas (TEX. CIV. PRAC. & REM. CODE ANN. § 16.070).

[157] Comfort Keepers Franchise Disclosure Document at 243−44 (issued Nov. 27, 2019).

[158] Crawlspace Ninja Franchise Disclosure Document at 93−94 (issued Mar. 5, 2020); *see also* Blo Blow Dry Franchise Disclosure Document at 113 (Issued July 10, 2017) ("Any claim concerning the franchised business or this Agreement or any related agreement will be barred unless an action for a claim is commenced within one (1) year from the date on which you knew or should have known, in the exercise of reasonable diligence of the facts giving rise to the claim.").

This provision incorporates discovery rule principles, and would require either party to proceed with claims within one year that the party knew, or should have known, of any claim.

In either case, there are a wide variety of reasons why franchisors may want this type of provision in its franchise agreements. First, it can reduce time on the risk by forcing franchisees to bring claims within a shortened period of time. In some cases, the statute of limitation on a claim can be upward of six years, or more if the discovery rule applies.[159] By implementing a shorter contractual period, the franchisor can limit prospective liability and cut down on risk of loss.

Second, from a practical perspective, "[f]ranchisor(s) operating in multiple states will not likely know the statutes of limitations for each state, and the inclusion of a contractual limitations period removes the need to know these statutes and creates a uniform limitations period for all franchisees" across the system.[160] There is substantial value to having certainty across the entire system, rather than relying on the patchwork of statutes of limitations in various state jurisdictions.[161]

These types of provisions have potential downsides for both parties. If the provision is mutual, like the two listed above, it could force the franchisor to file lawsuits against their franchisees (and vice versa) sooner than they otherwise would choose to in order to preserve their rights. This could force the franchisor's hand with respect to franchisees that are in the midst of performance improvement plans, or otherwise attempting to cure their breaches. Sometimes the added flexibility of working with franchisees to improve is more valuable than the reduced liability afforded by a contractual limitations period. Moreover, if the franchisor is more often the plaintiff in its disputes, it would be actively hindering its ability to pursue claims against franchisees.[162] Similarly, franchisees who might prefer to give the relationship time to improve can be forced to jeopardize it by suing in order to preserve claims they might never have brought under a longer limitation period.

Further increasing the pressure-cooker of the decision-making process is the potential existence of pre-litigation dispute resolution requirements, such as in-person meetings and mediation. Taking these requirements into account can further limit the amount of time to decide whether to pursue litigation. Presumably, the deadlines also incentivize compromise, however, which may explain their inclusion in some franchise agreements.[163]

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[159] Tucker, *supra* note 155.

[160] Tucker, *supra* note 155. Franchisees may not view this as a legitimate rationale, as knowledge of the law is necessarily imputed to the parties, whether or not the franchisor in fact knows the limitations. Atkins v. Parker, 472 U.S. 115, 130 (1985) ("All citizens are presumptively charged with knowledge of the law."). Moreover, franchisors have chosen to do business in multiple jurisdictions, and prudence dictates that they should be on notice of the laws in those jurisdictions (and often already are on notice of the law, as state franchise laws vary widely).

[161] 1-800-Got Junk? LLC v. Superior Court, 189 Cal. App. 4th 500, 514 (2010), *as modified* (Nov. 19, 2010). Bruce Napell of Lagarias, Napell & Dillon, LLP was one of the attorneys for the plaintiff in this case.

[162] Tucker, *supra* note 155.

[163] Franchisees, who are less likely to be familiar with the dispute process, may be impacted by this even more than franchisors. They will need to retain counsel and learn about the process on a shortened timescale.

As a result of the time crunch imposed by a short-fuse limitations period, many contractual limitations provisions contain carve outs that exclude claims for (1) franchisee's non-payment or under payment of amounts owed to the franchisor;[164] (2) trademark claims;[165] and (3) indemnification claims.[166] This grants the franchisor the one-sided ability to reap the benefit of a shorter limitation period on virtually all franchisee claims, while preserving its rights to pursue claims against its franchisees on the types of claims it is most likely to bring under the franchise agreement.[167]

Taken a step further, some franchisors impose unilateral contractual limitations periods, which prohibit the franchisee, and not the franchisor, from bringing claims outside the limitations period.[168] While there is some case law suggesting that a unilateral provision may be enforceable, the specific facts are probably critical to the analysis, and at least one commentator has noted that the enforcement is questionable.[169] Moreover, the type of overreach may discourage franchise sales if franchisees view the unilateral imposition on restriction of claims as unfair and an abuse of the franchisor's bargaining power. At a minimum, franchisees likely want a fair playing field and a provision that is equally applicable to both parties to the agreement.

E. **Venue/Choice of Law**

Franchise agreements typically include provisions selecting which state's law will govern disputes, and dictating the court or location where any suit or arbitration must be brought. Most often, the franchise agreements choose the law of the state and venue in the city where the franchisor has its headquarters.[170] This local forum is obviously more convenient for the franchisor, which might otherwise be required to defend claims in many locations, and it allows the franchisor to use its preferred counsel for most claims. Franchisees would typically prefer to bring any claim in their own locale for similar reasons, but they are typically stuck with the franchisor's choice.

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[164] Hertz Franchise Disclosure Document at 187 (issued Mar. 31, 2020); Orange Theory Franchise Disclosure Document at 132 (issued May 15, 2020).

[165] Mathnasium Franchise Disclosure Document at 133 (issued Mar. 4, 2020); Orange Theory Franchise Disclosure Document at 132 (issued May 15, 2020).

[166] Jimmy John's Franchise Disclosure Document at 183 (issued Apr. 24, 2020); Orange Theory Franchise Disclosure Document at 132 (issued May 15, 2020); Papa John's Franchise Disclosure Document at 179 (issued Apr. 15, 2020).

[167] Tucker, *supra* note 155 at 22 (proposing form language to incorporate into a franchise agreement that carves out franchisor claims related to intellectual property, indemnification, and underreported sales).

[168] Rainbow International Franchise Disclosure Document at 128 (issued Apr. 1, 2020) ("You and your owners and guarantors may not assert any claim or cause of action against us or our affiliates arising out of or relating to this Agreement or your Business after the shortest period of (i) the applicable statute of limitations, (ii) two years and one day following the effective date of expiration or earlier termination of this Agreement or (iii) two years and one day from the accrual of any such claim or cause of action. . .").

[169] Tucker, *supra* note 155 ("While a lack-of-mutuality argument was rejected in *Mobil Oil Co. v. Earhart Petroleum, Inc*., no one can confidently dismiss the possibility that another court in other circumstances might rule differently.").

[170] One franchisor that takes a different approach is Domino's, which selects the state law where the franchisee resides. The Domino's agreement does not dictate the forum for any claims but selects the law of the state where the franchisee is located. Domino's 2018 Franchise Agreement. (Sec. 22.6) ("The terms and provisions of this Agreement shall be interpreted in accordance with and governed by the laws of the State in which the Store is located.").

Some registration states require the franchisor to include a state-specific amendment agreeing to the law and venue of the franchisee's state. In other instances, a franchisee may be able to avoid a contract's choice of law and forum, based on a state law that invalidates an out of state choice of law or forum.[171] An inconvenient forum has also sometimes been cited as the basis for a claim of unconscionability.[172] Further, many state franchise laws provide that their protections cannot be waived.[173]

Putting aside these exceptions, the choices of law and venue included in the agreement by the franchisor have generally been enforced. This has encouraged some franchisors to include increasingly onerous claims procedures, in an apparent attempt to discourage claims from ever being brought. In *Zounds*, the franchise agreement specified Arizona law, franchisees were prohibited from bringing joint claims, and franchisees were required to mediate in Arizona before initiating any claim.[174] Four separate Ohio franchisees nonetheless joined in a suit in Ohio alleging violation of Ohio's Business Opportunity Act. In the course of a pre-trial conference in the Arizona court, franchisees' counsel explored the idea of acceding to franchisor's mediation requirements by agreeing to conduct separate mediations for the four plaintiffs, and asked whether the four separate mediations sought by franchisor could be held on the same day. However, the franchisor refused to conduct the individual mediations consecutively, and insisted that they be conducted on different non-consecutive days, presumably to insure that the four Ohio franchisees would be required to pay for four separate proceedings on four different occasions, thereby multiplying their travel, counsel, and mediator fees. Ultimately, the Arizona court determined that the Ohio statute applied, and that the statute invalidated the Arizona choice of law and venue clauses. The court reasoned further that since the Ohio statute authorized class actions, it also implicitly authorized joint claims and invalidated the contract's prohibition on joint claims. (After transfer back to Ohio, a single mediation was held in Cleveland, and a settlement was reached soon after).

In the past, some franchisors have taken this multi-step claims process even further. Under one franchise agreement for a Texas franchisor, all claims are subject to Texas law and must be arbitrated in Austin, Texas.[175] It also required three arbitrators, and the losing party was obligated to pay the prevailing party's legal fees and costs.[176] Before initiating an arbitration, however, a franchisee must first have a face-to-face meeting with a franchisor official in Austin,

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[171] That was the situation in *Zounds Hearing Franchising, LLC v. Bower*, cv-16-01462, 01465, 01467, 01470 and 00728, 2017 U.S. Dist. LEXIS 151940 (D. Ariz. Sept. 19, 2017), where four Ohio franchisees sued an Arizona franchisor for violation of Ohio's Business Opportunity Act. Stanley M. Dub represented the franchisees in this case.

[172] *See, e.g.,* Nagrampa v. MailCoups, Inc.*,* 469 F.3d 1257 (9th Cir. 2006) (where the franchise agreement required the envelope stuffing franchise buyer in California to travel to Massachusetts to initiate any claim).

[173] *E.g.,* CAL. CORP. CODE § 31512 ("Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void."). Similarly, Michigan requires an addendum which voids out of state venue provisions. MICH. COMP. LAWS § 415.1527(f). If franchisors are serious about wanting a single rule to govern all their franchise agreements then adopting the Michigan rule (at least in states like California with a home venue statute) would seem consistent, because unlike with Michigan franchisees, the California type statutes can result in more litigation over the effect of the venue statute in a particular case.

[174] *Zounds*, 2017 U.S. Dist. LEXIS 151940 (2017).

[175] CMIT Solutions Franchise Disclosure Document at 227−28 (issued Mar. 25, 2013).

[176] *Id.*

and must then conduct a mediation in Austin.[177] The agreement does not specify whether the face-to-face meeting and mediation can be held on the same day, but that would involve scheduling a mediation without knowing whether it would be needed, and presumably that was not intended. Thus, unlike the arbitration provision found unconscionable in *Nagrampa*, which would have required a franchisee was to travel from California to Boston to conduct its arbitration proceeding, the franchisee in this case could be required to make at least two separate trips to Austin as a condition of bringing any action, and at least one more for the arbitration itself.

As a practical matter, franchisors who sell franchises in multiple states are much more likely to have significant contacts with the franchisee's state than the franchisee is with the franchisor's home state. Strictly from a jurisdictional analysis perspective, the franchisor would have a greater expectation of being hauled into court in a state where it sells franchises (i.e., does business) than a franchisee would of being sued in the franchisor's home state. It would be a reasonable compromise for franchise agreements to provide for venue where the franchisee is located, or where the defendant is located (a compromise where the franchise statutes would not void it as applied to a franchisee plaintiff).

VI. PROPOSED COMPROMISE LANGUAGE

A. Post-Expiration Franchise Operations

One issue that is often not addressed in franchise agreements is the operation of a franchised business after the expiration of the scheduled term. Often it is the case that the parties wish to continue their relationship, but due to statutory requirements, or the vagaries of communication, they have failed to document the extension of the relationship properly. The authors propose the following compromise language which preserves both parties' rights under the expired franchise agreement, while simultaneously recognizing the parties' ongoing relationship.

> Permitted Operations After Expiration of Term. If Franchisor allows Franchisee to continue operating the Franchised Business after the expiration of the Agreement without entering into a successor franchise agreement or extension to this Agreement, then the continued operation shall be considered a temporary extension of the term of this Agreement. Either Party may discontinue such extension at any time and for any reason upon thirty (30) days written notice to the other, or upon expiration of any notice period required by applicable law, and in that event, the discontinuation will be considered a nonrenewal of this Agreement and not a termination.

B. Arbitration

As previously discussed, a common concern among franchisees is the fact that arbitration provisions are designed to drive up costs and discourage disputes. Among other things, this includes clauses that force the franchisee to litigate in far-flung jurisdictions, and in front of large panels of arbitrators. Franchisors face an uphill battle in forcing arbitration in jurisdictions other than where the franchise is located in states with statutes that mandate specific forums, and

[177] *Id.*

similarly often do not want to pay the cost of having multiple arbitrators resolve disputes. A proposed common ground provision might provide as follows:

> All disputes, claims or controversies arising out of or relating to this Franchise Agreement, the parties' relationship, or the Franchisee's Franchised Business will be determined by binding arbitration in the state and city in which the Franchised Business is operated. The Parties agree that all issues of arbitrability, including the scope, validity, and enforceability of the arbitration clause, are delegated to the arbitrator and the arbitrator shall have full and complete authority to decide any such issues. The Federal Arbitration Act, not state law, governs the arbitration proceedings, as well as the scope, validity, and enforceability of the arbitration clause. Except as provided by this Agreement, the arbitration shall be conducted and administered by JAMS pursuant to its Comprehensive Arbitration Rules and Procedures before a single arbitrator. If JAMS is no longer in business at the time an arbitration demand is made, the parties agree to conduct their arbitration pursuant to the Commercial Rules of the American Arbitration Association. The parties will keep confidential all matters relating to or arising out of the arbitration and the arbitration award, except as necessary to comply with applicable law. The Franchisor and the Franchisee both consent to the jurisdiction of the arbitrator to resolve all disputes arising out of or related to this Agreement. The parties agree that the arbitrator's award is conclusive, final, and binding, and that there will be no appeals of any awards even if allowed by the Comprehensive Arbitration Rules and Procedures. **THE PARTIES WAIVE ANY RIGHT TO TRIAL BY JURY, EXCEPT WHERE WAIVER IS PROHIBITED BY APPLICABLE FEDERAL OR STATE LAW.**

C. Transfers

The authors do not generally object to limitations imposed on transfers by an individual franchisee, except however, that transfer to an entity wholly-owned by the individual should be permitted if the reason for the transfer is to provide liability protection for the franchisee from third party claims, and the franchisor knew and understood at the time the franchise agreement was executed that the franchisee intended to incorporate an entity to provide such protection. In such a case, the following provision would allow for such a transfer (provided the franchisor does not ordinarily require the execution of a personal guaranty in connection with the execution of a franchise agreement):

> The rights granted to Franchisee pursuant to this Agreement may be assigned or transferred by Franchisee only with the prior written approval of Franchisor. Franchisee must apply to Franchisor for consent to an assignment, which consent shall not be unreasonably withheld. [INSERT CONDITIONS TO CONSENT RELEVANT TO BUSINESS]. Notwithstanding the conditions to obtaining Franchisor's consent set forth in this section, if the Franchisee is an individual, nothing shall prohibit the Franchisee from transferring the Franchise to an entity wholly owned by the Franchisee, provided that the Franchisee agrees to execute Franchisor's standard form of Guarantee for individual owners of Franchisees organized as entities. Any unauthorized assignment is a breach of this Agreement, void, and of no effect.

D. Indemnification

As discussed at length earlier, while franchisees indemnify franchisors broadly for virtually any action taken in the operations of the franchised business, franchisors generally only agree to a limited indemnification that extends to the use or display of the franchisor's trademark. While there are reasons this makes sense (the franchisor cannot exert control over the manner in which the franchisee operates its business without potentially running afoul of vicarious liability and joint employment issues), there are undoubtedly some additional protections that the franchisor can extend to franchisees for claims that arise in connection with the franchisee's compliance with system standards. Below is a proposed indemnity provision that provides additional protections beyond those typically afforded for trademark claims:

> Franchisor will indemnify and hold harmless Franchisee from and against damages; fines; charges; costs; expenses; reasonable attorneys' fees; court costs; settlement amounts; and judgments incurred in connection with any action, suit, proceeding, claim, or demand against Franchisee, arising out of or resulting from claims caused by Franchisee's implementation of any design, method, standard or specification required by the Franchise Agreement or Operations Manual. The indemnification obligations under this section shall not extend to any negligent, reckless, or intentional failure to implement such design, method, standard, or specification in strict conformance to the Franchise Agreement or Operations Manual. Franchisee will promptly give Franchisor notice of any such action, suit, proceeding, claim, or demand filed or instituted against Franchisee and, upon request, will furnish Franchisor with copies of any documents from such matters as Franchisor reasonably may request. Failure to promptly give notice of such claim shall constitute a waiver of any claim for indemnification under this section.

E. In-Term Capital Investments

Under most business format franchise agreements the franchisor can make changes to the system and require the franchisees to comply. As discussed above,[178] because franchise agreements are long lasting contracts, franchisors need some amount of ability to adapt the system to changing market conditions over time. One difficulty this can create is where the franchisor requires changes which impose an objectively large cost on the franchisee. Such difficulty most often arises where the franchisor can require remodeling, renovation, modernizing, or upgrading of a franchisee's business premises. Many franchise agreements which give the franchisor this power, limit it, either simply as to frequency, or in relationship to the previous remodel. Other franchise agreements limit the amount which the franchisee may be required to spend to a specific dollar amount. Because franchises vary enormously, this may require a result-based approach rather than be a one-size-fits-all provision.

For franchisees return on investment is arguably one of the most important metrics for judging a franchise. Ideally, a franchisee will be able to recoup the capital costs of purchasing and opening the franchise soon enough to have several years during the initial term with "net profit" which does not need to be used for loan repayment. If a franchisee is periodically required to inject additional capital to remodel, this lengthens the return on investment timetable. A fair remodeling provision would be both attractive to franchisees and allow the franchisor flexibility to respond to changing conditions.

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[178] *See, e.g., supra* Section III.B.

The provision we suggest strives for this balance. It necessarily depends on factors (thus adjustments) unique to each franchise system, and calculations which many franchisors may not currently make:

> We may require that you significantly remodel or modify your Business Facility from time to time (including altering the appearance, layout, design and/or replacing equipment) to comply with our then current System Standards. However, during the term of this agreement we will not require you to spend a cumulative amount over X% of the initial cost of developing your premises on such remodeling or modification within the first X years of the term of this Franchise Agreement.

VII. CONCLUSION

For ease of administration, franchisors strive for uniformity in their franchise agreements, and this can lead them to resist negotiating changes. This reluctance to make changes is sometimes cited as evidence of a "take it or leave it" attitude by franchisors, and proof that the terms of the agreement are simply imposed by franchisors, and that franchisors have no power to affect changes. Some franchisors address this problem by striving to write a document that anticipates and overcomes many of the common objections expressed by potential franchisees. The authors hope this program will assist drafters of Franchise Agreements in taking this approach. If a franchisor only includes provisions it can defend as reasonable and necessary, it can more easily justify telling a potential franchise candidate that the franchisor is generally not receptive to making changes the candidate may propose.

Indeed, while there is room for reasonable disagreement over the terms of franchise agreements, in many cases there is a reasonable middle ground. Some franchisors overreach, and some franchisees unreasonably complain. In the middle, at least as to some provisions, there can be harmony and agreement. Depending on the system, that may mean acceptance of a variety of provisions that are controversial or completely unacceptable to other franchisors. But ultimately, when drafting franchise agreements, parties should consider the reasonable expectations of their business partners, and, where possible, strive to adopt language that allows the relationship to flourish for the benefit of both sides. Doing so early will help avoid intractable disputes, bitterness, and unnecessary litigation costs. After all, franchisors and franchisees are in their respective businesses together; like castaways adrift in a sea of business.[179] They can either work together to find their way to salvation, or draw lots to see who gets eaten.[180]

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[179] One may or may not be a tiger in this analogy. *See, e.g.,* YANN MARTEL, LIFE OF PI 319 (2001) ("Very few castaways can claim to have survived so long at sea. . . and none in the company of an adult Bengal tiger.").

[180] NATHANIAL PHILBRICK, IN THE HEART OF THE SEA — THE TRAGEDY OF THE WHALESHIP *ESSEX* 176 (2000) ("They cut up a scrap of paper and placed the pieces in a hat. The lot fell to Owen Coffin. . . Coffin had already resigned himself to his fate. 'I like it was well as any other,' he said softly."). The differing fates of Captain George Pollard (who allowed his boatmates to shoot and kill his cousin, teenager Owen Coffin, for food) and First Mate Owen Chase (who led the majority of his boatmates to survive the tragedy without resort to cannibalism at the still-young age of twenty-two) is emblematic of the differences that leadership can make.

Biographies

Stanley M. Dub practices Franchise Law in Cleveland, Ohio, representing both franchisors and franchisees, and teaches Franchise Law at Case Western Reserve University Law School. A 1975 graduate of that law school, Mr. Dub served on the committee that drafted the 2012 amendments to the Ohio Business Opportunity Act. He is admitted to practice in Ohio and all Ohio federal courts and in the Sixth Circuit Court of Appeals. Stan represented the Ohio franchisees in the recent Arizona case of Zounds Hearing Franchising, LLC v. Bower, discussed in this paper.

Bruce Napell is a principal at Lagarias, Napell & Dillon, LLP in San Rafael, California, where he advises and represents franchisees, prospective franchisees and former franchisees. He is a member of the Bar Associations of California and the Commonwealth of the Northern Mariana Islands, and is admitted to practice before the Ninth Circuit Court of Appeals, and the federal courts in California and the CNMI. He is a California State Bar Certified Specialist in Franchise and Distribution Law. Bruce is a former chair of the California Bar Association's Franchise and Distribution Law Advisory Commission and Franchise Law Committee.

Daniel J. Oates is a partner with the Seattle office of Miller Nash Graham & Dunn, LLP. Dan's practice is focused on franchising and distribution litigation. Dan's litigation experience includes disputes ranging from pre-sale disclosure violations and fraud, to breach of contract claims, to post-sale relationship disputes (arising under contract or by statute). Dan has served on the editorial board of the ABA's *Franchise Law Journal* since 2013, and currently serves as the Editor-in-Chief. He earned his J.D. (*summa cum laude*) from Seattle University School of Law in 2007. Dan is admitted to practice in Washington and Oregon, all of the federal district courts in these states, and the United States Court of Appeals for the Ninth Circuit.

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