FRANCHISE AGREEMENTS: HOW COMPLICATED DO THEY NEED TO BE?

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I. INTRODUCTION  

*If I had more time, I’d write a shorter letter.*

—Mark Twain

It is a question as old as modern franchising itself—just how complicated, lengthy and detailed do franchise agreements need to be to ensure that the agreement and later interpretations of it reflect the intentions of the parties? In the blissful, golden age of franchising, franchise agreements were relatively short and simple. However, as franchise systems have grown, and as franchise law has evolved, the perceived need has arisen for longer, more detailed agreements. While franchisor and franchisee counsel alike have generally accepted the existence of these lengthy agreements, a debate remains as to the complexity with which franchise agreements should be written.

Potential franchisees and their counsel often believe that, when it comes to franchise agreements, "less is more," especially considering the franchisor's generally greater sophistication and knowledge of the intricacies of its business. It is also the belief of many franchisee attorneys that franchise agreements are primarily contracts of adhesion, and, since franchisees are often required to accept the agreements as written, the agreements should be written clearly, in a manner that franchisees can easily understand. Additionally, franchisee attorneys understand that brevity and uncertainty regarding franchisor rights and duties can sometimes work to their clients' advantage if future disputes arise.

While franchise marketing departments often desire franchise agreements that are as short as possible, under the belief that shorter, simpler agreements are more "sellable" to prospective franchisees, franchisor attorneys often disagree. Franchisor attorneys often desire franchise agreements to be as detailed as possible, to cover all eventualities that may transpire during the lengthy term of the franchise relationship. Franchisor counsel may also hope to avoid leaving "holes" that courts or arbitration panels can later plug, in a manner that may not accurately reflect the intentions of the parties. Franchisors and their attorneys fear that a concise, general statement as to the parties' understanding of a particular topic in the franchise agreement may lend itself to varying interpretations based upon the specific facts of the parties' dealings.

This paper addresses the comparative risks and rewards, based on judicial and arbitration decisions, of lengthy and abbreviated franchise agreements, with regard to seven key contract topics:

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1 The authors express their sincere gratitude to Kevin M. Shelley, partner, Kaufmann, Feiner, Yamin, Gildin & Robbins, LLP, Rachel R. Myers, associate, Dady & Garner, P.A., and Mary M. Kellerman, law clerk, Dady & Garner, P.A. for their assistance in preparing this paper.

• Franchisee territorial rights and restrictions/franchisor reserved territorial rights;
• Renewal;
• Sources of supply, rebates and system-wide supply contracts;
• Relationship of the parties/vicarious liability;
• Assignment;
• Choice-of-law provisions; and
• Franchisee acknowledgments and disclaimers.

Our analysis reveals that there is no easy answer to the question whether franchise agreements can be streamlined without exposing the franchisor and its franchisees to unintended and unwanted consequences. In certain instances, courts and arbitration panels have taken the most intricately crafted franchise agreement provisions and stood them on their heads, ascertaining “rights” and “obligations” seemingly at odds with the very words utilized in the contracts. On other occasions, succinct contractual references have proven more than sufficient for courts and arbitrators to divine accurately the true intent of the parties.

II. FRANCHISEE TERRITORIAL RIGHTS/FRANCHISOR RESERVATION OF RIGHTS

Few areas of franchise law have engendered as much arbitral and judicial scrutiny as the respective territorial rights of the franchisee and franchisor.

Saturating the marketplace with as many points of distribution as possible to maximize retail opportunities; making a company’s products or services as easily, conveniently and swiftly available as possible; and heightening a company’s name recognition and consumer awareness are retail concepts hardly restricted to franchising. When non-franchising entities seek to achieve market saturation, they may do so freely within the confines of their financial resources, management expertise, unit staffing abilities and advertising savvy.

But when franchisors attempt to achieve market saturation through the proliferation of new units, either company-owned or franchised, or distribution of products or services through other channels, they have an additional impediment to confront: the language of their franchise agreements and the possible opposition of existing franchisees, to whom the establishment of a new unit geographically (or virtually) proximate to their own may be viewed as a dire threat.

This is why a vast amount of judicial activity in franchising, since the mid-1980s, has been devoted to franchisee claims of franchisor “encroachment,” either following the establishment of a new company-owned or franchised unit in some proximity to a franchisee’s own unit, or following the franchisor’s institution of dual-distribution or nontraditional distribution programs. This tension between the franchisor’s need to compete, while observing the legal rights of franchisees, has led to a spate of litigation in this area.

This litigation generally centers on the following causes of action: breach of contract; breach of the implied covenant of good faith and fair dealing; common-law fraud; and violation of federal/state franchise disclosure laws, rules and regulations.

With regard to the breach of contract cause of action, one would think that the outcome should be readily determinable. Either the contract grants territorial exclusivity to the franchisee, thus blocking the establishment of a new unit in the territory absent the franchisee’s consent, or it does not. But that is not the case. As examined in detail below, even when a franchise agreement expressly states or strongly infers that no territorial rights are being
conferred upon franchisees, franchisees have argued—and courts have sometimes agreed—that the implied covenant of good faith and fair dealing precludes the expansion activity.

Causes of action for common-law fraud or violations of federal and state franchise disclosure laws are usually fact-specific and thus more easily determinable. If the franchisor’s disclosure document allows for the establishment of additional units within any given territory, the franchisor may prevail, unless the franchise agreement contravenes the disclosure document. If the disclosure document does not adequately address franchisee territorial rights and restrictions, or is silent or ambiguous on the issue, then franchisees will likely assert common law and statutory fraud causes of action claiming “omissions of material fact,” along with claims that the franchisor has breached the implied covenant of good faith.

Given the generally predictable outcomes of breach of contract and statutory/common-law fraud causes of action, it is perhaps not surprising that most franchisee lawsuits challenging a franchisor’s establishment of new units, its inauguration of a “dual distribution” program, or the institution of some other new channel of distribution will usually revolve around the implied covenant of good faith and fair dealing. As explained below, this doctrine is so elastic that litigation advancing it is frequently unpredictable.

A. History and Application of the Implied Covenant of Good Faith and Fair Dealing

The New York Court of Appeals first articulated and defined the implied covenant of good faith and fair dealing in 1933, when it held that:

[In every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.]3

The covenant has since been codified in Section 1-203 of the Uniform Commercial Code, which states that “[E]very contract . . . imposes an obligation of good faith in its performance or enforcement,” and in the Restatement (Second) of Contracts, Section 205. Courts have addressed the UCC’s applicability to franchise relationships; they are divided over whether the Code itself or only its principles apply, but frequently invoke the UCC implied covenant language in franchise cases.4

In addition, many of the nineteen state franchise relationship laws codify the concept of good faith.5 For example, the Arkansas Franchise Practices Act provides that “[i]t shall be a

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violation of this act for any franchisor . . . to refuse to deal with a franchisee in a commercially reasonable manner and in good faith." Many other state relationship laws similarly provide that franchisors must deal with their franchisees in good faith or, alternatively, provide that no termination or failure to renew a franchise shall be made in "bad faith."

B. Current Case Law Applying the Implied Covenant of Good Faith and Fair Dealing to Territorial Rights in the Franchise Relationship

Given the broad definition of the implied covenant of good faith and fair dealing, it is not surprising that parties to a contract seek to have implied covenant notions of fairness supplant the express provisions of their contracts. However, the implied covenant is not supposed to be used to displace express contractual terms; rather, it may only be used to augment or construe those terms. Otherwise, one party to a contract could today seek to substitute implied covenant notions of fairness for the very deal bargained for many years ago.

As the New York Court of Appeals noted, the implied covenant of good faith and fair dealing is limited by the fact that "no obligation can be imposed that would be inconsistent with other terms of the contractual relationship." Therefore, the mere exercise of one's contractual rights, without more, cannot constitute a breach of the implied covenant of good faith and fair dealing. Based on the specific facts of each particular case, however, courts have come to varying conclusions regarding the effect of the implied covenant of good faith and fair dealing.

1. Franchise Agreements Containing Express Provisions Regarding Territorial Rights

When a contract contains an express provision regarding the territorial rights of a franchisee—or lack of rights—many courts have found that the provisions are not limited by the implied covenant of good faith and fair dealing.

In *Vicorp. Restaurant, Inc. v. Village Inn Pancake House of Albuquerque, Inc.*, a franchisee brought claims arising out of a franchisor's development of a competing Village Inn in close proximity to the franchisee's unit. The parties' franchise agreement provided that:

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6 Arkansas Laws, Act 355 (1977) and Act 424 (1979), Section 7.


9 Bus. Franchise Guide (CCH) ¶ 13,094 (D.N.M. 1996); see also C.K.H., LLC v. The Quizno's Master, LLC, Bus. Franchise Guide (CCH) ¶ 13,027 (D. Colo. 2005) (noting that: [T]he duty of good faith and fair dealing does not obligate a party to accept a material change in the terms of the contract or to assume obligations that vary or contradict the contract's express provisions. Nor does the duty of good faith and fair dealing inject substantive terms into the parties' contract. Rather, it requires only that the parties perform in good faith the obligations imposed by their agreement.

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“Franchisor . . . shall and does have the right to franchise other territories, cities or areas within the State of New Mexico.” Because the plain language of the franchise agreement granted the franchisor the right to franchise other areas in the state, the court rejected the franchisee’s claim that the franchisor breached the implied covenant of good faith. The court noted that “[a]n act contemplated by the plain language of the parties’ contract cannot constitute a bad faith breach of that contract.”

Other courts have rejected franchisees’ claims that the franchisor violated the implied covenant by developing nearby units when the franchise agreement and the franchise disclosure document made it clear that the franchisee was receiving “site only” territorial protection.10 Additionally, courts have held that clauses granting the franchisor “the right to construct and operate [the franchised business] at any place other than the site licensed hereby” do not grant the franchisee territorial rights because “[t]he implied obligation to execute a contract in good faith . . . modifies the express terms of the contract and should not be used to override or contradict them.” 11

In fact, courts have interpreted a wide variety of contractual language—and even a lack of contractual language addressing territorial rights—to mean that the franchisor maintains the right to franchise and develop the franchised business near existing franchises. In Patel v. Dunkin’ Donuts of America, Inc., the operative franchise agreement afforded Dunkin’ Donuts “the right to operate or franchise other Dunkin’ Donuts’ shops on . . . such terms and conditions as Dunkin’ Donuts deems acceptable.” The court rejected the plaintiff franchisee’s claim that the franchising of a competitive business within one mile of its unit violated the implied covenant of good faith and fair dealing, reasoning that:

[T]he parties did address the competition issue in the franchise agreement by giving defendants the right to establish a new business at its own discretion and on its own terms. Thus, there is no way the implied covenant of good faith can be expanded to bar defendants from opening a new franchise within one (1) mile of plaintiff’s business.12

Therefore, franchisors and their attorneys should add language in franchise agreements that specifically outlines the non-exclusivity of the agreement and grants the franchisor full rights to franchise and develop any territory around an existing franchise. Language that grants “site-only” exclusivity may allow a franchisor to franchise any area around an existing franchise,

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10 See Chang v. McDonald’s Corp., Bus. Franchise Guide (CCH) ¶ 10,677 (N.D. Cal. 1995), aff’d., 105 F.3d 664 (9th Cir. 1996) (unpublished opinion) (noting that “[t]he License Agreement’s express provision against territorial protection of Plaintiff could not have reasonably expected protection from Defendant’s expansion”); see also Sparks Tune-Up Centers, Inc. v. White, 1989 WL 45758, Bus. Franchise Guide (CCH) ¶ 9411 (E.D. Pa. 1989) (refusing to find a violation of the implied covenant of good faith and fair dealing when franchisor opened stores near franchisee because the language of the franchise agreement specifically provides that the agreement is non-exclusive and that the franchisor and its affiliates may compete with the franchisor).

11 Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480 (5th Cir. 1984); see also Super Valu Stores, Inc. v. D-Mart Food Stores, Inc., 431 N.W.2d 721 (Wis. Ct. App. 1988) (holding that a franchisor that opens a warehouse store does not violate a franchise agreement that is non-exclusive and allows the franchisor to franchise other dealerships in its sole discretion. The court noted that “it would be a contradiction in terms to characterize an act contemplated by the plain language of the parties’ contract as a ‘bad faith’ breach of that contract.”)

despite the implied covenant of good faith and fair dealing. Courts have often upheld this
language, and refused to invoke the implied covenant of good faith and fair dealing when
application of the covenant would directly contradict express terms of the franchise agreement.

As discussed below, franchisees who cannot get express territorial exclusivity may,
nevertheless, benefit from language that does no more than deny them an exclusive territory.

2. Applying the Implied Covenant of Good Faith and Fair Dealing to
Grant Territorial Protection to Franchisees

_Scheck v. Burger King Corp._, and a string of cases relying on this opinion, broke new
ground for franchisees seeking territorial protection.13

_Scheck_ stemmed from Burger King’s planned opening of a restaurant on the
Massachusetts Turnpike two miles from plaintiff’s franchised Burger King restaurant. The
franchise agreement at issue contained a clause stating that: “[t]his license is for the described
location only and does not in any way grant or imply any area, market or territorial rights
proprietary to Franchisee.” However, the franchisee brought an action against Burger King for
breach of contract and breach of the implied covenant of good faith and fair dealing.

In denying Burger King’s motion for summary judgment, the U.S. District Court for the
Southern District of Florida held:

The express denial of an exclusive territorial interest to Scheck does not
necessarily imply a wholly different right to Burger King—the right to open other
proximate franchises at will regardless of their effect on (Scheck’s) operations. It
is clear that while Scheck is not entitled to an exclusive territory, he is entitled to
expect that Burger King will not act to destroy the right of the franchisee to enjoy
the fruits of the contract . . . .

The court reasoned that in order to retain a right to develop and franchise locations near
a franchisee’s location, Burger King needed to include a clause in the franchise agreement
allowing it to do so and not simply a clause stating that the agreement was non-exclusive.

In _Burger King Corp. v. Weaver_, the same court that decided _Scheck_ (albeit, different
judges) faced a similar factual setting, and the same contract and legal issues, as it did in
_Scheck_: a Burger King franchisee claimed that Burger King breached the implied covenant of
good faith and fair dealing by placing a new restaurant near the franchisee’s Burger King
restaurant. However, in this case, the district court granted Burger King’s motion for summary
judgment. Florida law does not recognize claims for breach of the implied covenant unless the
plaintiff also alleges breach of an express contract term. Since the franchisee failed to claim a
breach of an express provision of the franchise agreement, its implied covenant claim failed.14

The _Weaver_ court went on expressly to repudiate _Scheck_: “To the extent that our
decision today may conflict with _Scheck_, we find that it reads Florida law more expansively than
is warranted by the case law.”

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In 1998, however, the U.S. Court of Appeals for the Eleventh Circuit decided *Camp Creek Hospitality Inns, Inc., d/b/a Sheraton Inn Atlanta Airport v. Sheraton Franchise Corporation*\(^{15}\) in accord with *Scheck*. The *Camp Creek*, franchisee-plaintiff operated a Sheraton Inn near the Atlanta airport. When Sheraton acquired for itself another hotel property near the airport, the *Camp Creek* franchisee brought a claim for breach of the implied covenant of good faith and fair dealing arising from Sheraton’s alleged encroachment.

In denying Sheraton’s motion for summary judgment, the Eleventh Circuit noted that the Sheraton license agreement did not grant territorial exclusivity to *Camp Creek* but was “site only” in nature. The court based its decision on contractual language that specifically reserved to Sheraton the right to license additional hotels, while remaining silent on Sheraton’s ability to acquire and operate competing hotels for itself.

The Eleventh Circuit then expressly relied upon *Scheck*, holding that it is not enough for a franchisor to tell its franchisee that it will enjoy absolutely no territorial exclusivity or protection whatsoever. Instead, the franchisor also must specifically inform the franchisee that the franchisor, either itself or through other franchisees, could open units nearby.

*Scheck’s* rebirth was short lived. In 1999, just a year after the *Camp Creek* decision, a different panel of the same Eleventh Circuit affirmed the district court’s *Weaver* decision and pronounced the “*Scheck* court’s attempt to separate the franchisee’s right from the franchisor’s duty logically unsound.”\(^{16}\) As the panel explained, “right and duty are different sides of the same coin; if one party to a contract has no *right* to exclusive territory, the other party has no *duty* to limit licensing of new restaurants.”\(^ {17}\) Therefore, the court reasoned, “[i]n the absence of an agreement, neither party has a duty to perform and neither has a right against the other.”\(^ {18}\)

3. **Territorial Rights and “E-Business”**

With e-business quickly on the rise, it was only a matter of time until a franchisee’s claim of “virtual encroachment” arose—a complaint that the franchisor’s offer and sale of goods or services over the Internet breaches the franchisee’s “exclusive” or other territorial rights. That time arrived at the turn of the century, when an American Arbitration Association panel issued a decision holding that the franchisor, Drug Emporium, Inc., could not use its website to compete with its own franchisees.

Drug Emporium’s standard franchise agreement granted every franchisee the exclusive right to conduct business within a defined geographic area. The claimant franchisees alleged that their franchisor violated these so-called “exclusive territories” by using its website to sell directly to customers within those territories. Noting that Drug Emporium marketed its website as “the full service on-line drug store”; the company described the site as a “drug store” in its Securities and Exchange Commission filings; and the company advertised the site as “your neighborhood pharmacy for 20 years.”

The arbitration panel issued a preliminary injunction, after concluding that the franchisees established a strong likelihood of prevailing on the merits of their encroachment claim. The panel ordered Drug Emporium, which operated the website “DrugEmporium.com,”

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\(^{15}\) 139 F.3d 1396, Bus. Franchise Guide (CCH) ¶ 11306 (11th Cir. 1998).
\(^{16}\) *Id.* at 1317.
\(^{17}\) *Id.*
\(^{18}\) *Id.*
not to sell to any potential customer located within a Drug Emporium franchisee’s territory and to have its website direct customers to the nearest franchised outlet.\(^{19}\)

However, no court has issued a ruling similar to the Drug Emporium arbitration award. Most recently, in Pro Golf of Florida, Inc. v. Pro Golf of America, Inc., the plaintiff franchisees sued for breach of contract arising out of the franchisor’s Internet sale of golf merchandise in the plaintiffs’ designated territories. The franchisees sought a ruling that the franchisor’s Internet sales of the merchandise constituted a material breach of the plaintiffs’ franchise agreements.\(^{20}\)

On a motion for reconsideration, the court noted that the subject franchise agreements:

[D]id not grant plaintiffs the exclusive right to solicit business from individuals located within their territories. Such a reading would mean that every time an individual that resides within Plaintiffs’ territories travels outside those territories and purchases golf equipment from a . . . distributor other than Plaintiffs, the franchise agreements had been breached.\(^{21}\)

Another arbitration, In the Matter of the Arbitration Between Franklin 1989 Revocable Family Trust, Claimant and H&R Block, Inc. Respondent,\(^{22}\) yielded a clear determination of the franchisor’s right to engage in internet commerce within franchisees’ territories. The arbitration panel majority (over a vigorous dissent by one of your authors) concluded that franchisor H&R Block did not violate the exclusive territory provision of its franchise agreements by offering tax return preparation services over the Internet. The subject franchise agreement precluded H&R Block from “operating from a location” within the franchisees’ territories. Ultimately, the majority concluded that the franchisor’s Internet presence in the franchisees’ territories was not the same as the franchisor’s physical presence there and that, so long as the franchisor’s web-based services did not unreasonably intrude on the franchisees’ brick-and-mortar operations, the franchisor was not operating in violation of the franchisees’ territorial exclusivity.

Arbitrator J. Michael Dady argued in dissent that the franchisor’s web-based services violated the subject franchise agreements’ unambiguous, exclusive right to operate an income tax preparation service for customers located in the franchisees’ territories. He contended that if any ambiguity existed as to what “operating from a location” meant, it should be resolved against the franchisor as the drafter of the agreement. Finally, citing Drug Emporium, he claimed that one of the franchisees’ legitimately-expected fruits of their agreements was the expectation that the franchisor would not compete with them from any type of location within the franchisees’ territories.

The arbitrator deciding In the Matter of Hale’s v. Conroy’s, Inc.,\(^{23}\) concluded that a franchisor did not breach either the express terms of its franchise agreement with a flower shop or the implied covenant by marketing flowers over the Internet and through “800” toll-free telephone sales. The arbitrator held that the subject franchise agreement specifically reserved


\(^{23}\) Bus. Franchise Guide (CCH) ¶ 12,177 (JAMS Dispute Resolution, Los Angeles, Cal., June 14, 2001).
to the franchisor the right to develop and use other systems and technology and rejected Drug Emporium as not being persuasive in this case.

In light of the authority surveyed above, franchisors and their attorneys should avoid abbreviating franchise agreements and, instead, should include a clause specifically reserving for themselves the right to conduct e-business. Conversely, franchisees and their attorneys who cannot obtain an express prohibition of competing, same-brand e-business want a simple, precise agreement governing the territorial rights of the parties, thereby allowing room for differing interpretations regarding the effect of e-business on the franchise relationship.

III. FRANCHISE RENEWALS: CONTRACTUAL LIMITATIONS, EXTRA-CONTRACTUAL POLICIES AND STATUTORY PROTECTIONS

Among the most critical issues addressed in franchise agreements are the parties’ respective rights and obligations upon the expiration of the initial term of the franchise. While an abbreviated franchise agreement might provide, simply, for an initial term and a right to renew upon mutual consent of the parties, a more fully developed franchise agreement typically provides that the franchisee may renew and extend the term of the franchise as long as it meets certain contractual conditions. These conditions often include the execution of the then-current form of franchise agreement, satisfaction of all financial obligations from franchisee to franchisor and even the execution of a general release in favor of the franchisor.

Generally, a franchisee interested in renewal is successful, and does not object to meeting the contractual conditions to renew, provided that they are not materially different from the terms of the initial agreement. However, if a franchisee is unable or unwilling to meet the contractual conditions for renewal, the franchisee may claim either an expanded contractual or an extra-contractual right to renew or, alternatively, assert that enforcement of the contract as written violates applicable federal and state franchise-related statutes and regulations. Additionally, franchisee counsel have had some success arguing that “renewal” implies an obligation to provide a new form of agreement that bears some semblance to the initial agreement. As discussed below, however, when the franchise agreement is integrated and sufficiently precise, attempts to create renewal rights not originally bargained for usually meet with judicial skepticism.
A. Reliance On Extra-Contractual Renewal Policies

The McDonald’s franchise system is one of the oldest and most respected systems in the nation, and it utilizes a comprehensive franchise agreement that directly addresses the topic of renewals. The fully-integrated McDonald’s franchise agreement provides that the franchise is granted for a specific term, with no promise or representation about renewal of the franchise or grant of a new franchise upon expiration of the initial term. Thus, upon expiration, it is up to McDonald’s to decide whether to renew the franchise—a decision that it makes in its sole discretion with the aid of various corporate standards and policies (referred to as the “McDonald’s Rewrite Policy”).

Faced with clear contractual language disclaiming any agreement or expectation of renewal upon expiration, a number of McDonald’s franchisees confronting non-renewal have attempted to circumvent the express language in the franchise agreement by arguing that the McDonald’s Rewrite Policy is incorporated into the franchise agreement, and that McDonald’s failed to comply with its own policy in deciding not to offer renewal. However, due in large part to the comprehensive nature of the McDonald’s franchise agreement, courts have declined to upset the parties’ agreement and expectations by engrafting the McDonald’s Rewrite Policy upon its franchise agreement.

For example, in Talamantez v. McDonald’s Corp., a McDonald’s franchisee, upon learning of McDonald’s decision not to renew her franchise agreement, sued for breach of contract and breach of the implied covenant of good faith and fair dealing. The franchisee alleged that the McDonald’s Rewrite Policy was part of the franchise agreement, and that McDonald’s failure to comply with its own policy constituted a breach of contract. According to the franchisee, the franchise agreement’s references to the “McDonald’s System” referred to and incorporated the McDonald’s Rewrite Policy. Relying on the plain language of the franchise agreement, including an integration provision and disclaimer of reliance on any representations and warranties outside of the franchise agreement, the court disagreed with the franchisee and held that the franchise agreement did not incorporate the McDonald’s Rewrite Policy. As a result, the court dismissed the franchisee’s breach of contract claim.

The Talamantez franchisee further argued that McDonald’s violated the implied covenant of good faith and fair dealing by abusing its discretion in not electing to grant her request for renewal. However, because the franchise agreement expressly stated that McDonald’s made no promise or representation regarding renewal of the franchise or the grant of a new franchise, the court held that the implied covenant could not be applied to contradict its express terms.

To protect their interests and benefit from the franchise agreement, franchisees and their attorneys may want to ensure that the franchise agreement itself contains a provision allowing for renewal, ideally on terms not materially different from those set forth in the original agreement—e.g., locking in the royalty rate.

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Franchisors, on the other hand, may be well-advised by their attorneys to include a provision in the franchise agreement expressly disallowing renewal, thereby allowing franchisors to end relationships with franchisees at the end of the original contract term.

B. Statutory Protections and Non-Renewal

Apart from contending that extra-contractual representations, agreements or policies require renewal, franchisees often argue that the franchisor is statutorily precluded from failing to renew the franchise. Certain franchise relationship statutes limit the ability of a franchisor to terminate a franchise agreement or, at the very least, place conditions upon the franchisor upon termination. Many franchisees have argued that non-renewal constitutes constructive or "de facto" termination, and that relationship laws outlawing termination without "good cause" apply to non-renewal. Since most of these franchise statutes require notice and good cause for termination, franchisees have argued that the statutes also require notice and good cause for non-renewal. Therefore, franchisees and their attorneys often argue that, notwithstanding its express limited term, the franchise agreement continues until or unless it can be terminated or not renewed for good cause (as defined by a particular statute). Franchisors and their attorneys, however, strongly disagree.

State franchise relationship statutes that address non-renewal variously provide: (i) non-renewal is treated the same as termination, requiring notice and good cause;25 (ii) non-renewal requires a lengthy notice period;26 (iii) non-renewal is permitted upon one or more conditions;27 (iv) non-renewal is permitted only if the franchisee can sell the franchise to a qualified purchaser or compete after non-renewal;28 (v) non-renewal is expressly permitted pursuant to terms of the franchise agreement;29 (vi) non-renewal is permitted as long as it is in accordance with the franchisor’s current policies or practices or is non-discriminatory;30 or (vii) non-renewal is permitted only if the franchisor fairly compensates the franchisee for the fair market value of the franchisee’s inventory, supplies, equipment, goodwill and furnishings purchased from the franchisor.31 Many of these statutes also provide that parties cannot contract out of the statute’s requirements.

In Wright-Moore Corp. v. Ricoh Corp., one of the first decisions to address the application of statutory protections against termination to non-renewals, the U.S. Court of Appeals for the Seventh Circuit, interpreting the Indiana franchise relationship statute, held that a franchisor could refuse to renew only if the franchisee had breached the agreement.32 After finding that the good cause requirement applied to non-renewal as well as termination, the court held that the franchisor’s non-renewal of a distributorship agreement for internal economic reasons, although not shown to be in bad faith, was not for “good cause” the Indiana statute.

31 See, e.g., RCW § 19.100.180(2).
32 Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128 (7th Cir. 1990).
required. The court declared that good cause under the Indiana statute required problems with the performance of the franchisee, not economic reasons internal to the franchisor. Notwithstanding a franchise agreement provision limiting the term of the relationship and the absence of any contractual right to renew, in Wright-Moore, the Seventh Circuit applied the Indiana statute to a non-renewal, thereby imposing additional terms and conditions upon non-renewal.33

More recently, in Tatan Management v. Jacfran Corp.,34 a former franchisee sued its franchisor in Puerto Rico federal court, claiming that termination or non-renewal of its franchise agreement violated the Puerto Rico Dealers' Contracts Act,35 which prohibits parties from performing "any act detrimental to the established relationship or refus[ing] to renew said contract on its normal expiration, except for just cause." The franchisee argued that the franchise agreement was terminated or, in the alternative, not renewed, in violation of the statute. However, construing the "just cause" provision of the statute broadly, the court found that the franchisor had the requisite cause under the statute both to terminate the agreement and to refuse to renew it, based upon the franchisee's numerous financial defaults under the franchise agreement. The court declined to utilize the statute to interpose additional restrictions upon the franchisor's right to terminate or not renew.36

While creative advocacy and statutory protections may preclude absolute assurance that an expiring franchise agreement will, in fact, end the relationship, if so desired by the franchisor, utilization of a clear and unambiguous renewal/non-renewal provision in the franchise agreement will go a long way to establish the parties' rights. Additionally, in many jurisdictions, renewal provisions may be supplemented by state law.

33 See also Petereit v. S.B. Thomas, Inc., 63 F.3d 1169 (2d Cir. 1995), in which the U.S. Court of Appeals for the Second Circuit held that a written distribution agreement that expressly allowed alteration of the distributors' territories did not preclude a finding that the realignment of the distributors' routes constituted constructive termination under the Connecticut Franchise Act, which contained a non-waiver provision that prevented the parties from contracting out of their protections.
35 1964 P.R. Laws 75, 10 P.R. Laws Ann. § 278-278(d)
36 See, also, Wisconsin Music Network, Inc. v. Muzak L.P., 822 F. Supp. 1332 (E.D. Wis. 1992), aff’d, 5 F.3d 218 (7th Cir. 1993) (a music provider franchisee’s refusal to sign a new franchise agreement after expiration of the old one constituted good cause for non-renewal within the meaning of the Wisconsin Fair Dealership Law); Unified Dealer Group v. Tosco Corp., 16 F. Supp. 2d 1137 (N.D. Cal. 1998), aff’d, 216 F.3d 1085 (9th Cir. 2000) (unpublished opinion) (a gasoline station franchisor’s insistence that several franchisees change to a different trademark controlled by the franchisor prior to renewal did not constitute effective termination or non-renewal of the franchise relationship as defined in the Petroleum Marketing Practices Act); Dale Carnegie & Associates, Inc. v. King, 31 F. Supp. 2d 359 (S.D.N.Y. 1998) (the franchisor's non-renewal of franchise did not violate the California Franchise Relations Act); Caribbean Wholesales & Service Corp. v. U.S. JVC Corp., 963 F. Supp. 1342 (S.D.N.Y. 1997) (manufacturer’s non-renewal of distribution relationship enforced pursuant to the agreement; non-renewal did not violate the Puerto Rico Dealer's Contracts Act); Craig D. Corp. v. Atlantic Richfield Co, 860 P.2d 1015 (Wash. 1992) (renewal on different terms did not violate Washington Franchise Investment Protection Act).
IV. SOURCES OF SUPPLY/REBATES/SYSTEM-WIDE SUPPLY CONTRACTS

Vendor rebates are common in franchising. Often, franchisors will receive rebates or commissions from suppliers based upon their franchisees’ purchases of goods and services. However, federal antitrust laws and state franchise laws may, in certain circumstances, regulate these payments to the franchisors. Additionally, the FTC Franchise Rule and state laws regulating the sale of franchises require that franchisors disclose, in Item 8 of the disclosure document, whether the franchisee must purchase certain items only from approved suppliers and vendors. Further, the franchisor must disclose the nature and extent of any arrangements whereby the franchisor will receive payments or rebates as a result of these relationships with approved suppliers.

To meet these requirements, Item 8 of the disclosure document should include an express disclosure by the franchisor addressing payments it receives from vendors that are a result of franchisee purchases from these vendors.

A. Section 2(c) of the Robinson-Patman Act

Federal antitrust law, and particularly, section 2(c) of the Robinson-Patman Act, speaks to the payment of vendor rebates. Section 2(c) specifically prohibits:

any person engaged in commerce, in the course of such commerce, to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares, or merchandise, either to the other party to such transaction or to an agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control, of any party to such transaction other than the person by whom such compensation is so granted or paid.37

This provision has “bewildered lawyers and judges”38 ever since its enactment and has been described as a “prolix and obscure statute [which] is a model of bad drafting.”39 However, Section 2(c) has been interpreted to forbid the payment or receipt of commissions, except for services rendered, in connection with the sale or purchase of goods, either to the other party to the transaction or to an agent of that party. This interpretation supports the general purpose of the Robinson-Patman Act, which “was enacted in 1936 to curb and prohibit all devices by which large buyers gained discriminatory preferences over smaller ones by virtue of their greater purchasing power.”40

The confusion that Section 2(c) has caused courts is evident in 2660 Woodley Road Joint Venture v. ITT Sheraton Corp., where the U.S. Court of Appeals for the Third Circuit reversed the district court’s ruling that a hotel franchisor, acting in its capacity as the franchisee’s hotel manager (but not in its capacity as franchisor), had violated Section 2(c).41 In 2660 Woodley Road, Sheraton negotiated large-volume discounts with vendors seeking to

38 Augusta News Co. v. Hudson News Co., 269 F.3d 41, 44 (1st Cir. 2001).
41 369 F.3d 732 (3d Cir. 2004).
supply its hotels. Sheraton required the vendors to add a surcharge to the price billed to the individual hotels for each purchase, but the surcharge was not itemized, or even disclosed, on any bills or invoices that vendors sent to individual hotels. The surcharge was remitted directly to Sheraton in the form of a rebate.

The franchisee claimed that the rebates violated section 2(c) of the Robinson-Patman Act, and Sheraton responded that the hotel management contract permitted it to obtain reimbursement from vendors for the costs of providing services, and that, specifically, the rebates reimbursed it for centralized purchasing services as well as associated overhead costs.

At trial, the jury found for the franchisee and awarded a total of $31,497,000, including $750,000 on the Robinson-Patman Act claim, which the court later trebled. The final award included $11,832,000 in compensatory damages and $17,415,000 in punitive damages.

The Third Circuit reversed, concluding that the franchisee had not suffered an “antitrust injury” and, therefore, had no standing to sue. The appellate court reasoned that the franchisee’s antitrust recovery was inextricably intertwined with its awards on the breach of contract and breach of fiduciary duty claims, which created insurmountable problems in apportioning damages along with the real possibility of cumulative damages.

Faced with virtually the same facts in In Town Hotels Limited Partnership v. Marriott International, Inc., a federal district court found that franchisee hotel operators had suffered antitrust injury and, accordingly, had standing to assert their claims, since the hotel franchisor’s receipt of secret rebates from vendors—received in its capacity as the franchisee’s hotel manager (but not in its capacity as franchisor)—caused the franchisees to pay inflated prices for goods and operate at a competitive disadvantage.

B. State Franchise Laws

When franchises are offered for sale, state franchise disclosure laws, the FTC Franchise Rule, and the Uniform Franchise Offering Circular (“UFOC”) Guidelines require franchisors to furnish prospective franchisees with detailed information so that the prospects can make informed decisions whether to buy into the franchise opportunity. Under the UFOC Guidelines, with which franchisors are required to comply under state franchise laws (until July 1, 2008 when the revised FTC Franchise Rule disclosure format will displace them), franchisors must disclose whether franchisees may only buy goods or services from approved suppliers, and whether the franchisor receives revenue—i.e., vendor rebates—as a result of these required purchases.

Item 8 of the UFOC Guidelines specifically requires the franchisor to:

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42 Id. at 735.
43 Id.
44 Id.
45 Id.
46 Id. at 736.
47 Id. at 743.
Disclose franchisee obligations to purchase or lease from the franchisor, its
designee or from suppliers approved by the franchisor or under the franchisor's
specifications. For each obligation disclose:

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D. Whether, and if so, the precise basis by which the franchisor or its affiliates
will or may derive revenue or other material consideration as a result of
required purchases or leases.49

If a franchisor receives vendor rebates or commissions from suppliers without disclosing the
payments to its franchisees in Item 8, the franchisees may have a claim for an unlawful
franchise offering.

The language of the disclosure documents often will determine whether a franchisor's
receipt of vendor rebates is lawful. In C.K.H., L.L.C. v. The Quizno’s Master, L.L.C., a sandwich
shop franchisor was found not to have breached its agreements with several franchisees by
failing to secure the best possible prices for goods and equipment and by failing to pass on
vendor rebates to the franchisees.50 The franchisees based their claim on language in the
franchisor's UFOC stating that the franchisor would “negotiate arrangements with suppliers for
the benefit of franchisees, which often include volume discounts.”51 The court assumed the
UFOC was a contract,52 while noting that the issue was not at all clear, and found that nothing
in the UFOC suggested that the discounts were required to be passed on to franchisees. The
UFOC itself said that the franchisor had “the right to receive payments from suppliers on
account of their dealings with [the individual franchisee] and other Franchisees and to use the
Additionally, the franchise agreement gave the franchisor the right to use any volume discounts
it received “without restriction and for any purpose Franchisor deem[ed] appropriate.”54 The
court concluded that the franchisees' breach of contract claim could not survive in the face of
this unambiguous language.55

Some franchisee lawyers recommend that their clients request full and complete
information in the disclosure document that clearly and concisely outlines the nature and extent
of all revenues, rebates and commissions that the franchisor will receive from the relationship it
has with any of its vendors. Potential franchisees should be leery of any situation where the
franchisor does not commit to use these revenues, rebates and commissions to benefit the
franchise system as a whole—e.g., promising to contribute the monies received from its vendors
to the advertising fund. While full disclosure benefits potential franchisees, franchisee attorneys
also suggest that this disclosure may benefit the franchisor, in that it could possibly alleviate any
violations or perceived violations of the Robinson-Patman Act.

49 Bus. Franchise Guide (CCH) ¶ 5,760.
51 Id.
52 Some franchisee lawyers find this conclusion to be unfounded and problematic. For a case holding the
opposite, see Bores v. Domino’s Pizza LLC, 489 F. Supp. 2d 940 (D. Minn. 2007).
53 Id.
54 Id.
55 Id.
Franchisors and their attorneys, on the other hand, may wish to include language stating that discounts resulting from negotiations with and volume discounts from vendors and suppliers may be used for any purpose that the franchisor desires.

Claims alleging improper UFOC Item 8 disclosure often turn on whether the franchisee is required to purchase from suppliers designated by the franchisor. For example, in Team Tires Plus, Ltd. v. Heartlein, franchisees alleged that a franchisor of tire and oil change businesses had committed fraud and violated the Illinois Franchise Act by failing to disclose certain rebates it received from vendors based on sales of products to its franchisees. The franchisees alleged that, unknown to them, the franchisor had agreements with certain third-party vendors, whereby these companies charged franchise stores an inflated price for goods purchased directly from them, and that the vendors would rebate to the franchisor between five and ten percent of the value of the franchisees’ purchases.

The court granted the franchisor’s motion for summary judgment on the franchisees’ fraud allegations, holding that the franchisees had failed to provide facts sufficient to show fraud by omission. The court found that, under the UFOC, the franchisees were free to purchase goods from any third-party vendor of their choice. Additionally, the franchisees offered no evidence of detrimental reliance or damage in that there was no indication whether the vendor payments resulted in any price differential to the franchisees.

The franchisees also alleged that, under the Illinois Franchise Act, the rebate scheme violated regulations requiring a franchisor to disclose recurring fees or payments that the franchisee must pay to the franchisor or its affiliates, or that the franchisor or its affiliates collect on behalf of a third party. The court found that, regardless of the amount of rebates some vendors were returning to the franchisor, the franchisees had presented no evidence of: (1) fees that they had to pay to the franchisor or an affiliate; or (2) fees that the franchisor or an affiliate collected on behalf of a third party.

Additionally, the court found that the franchisor had not violated the instructions to Item 8 of the UFOC Guidelines, which set out certain disclosure requirements if a franchisor receives revenue “as a result of required purchases or leases.” Since the franchisees were free to purchase goods from any vendor they chose, the court granted the franchisor’s motion for summary judgment on all Illinois Franchise Act allegations regarding the vendor rebate system.

It is important to note that franchisees still may have a claim for unlawful vendor rebates, even where the franchisor makes the required disclosures in Item 8. In Substantial Investments, Inc. v. D’Angelo Franchising Corp., the franchise agreements required sandwich shop franchisees to purchase products from suppliers designated by the franchisor. One of the designated suppliers required the franchisees to pay a flat delivery fee for all supply

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56 Bus. Franchise Guide (CCH) ¶ 12,821 (D. Minn. 2004).
57 Id.
58 Id.
59 Id.
60 Id.
62 Id.
63 Id.
64 Id.
purchases. The plaintiff franchisees alleged that, without their knowledge, the designated food supplier was rebating a substantial portion of delivery fees to the franchisor, in violation of Section 2(c) of the Robinson-Patman Act.

The UFOC said that “[w]e and our parent, or persons affiliated with us, may derive revenue as a result of your purchases of approved supplies or from approved suppliers,” but the court nonetheless concluded that the franchisees adequately stated a claim for a violation of Section 2(c) of the Robinson-Patman Act. First, the court noted that, since the UFOC was only provided to prospective and not to existing franchisees, it was unclear whether the UFOC was something of which the franchisees knew or should have known. Additionally, the court found the franchisees’ allegations to be adequate since the franchisees alleged that: (1) the franchisor effectively compelled the franchisees to purchase supplies from the approved supplier; (2) the franchisor purchased supplies directly from the supplier for use in its own franchisor-owned sandwich shops; and (3) the payment scheme forced the franchisees to operate their sandwich shops at a competitive disadvantage to the franchisor-owned shops and other competitors, allegedly resulting in estimated lost sales and profits in excess of $1.5 million. As a result, the court refused to grant separate motions to dismiss filed by the franchisor and the supplier.

The D’Angelo franchisor may have avoided that outcome if it had included a clause allowing it to derive revenue as a result of franchisees’ purchases from approved suppliers in its franchise agreement. However, if this was the case, franchisees might have sought an express commitment from the franchisor to disclose the revenue it would receive from franchisees’ purchases from approved suppliers, as well as a promise to use the revenues received to benefit the franchise system as a whole—e.g., by putting the revenues into the advertising fund.

To ensure compliance with federal law, any benefits that a franchisor will derive from supply contracts should be clearly disclosed to franchisees in the disclosure document and reserved in the franchise agreement. Additionally, franchisee attorneys should ensure that the disclosure is easy for franchisees to understand and clearly applicable to any contractual arrangements that bring benefits to the franchisor.

V. RELATIONSHIP OF THE PARTIES: CAN YOU CONTRACT OUT OF AGENCY, FIDUCIARY OR EMPLOYMENT CAPACITIES?

Most well-drafted franchise agreements contain an express representation that the franchisee is an independent contractor of the franchisor, and that the relationship is created and solely governed by the written agreement. Further, franchise agreements typically expressly disclaim the existence of an agency, fiduciary or employment relationship between the franchisor and franchisee.

However, in stark contrast to many other areas of contract interpretation, where integrated and precise contractual provisions are generally enforced, courts sometimes

\[66\text{Id. at }*1.\]
\[67\text{Id.}\]
\[68\text{Id. at }*3.\]
\[69\text{Id.}\]
\[70\text{Id. at }*2-3.\]
\[71\text{Id.}\]
disregard the contractual “relationship-defining” provisions and determine the nature of the relationship from the totality of the particular facts and circumstances presented. Nevertheless, except in extraordinarily narrow circumstances, the judiciary has almost universally rejected the notion that franchisors owe a fiduciary duty to their franchisees.

A. Agency

Perhaps the most critical issue arising from the characterization of the relationship between a franchisor and franchisee is the determination whether franchisees should be considered the actual or apparent agents of the franchisor. Once a court establishes an agency relationship, a franchisor can be held responsible for a wide range of liabilities stemming from its franchisees’ acts and omissions, since vicarious liability is not dependent upon a finding of fault on the franchisor’s part. Accordingly, agency and vicarious liability issues have been vigorously litigated in franchise cases for decades. Results have been inconsistent and often contradictory within a particular jurisdiction. But there has been one constant in the ebb and flow of franchise-related vicarious liability litigation: courts routinely refuse to hold that a contractual provision disclaiming the existence of an agency relationship decides the issue.

The central source of judicial inconsistency imposing vicarious liability upon franchisors arises from the historically confused application of a traditional “control test” to the franchise relationship for purposes of establishing any number of legal duties, rights or relationships, even though the franchise relationship, by definition, requires the franchisor to enforce system-wide standards of operation. The often confused judicial attempts to reconcile these two concepts have often produced inequitable, inconsistent and potentially devastating results.72

Furthermore, in applying the traditional “control test” for purposes of determining whether an agency relationship exists between a franchisor and its franchisee, courts have historically disregarded any attempts by the parties to define their relationship contractually. Courts routinely have held that contractual provisions stating that the franchisee is an independent contractor, and specifically disclaiming an agency relationship between the franchisee and franchisor, do not eliminate the franchisor’s potential vicarious liability arising from the acts and omissions of its franchisees.73

In the past few years, however, a number of courts have recognized the inherent problem in applying the traditional “control test” to the franchise relationship in order to determine agency and have moved toward a more sophisticated analysis of that relationship. These courts have analyzed in detail the unique nature of the franchise relationship and concluded that contractual provisions that might indicate control in an employment or other relationship do not justify imposition of vicarious liability, under an agency theory, in franchise cases. Under this analysis, a franchisor’s general right to “control” its franchisees, by enforcing system-wide standards of operation and closely monitoring the franchisees’ use of its trademarks, is insufficient to establish an agency relationship.

Recognizing that this control is inherent in the franchise relationship, these courts have sustained the imposition of vicarious liability upon a franchisor only when the franchisor actually controlled, or had a right to control, the daily operation of the specific aspect, or “instrumentality,” of the franchisee’s business that is alleged to have caused the harm.\(^\text{74}\)

Given the unsettled state of the law in this area, franchisees and their attorneys often conclude that the inclusion of a contractual provision disclaiming the existence of an agency relationship is superfluous, since the courts do not find these provisions to be dispositive. On the other hand, franchisors and their attorneys should note that, although that general principle holds, it is also true that courts will take the parties’ expressed intent into consideration when evaluating whether an agency relationship exists for the purpose of imposing vicarious liability upon a franchisor.

Even under the emerging “instrumentality” test noted above, courts are apt to consider the intentions of the parties concerning their relationship, as expressed in a contractual disclaimer. In Vandemark v. McDonald’s Corp., the court noted that, under applicable New Hampshire law, whether an agency relationship has been established is a question of fact, and that “an agency relationship, or a lack thereof, does not turn solely upon the parties’ belief that they have or have not created one.”\(^\text{75}\) This language implies that the contractual provision is accorded some weight, while not dispositive. Other courts, however, have gone much further, holding that a contractual disclaimer of agency serves almost as a presumption, which can be overcome only by a clear factual record.\(^\text{76}\)

\(^{74}\) See, e.g., Wu v. Dunkin’ Donuts, Inc., 105 F. Supp. 2d 83 (E.D.N.Y. 2000) (franchisor could not be held vicariously liable for injuries arising from franchisee’s failure to prevent assault of its employee, since franchisor did not mandate specific security equipment or procedures or otherwise control the steps taken by its franchisees with respect to security to protect employees); Allen v. Choice Hotels International, 942 So. 2d 817 (Miss. App. 2006) (hotel franchisor not vicariously liable, under a theory of actual agency, for the injuries sustained by a hotel guest and her husband who were harmed by criminal acts of an intruder); Vandemark v. McDonald’s Corp., 153 N.H. 753, 904 A.2d 627 (2006) (because franchisor did not control the franchisee’s security operation, franchisor was not vicariously liable for the injuries of an employee of one of its franchisees sustained while working as an overnight custodian; plaintiff did not establish that the franchisor had control over the security measures implemented by the franchisee); Allen v. Greenville Hotel Partners, Inc., 409 F. Supp. 2d 672 (D.S.C. 2006) (hotel franchisor could not be held vicariously liable under theory of actual or apparent agency, as the franchisor did not control the hotel’s daily operations, nor did it control the specific instrumentality — the hotel’s security and life safety systems — which allegedly caused the harm.); Kerl v. Dennis Rasmussen, Inc., 682 N.W.2d 328 (Wis. App. 2004) (quick serve restaurant franchisor could not be held vicariously liable for injuries sustained from shooting perpetrated by franchisee’s employee; franchisor did not have control or right to control franchisee’s supervision of its employees, as was required to hold franchisor vicariously liable for franchisee’s alleged negligence).

\(^{75}\) Vandemark, 904 A.2d 627 (emphasis added) (quoting Herman v. Monadnock PR-24 Training Council, 802 A.2d 1187 (N.H. 2002)).

\(^{76}\) See, also, Martin v. Southland Corp., Bus. Franchise Guide (CCH) ¶ 11,019 (Cal. App. 1996) (a contractual provision that stated that a convenience store franchisee was an independent contractor and specifically disclaimed any agency relationship between the franchisee and the franchisor was not controlling with respect to the franchisor’s potential liability for the assault of the customer by one of the franchisee’s employees; the actual nature of the parties’ relationship, not the agreement’s characterization of the relationship, was controlling); State of Maryland v. Cottman Trans. Systems, Inc., 587 A.2d 1190 (Md. App. 1991) cert. den., 596 A.2d 627 (Md. 1991) (a transmission shop franchisor could not be held vicariously liable for misrepresentations made by its franchisees under an agency theory; the franchise agreement contained a disclaimer of agency status that was borne out by the record); Kerl v. Dennis Rasmussen, Inc., 682 N.W.2d 328 (Wis. App. 2004) (noting that the use of a
B. Fiduciary Relationship

Courts also often face claims that the relationship between a franchisor and its franchisee is fiduciary in nature, notwithstanding that many franchise agreements contain express disclaimers of a fiduciary relationship. Generally, courts view disclaimers of fiduciary duty as informative, but not dispositive. As in the agency analysis, courts look at the totality of the circumstances surrounding the relationship between the parties to determine whether a fiduciary relationship has been established.

Franchisees and their attorneys would like to believe that, given the inherent nature of the franchisor/franchisee relationship—including the substantial control that the franchisor commonly exerts, the franchisee’s substantial financial commitment, and the parties’ continuing, interwoven dealings with each other—the franchisor should be held, as a matter of law, to a fiduciary duty in its business dealings with its franchisees. Unfortunately for franchisees and their attorneys, courts have almost universally determined that a fiduciary relationship does not exist in franchising. However, courts have made one exception to this general rule: If a franchisor agrees to spend the franchisees’ money prudently or to manage the franchisees' money for the benefit of the franchisees in a separate fund, the franchisor's legal duties to

disclaimer of agency relationship in the franchise agreement “is informative but not dispositive”); O’Bryant v. Century 21 South Central States, Inc., 899 S.W.2d 270 (Tex. App. 1995 no writ). (to overcome an express provision in a franchise agreement that no agency existed between the franchisor and franchisee, the plaintiff must produce proof to show that the true operating agreement was one which vested the right of control in the franchisor). In each of these cases, the contractual disclaimer of an agency relationship was given at least some level of deference by the court in its determination. Compare, Butler v. McDonald’s Corp., 110 F. Supp. 2d 62 (D.R.I. 2000) (notwithstanding disclaimer of agency relationship in franchise agreement, the court found the existence of the agency relationship was a question of fact for the jury, noting that “a party cannot simply rely on statements in an agreement to establish or deny agency”); J.M. v. Shell Oil Co., 1995 WL 713052, Bus. Franchise Guide (CCH) ¶ 10,817 (Mo. App. 1995), rev’d on other grds 922 S.W.2d 759 (Mo. 1996) (general disclaimers contained in dealership and lease agreements between gasoline station franchisor and franchisee, which stated that nothing in the agreement should be construed as reserving to the franchisor a right to exercise any control over the franchisees’ operations, might not shield the franchisor from vicarious liability for the criminal assault of a customer while on the franchisee’s premises; despite the disclaimer, numerous other provisions of the agreements granted the franchisor the right to control hours of operation, the kinds of products sold, and employee training, such that a reasonable jury could find that the franchisor had general control over the franchisee’s operations); Ely v. General Motors Corp., 927 S.W.2d 774 (Tex. App. 1996) (a franchise agreement provision expressly disclaiming the existence of an agency relationship between an automobile manufacturer and a dealer did not necessarily shield the manufacturer from liability for a fatal accident caused by one of the dealer’s employees while test driving a vehicle that had been brought in for warranty repairs; if manufacturer had retained the right to control the dealer’s operations, it could still be liable for the accident).

77 This theory is based on the basic premise of agency law that “the agreement to act on behalf of the principal causes the agent to be a fiduciary, that is, a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking.” Restatement (Second) of Agency § 13, cmt. a.

78 See e.g., Brock v. Baskin Robbins, Bus. Franchise Guide (CCH) ¶ 12,585 (E.D. Tex. 2003) (finding that no fiduciary relationship existed on the part of the franchisor to disclose that it knew that some of its store formats were not viable where the parties’ agreements did not create fiduciary relationship); Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 280 (7th Cir. 1992) ("parties to a contract are not each other’s fiduciaries—even if the contract is a franchise") (citations omitted); O’Neal v. Burger Chef Sys., Inc., 860 F.2d 1341, 1349 (6th Cir. 1988) (“in general, franchise agreements do not give rise to fiduciary or confidential relationships between the parties”).
franchisees with respect to these undertakings may be deemed to be governed by fiduciary principles.

This exception has allowed franchisee attorneys to contend that a franchisor has breached its fiduciary duty. The argument is this: where a franchisor may be deemed to be acting as an agent for its franchisees—e.g., in negotiating the best possible prices for its franchisees, handling franchisee funds, or committing to collect funds from third parties and use the funds collected to promote the franchise system—it may bestow upon it a duty akin to that of a fiduciary, to act in a focused, unadulterated way, without conflict of interest, for the good of its principals, the franchisees.

This version of fiduciary duty, not generally owed, may nevertheless arise in the narrow circumstances where the franchisor enters into a management agreement with the franchisee, under which the franchisor assumes fiduciary responsibilities (not as “franchisor,” but as the franchisee’s “manager-agent”). In *Town Hotels Limited Partnership*, franchisee hotel owners sued a hotel franchisor-manager claiming, among other things, breach of fiduciary duty. The franchisees alleged that the management agreement between the parties, under which the hotel franchisor was granted unfettered authority to manage and control the franchisees' hotel, created an agency relationship whereby the hotel franchisor, as manager, had a fiduciary duty to operate the franchisees' hotel solely for the benefit of the franchisees. Since the hotel franchisor served as an agent for the franchisees in procuring and purchasing goods and supplies under the management agreement, the hotel franchisor breached the management agreement by “receiv[ing] undisclosed payments and rebates from vendors for the opportunity to sell goods to [the franchisees].”

Similarly, in *2660 Woodley Road Joint Venture*, hotel franchisees sued their hotel franchisor-manager seeking damages for breach of fiduciary duty under the parties’ hotel management agreement. After the jury returned a verdict for the franchisees on the breach of fiduciary duty claim, the franchisor-manager brought several post-trial motions to overturn the verdict. The district court denied the motions, concluding that the franchisees presented sufficient evidence to support the jury’s verdict, including evidence that the franchisor, in its capacity as the hotel’s manager, improperly received kickbacks despite its role as the franchisee’s agent. The district court’s finding of a breach of fiduciary duty was upheld on appeal, although the amount of damages awarded was reduced.

However, franchisees’ claims for breach of fiduciary duty under franchise agreements are not always successful. For example, in *Broussard v. Meineke Discount Muffler Shops, Inc.*, franchisees were ultimately not allowed to advance their claims for breach of fiduciary duty by the muffler shop franchisor for the franchisor’s management of a franchisee advertising fund. The U.S. Court of Appeals for the Fourth Circuit held that the plaintiffs’ claim for breach of fiduciary duty could not survive where there was “no indication that North Carolina law would

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80 Id. at 472.
81 Id. at 480.
82 369 F.3d 732 (3d Cir. 2004).
83 Id. at 736.
84 Id.
85 Id. at 743-44.
recognize the existence of a fiduciary relationship between franchisee and franchisor.” The court stated that a fiduciary relationship would exist only if the franchisor “held all the cards.” Because the franchisees in this case were independent and sophisticated businesspeople occupying positions of equal bargaining power with the franchisor, the court found that imposition of a fiduciary relationship was improper. The court also relied on the existence of federal regulations and state franchise laws to support its finding that franchisees had sufficient protections already in place and did not require imposition of a fiduciary duty upon the franchisor.

In drafting franchise agreements, some franchisees would prefer that the existence or non-existence of a fiduciary relationship not be addressed in the agreement, therefore leaving room for a court to determine the issue based on the specific facts of the parties’ relationship. Franchisors, on the other hand, almost always want to include a clause defining the parties’ relationship and disclaiming any fiduciary duties.

A number of courts have specifically held that a franchise agreement’s disclaimer of a fiduciary relationship is enough, by itself, to defeat a franchisee’s fiduciary duty claim. These decisions should encourage franchisors to include these disclaimers in their franchise agreements. In Dunkin’ Donuts v. N.A.S.T., Inc., a doughnut store franchisor sued a franchisee for breach of the franchise agreement. The franchisee initially asserted a number of counterclaims, including a claim alleging breach of fiduciary duty, which the franchisee later dismissed after the franchisor moved for summary judgment. After dismissal, the franchisor sought to recover the costs incurred in defending the breach of fiduciary duty claim. The court held that there was no good faith justification for that claim, given the franchise agreement’s express disclaimer of a fiduciary relationship—which the court stated was “dispositive on the subject”—and the near uniform judicial rejection of a fiduciary relationship between franchisors and franchisees. The court noted that the franchisee “ha[d] failed to identify a single court authority that support[ed] his approach to that issue in conjunction with a rejection, as somehow unenforceable, of a contractual disclaimer such as that contained in the Franchise Agreements.” Because the contractual disclaimer of a fiduciary relationship made a claim for breach of fiduciary duty frivolous under 28 U.S.C. §1927, the court awarded the franchisor the costs incurred in defending the claim.

A number of other courts have likewise dismissed breach of fiduciary duty claims as a matter of law based, at least in part, on a franchise agreement disclaimer. In Prince Heaton Enterprises, Inc. v. Buffalo’s Franchise Concepts, Inc., for example, the defendant franchisor moved to dismiss the plaintiff franchisee’s claim for breach of fiduciary duty. The parties’ franchise agreement provided that “this agreement does not establish a fiduciary relationship between [the parties].” The court granted the motion, holding that the plaintiff’s allegation failed by virtue of the contract language and because a franchisor does not generally have a fiduciary duty to its franchisees under applicable Georgia law.

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87 Id.
88 Id.
89 Id.
90 Id.
91 266 F. Supp. 2d 826 (N.D. Ill. 2003).
92 Id. at 829.
Given these principles, is it worthwhile for a franchise agreement expressly to disclaim the existence of a fiduciary relationship? Franchisors will argue that judicial decisions giving substantial, if not dispositive, weight to contractual disclaimers of a fiduciary relationship strongly favor insertion of disclaimers. A disclaimer may add clarity, while not adding much length to a franchise agreement (as it can be combined with the disclaimer of agency relationship discussed above).

On the other hand, franchisees may suggest that this clause may prove superfluous, given the settled law in many jurisdictions that this type of clause is not dispositive, and that courts will often look at the totality of the circumstances to determine if a fiduciary relationship exists.

C. Employment Relationship

Is a franchisee, particularly an individual franchisee operating outside the constraints of a “brick and mortar” location, an employee of the franchisor for unemployment insurance, vicarious liability, or other purposes? Can the franchise agreement conclusively disclaim that relationship?

At least one court has held that individual franchisees were employees of their franchisor, notwithstanding provisions to the contrary in the parties’ franchise agreements.94 Once again, these cases largely turn on their facts, and courts will take note of contractual disclaimers, but will not find the disclaimers dispositive.

It is difficult to predict the numerous circumstances under which the employment/independent contractor relationship can become an issue in the life of a franchise and what law will be applied to make that determination. While an employment relationship is generally determined by an examination of the putative employer’s right to control the employee, other, more particularized standards are applicable when the relationship is being examined for the purposes of imposition of employment insurance contributions.95 Thus, while including disclaimer language may clarify the parties’ intent at the commencement of the franchise relationship, those intentions may not be conclusive in later judicial proceedings.

VI. ASSIGNMENT

Clauses governing the assignment and transfer of franchises are essential to protect the interests of the franchisor, the franchisee and prospective transferees. Fluctuating business conditions often necessitate changes, and clear, detailed franchise agreement provisions governing these situations will avoid costly litigation and provide smooth and beneficial transitions for both parties. These clauses should simply outline whether the franchisee must first obtain written consent from the franchisor before assignment or transfer; whether the proposed transferee must satisfy any qualifications; and whether the franchisor has a right of first refusal to the sale of a franchise.

A. Sale by Franchisee

Generally, franchise agreements give the franchisee a right to assign or transfer the agreement, subject to certain conditions, such as obtaining the consent of the franchisor, giving

95 Id.
the franchisor a right of first refusal and/or satisfying the franchisor’s general qualifications of a franchisee.96

Franchise and dealer agreements usually require consent of the franchisor for the franchisee/dealer to assign or transfer rights under the agreement. Often, the provisions will also state that the franchisor may not unreasonably withhold its consent. In Walner v. Baskin-Robbins, the court held that a franchisor’s refusal to consent to a transfer is not grounds for an interference with contract claim because the parties’ agreement specifically required the franchisee to obtain the franchisor’s consent before transferring the franchise.97

In Richter v. Dairy Queen, the franchise agreement stated that the franchisor had to consent to any transfer; that consent could not be unreasonably withheld; and that the franchisor could insist that the transferee meet certain qualifications. The court held that the reasonableness requirement also applied to the franchisor’s determination regarding whether the transferee met the required qualifications. While the franchisor, under this agreement, could withhold consent for valid business reasons, the court held that the franchisor unreasonably withheld consent because the evidence showed that the proposed transferees were “reputable and experienced business persons.” Additionally, the court held that the decision to withhold consent must be in good faith.98

Under the Petroleum Marketing Practices Act (“PMPA”), a motor fuel franchisor’s qualification requirements must be reasonable, which generally means that the qualifications must relate to concerns about the transferee’s character, business experience and training, or financial ability.99 In franchise cases generally, courts have held that franchisors do not act unreasonably by withholding consent to the transfer of a franchise to a party that owns a competing business, lacks sufficient capital or is financially unstable.100

Courts are divided over how the implied covenant of good faith and fair dealing interplays with clauses in franchise agreements requiring franchisor consent to transfer or assignment. In Larese v. Creamland Dairies, Inc., the U.S. Court of Appeals for the Tenth Circuit held that, under Colorado law, franchisors have a duty to act reasonably and in good faith when refusing consent to a franchisee’s proposed transfer of a franchise, even if the parties’ agreement does not have a requirement that the franchisor may not unreasonably withhold consent.101 Other courts have held that the implied covenant of good faith and fair dealing does not override an express provision of a contract; therefore, provisions allowing a

96 See W. Michael Garner, Franchise Distribution Law and Practice, § 3:49 (West 2005). Generally, the franchisor does not have a right of first refusal when the franchisee transfers to a corporation wholly owned by the individual franchisee. See id. at § 3:50.
100 Rickel v. Schwinn Bicycle Co., 144 Cal. App. 3d 648 (Cal. App. 1983); In re Pioneer Ford Sales, Inc., 729 F.2d 27 (1st Cir. 1984); Mikeron, Inc. v. Exxon Co., U.S.A., 264 F. Supp. 2d 268 (D. Md. 2003). See also Dunkin’ Donuts Inc. v. Sharif, Inc., 177 Fed. Appx. 809 (10th Cir. 2006) (franchisor did not unreasonably withhold consent to transfer of franchise to party with bad credit rating when the franchise agreement specifically provided that the “transferee shall have a good credit rating and business qualifications reasonably acceptable to” the franchisor).
101 767 F.2d 716 (10th Cir. 1985) (also noting that provisions allowing a franchisor to withhold consent to transfer unreasonably or arbitrarily must be bargained for to be enforceable). See also Preston v. Mobil Oil Corp., 741 F.2d 268 (9th Cir. 1984) (holding that a franchisor must have a good faith, reasonable reason to withhold consent, even though the contract did not contain a reasonableness requirement).
Author J. Michael Dady believes that franchisees may benefit from the inclusion of an express covenant of good faith and fair dealing in the franchise agreement. If the agreement states that “the parties to the Agreement commit to deal with each other in good faith, fairly, honestly and in a non-discriminatory, commercially reasonable way,” both parties may benefit from the business transaction if the franchisee seeks to transfer its franchise. For example, under this clause, the franchisee would be bound to ensure that proposed transferees are qualified to operate the franchise, under the franchisor’s reasonable standards, and the franchisor would be bound to not unreasonably withhold consent to a transfer that will meet the needs of both parties.

Franchisors, however, will almost never wish to include the provision, in hopes that franchisees’ claims for breaches of the implied covenant of good faith and fair dealing will be dismissed as contradicting the express terms of the parties’ agreement.

Many franchise agreements contain a provision giving the franchisor a right of first refusal to a franchisee’s proposed sale of the franchise to a third party. These provisions are usually enforced. A franchisor’s exercise of the right of first refusal generally does not threaten franchisees, so long as the franchisor will pay the same price for the franchise as the prospective buyer agreed to pay. However, if possible, franchisee attorneys prefer to get this provision removed because it tends to depress the value of the franchisee’s business.

In *Crivelli v. General Motors Corp.*, the court held that exercising a right of first refusal did not violate a state statute preventing a franchisor from unreasonably withholding consent to a transfer or sale and did not constitute tortious interference with contract. The court took care to distinguish between consent requirements, which are more restrictive on the franchisee’s ability to sell or assign a franchise, and the right of first refusal, which is less restrictive because it requires the franchisor to match the terms of the proposed sale.

Both franchisees and franchisors should take note that many states have statutes affecting the rights of franchisees who wish to sell, transfer or assign the franchise. These statutes may be violated by a franchisor’s unreasonable restriction on a franchisee’s right to assign or transfer the agreement. Both parties should also take note of the laws of various jurisdictions that may govern their agreement, paying close attention to choice-of-law provisions, and determine how these regulations and protections may affect sale and assignment rights.

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103 See Garner at § 3:54.

104 215 F.3d 386 (3d Cir. 2000).

B. Sale or Assignment by Franchisor

Generally, franchise agreements provide that the franchisor may transfer or assign the agreement upon notice to the franchisee. However, both the original franchisor and the entity acquiring the franchise system may, in certain narrow circumstances, have transfer duties and responsibilities arising under the implied covenants of good faith and fair dealing.

In Hanson Hams, Inc. v. HBH Franchising Co., LLC, a subsidiary of a competing company acquired a franchise system. The franchisees alleged violations of the Florida Unfair and Deceptive Trade Practices Act (“FUDTPA”) because the acquisition placed rival franchises under the same parent company. According to the franchisees, the acquisition “pits franchise siblings against one another while placing the parent in a position where it can favor one franchise system over the other by way of promotion, development and support.” The court denied the franchisor’s motion to dismiss, holding that the franchisees’ allegations, taken as true, could support a finding of liability under the FUDTPA. However, the court eventually denied the claim, because the original franchise agreement gave the franchisor a right to merge, acquire, joint venture or affiliate with any existing franchise business, whether competitive or not, and the new franchisor was taking substantial steps to promote the acquired franchise.

Author J. Michael Dady believes that franchisees may benefit from a clause in the agreement that provides reasonable protection against the same or similar competition from the franchisor, its affiliates, or its other franchisors and licensees. Additionally, it is important for franchisees to get the franchisor’s commitment to sell only to financially viable successors who agree to assume all obligations of the franchisor. Although franchisors may require the flexibility offered by a clause allowing them to merge or affiliate, franchisees should press for a covenant requiring that successor franchisors acquire the original franchisor’s obligations, including the obligation to promote the franchisee’s business. Conversely, franchisors generally desire clauses that provide them with the greatest amount of flexibility in making these business decisions.

Both franchisees and franchisors should also note that a franchisor’s assignment may constitute constructive or “de facto” termination of the franchise agreement when the assignment results in a breach of one of the statutory or contractual components of a franchise agreement. The assignment must not create an increase in contractual burdens for the franchisee.

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106 See Garner at § 3:47.
108 Id.
109 See, e.g., Chestnut Hill Gulf, Inc. v. Cumberland Farms, Inc., 940 F.2d 744 (2d Cir. 1991); May-Som Gulf, Inc. v. Chevron U.S.A., Inc., 869 F.2d 917 (6th Cir. 1989) (The statutory components of a franchise agreement are: “a contract to use the refiner’s trademark, a contract for the supply of motor fuel to be sold under the trademark, and a lease of the premises at which motor fuel is sold”); Shukla v. BP Exploration & Oil, Inc., 115 F.3d 849 (11th Cir. 1997).
110 Shukla, 115 F.3d at 853-54.
VII. FRANCHISEE ACKNOWLEDGMENTS AND DISCLAIMERS

More and more franchise agreements feature various franchisee acknowledgments and disclaimers, either internally or as annexed appendices, addressing critical aspects of the franchise sales process. The franchisee will generally be asked to acknowledge receipt and review of the franchise disclosure document; disclaim receipt of any representations concerning the franchise not specifically set forth in the franchise disclosure document; disclaim receipt of and reliance upon any financial representations or earnings claims other than those set forth in Item 19 of the franchise disclosure document; and acknowledge that the franchised business involves an element of risk, and that no assurance has been given that the franchise business will be successful.

Acknowledgments may prove quite useful to the franchisor in the event that the prospective franchisee later asserts that it was fraudulently induced to enter the franchise agreement, or was otherwise misled with respect to its purchase of the franchise. These acknowledgments on their face may defeat, as a matter of law, a claim that the franchisee relied on anything other than the information set forth in the franchise disclosure document, since reliance has been expressly disavowed.

However, depending on the jurisdiction, acknowledgments and disclaimers may be given limited effect in defeating the reliance element of a franchisee’s fraud or misrepresentation claim. Under Minnesota law, general disclaimers and integration clauses are given no effect in misrepresentation cases, and even fairly specific disclaimers are typically held to create jury questions about reliance, rather than to negate reliance as a matter of law. Further, some franchise statutes, including the Minnesota Franchise Act, beg the question whether justifiable or reasonable reliance is even an element of a claim for misrepresentation. If this is the case, and neither justifiable nor reasonable reliance is required, acknowledgments and disclaimers in

111 See Clements Auto Co. v. Serv. Bureau Corp., 444 F.2d 169, 178 (8th Cir. 1971) (“a general disclaimer clause is ineffective to negate reliance on even innocent misrepresentations”).
113 See Randall v. Lady of Am. Franchise Corp., No. 04-3394, 2007 WL 2128180 (D. Minn. July 24, 2007) (declining to grant summary judgment on the basis that the disclaimers in the franchise agreement negated the franchisees’ justifiable reliance on the franchisor’s representations, stating that “nowhere does the statute mention justifiable reliance” and “no Minnesota court has read such a requirement into the Minnesota Franchise Act’s prohibition on misrepresentations by franchisors”). Compare Cook v. Little Caesar Enters., Inc., 210 F.3d 653, 659 (6th Cir. 2000) (holding that reasonable reliance is an element of a misrepresentation claim under Michigan’s franchise law); Hardee’s of Maumelle, Ark., Inc. v. Hardee’s Food Sys., Inc., 31 F.3d 573, 579 (7th Cir. 1994) (observing that lower Indiana courts have read a reasonable-reliance requirement into Indiana’s franchise law, but not reaching question); Bonfield v. AAMCO Transmissions, Inc., 708 F. Supp. 867, 876-78 (N.D. Ill. 1989) (reading reasonable reliance requirement into Illinois’s franchise law) (superseded by statute on other grounds, as explained in Lewis v. Hermann, 775 F. Supp. 1137, 1153 (N.D. Ill. 1991)).
the disclosure document and franchise agreement may not, as a matter of law, defeat a franchisee’s fraud claim or misrepresentation claim under the applicable franchise statute.

The question then arises whether the acknowledgment violates the anti-waiver provisions included in most franchise registration/disclosure statutes. In 2006, a New York trial court addressed this issue and held that the New York Franchise Act’s anti-waiver provisions do not preclude a franchisor from relying on franchisee disclaimers in an executed “Questionnaire/Rider” annexed to the parties’ franchise agreement.

In *Emfore Corp. v. Blimpie Associates, Ltd.*, the plaintiff franchisee received a Blimpie’s UFOC, which said that Blimpie made absolutely no statements or representations regarding historic or projected franchised unit sales, profits or earnings and that further informed prospective franchisees that no Blimpie sales personnel were authorized to disseminate any of this financial performance information. The UFOC also stated that Blimpie franchisees might have an additional opportunity for business growth by “co-branding” within Blimpie franchised restaurants.114

Before the franchisee executed its franchise agreement, Blimpie presented a letter asking the franchisee to confirm both the absence of financial performance representations and that the franchisee received no representations other than those in Blimpie’s UFOC. The franchisee executed the letter, initialing each paragraph without comment.

Less than a year after opening its business, the franchisee sued Blimpie and certain of its officers, alleging common-law fraud, breach of contract, and violation of the New York Franchise Act in connection with alleged presale misrepresentations concerning the availability of a co-branding opportunity and Blimpie’s dissemination of information concerning the amount of income that the plaintiff would earn from the operation of its Blimpie restaurant.

Blimpie moved for summary judgment, relying on the franchisee’s disclaimer letter. The court noted that the UFOC and the disclaimer letter each explicitly disclaimed any financial performance representations, and therefore dismissed all common-law fraud claims. With regard to the allegation that Blimpie violated the New York Franchise Act, the court again referred to the UFOC and the disclaimer letter. Rejecting plaintiff’s argument that the disclaimer letter violated the anti-waiver provisions of the New York Franchise Act, the court held:

While plaintiff is correct in stating that the “clear and unambiguous” language of the Franchise Act bars release and waiver clauses, there is no language barring the type of Questionnaire disclaimers presented herein. Nor is the broad statutory anti-fraud purpose furthered by construing the disclaimers in the Questionnaire/Rider as “illegal”. Rather, it is consistent with the Franchise Act’s purpose enabling the prospective franchisee to assess the franchisee’s [sic] offer and to keep them fully informed as to its rights.115

However, under certain franchise laws, anti-waiver provisions prevent franchisors from using contractual provisions to protect themselves from being sued for misrepresentation.116

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115 Id.
116 See, e.g., Minn. Stat. § 80C.21; S.D. Codified Laws § 37-5A-86 (foreclosing franchisors from using disclaimers to defeat franchisees’ claims under South Dakota’s franchise law).
Recently, in *Randall v. Lady of America Franchising Corp.*, the U.S. District Court for the District of Minnesota held that the anti-waiver provision of the Minnesota Franchise Act ("MFA") voided the acknowledgement and disclaimer provisions of the franchise agreement, since they had the "legal effect" of requiring a franchisee to waive compliance with the MFA. The District Court reasoned that the plain language of the anti-waiver provision, together with the broad, remedial scope of the MFA, was meant to protect franchisees and burden franchisors. As a result, the franchisor's contractual disclaimers were found to be unenforceable.

**VIII. CHOICE-OF-LAW PROVISIONS**

Franchisors often include elaborate choice-of-law provisions in their franchise agreements in an attempt to control the substantive law that will govern the franchise relationship. Often a choice of law is made based upon perceived convenience rather than on the merits of the laws applicable in the franchisor's home jurisdiction. The franchisor's selection of a particular state's law is an important decision because the chosen law may dramatically affect the rights of both the franchisor and the franchisee, especially considering the presence of state laws that regulate the termination or substantial alteration of franchise relationships and the wide disparity among jurisdictions in the nature and amount of franchise regulation.

**A. Nexus Requirement**

Usually, courts will enforce a contractual choice-of-law provision if there is a reasonable relationship between the forum whose law is chosen and the contractual relationship between the parties. Most frequently, this forum will be the home state of the franchisor or another state that has contacts with the franchise relationship.

However, when the parties have selected the law of a state other than the forum state, courts determine whether to apply the foreign state law by applying this four-part test (or a close variation of it): (1) Did the parties agree to the choice-of-law provision in advance?; (2) Are the contacts of the parties evenly divided between the chosen state and the plaintiff's state?; (3) Are the parties of relatively equal bargaining strength?; and (4) Is the application of the chosen law repugnant to the public policy of the franchisee's state?

**B. Applicability of Chosen Venue's Franchise Laws/Disclaiming Applicability Thereof**

While the parties are free to select the law that will govern the franchise relationship, they cannot choose a law that is in derogation or contravention of a strong public policy of the state seeking to protect its citizens. Often, courts have viewed state statutes regulating the conduct of parties to a franchise agreement as embodying the fundamental public policy of the state, and, courts have consistently held that these statutes prevailed over conflicting language in the agreements between the parties. State franchise statutes will often be deemed the

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118 *Id.* at 30.
119 *Id.*
120 Restatement (2d), Conflict of Laws, §§ 187-188.
122 *See Luis Rosario, Inc. v. Amana Refrigeration*, 733 F.2d 172, 173 (1st Cir. 1984) (holding that the public policy of the Puerto Rico Dealer's Act was to prevent dealer termination without just cause); *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979) (holding that the South Dakota Franchise Act indicated
fundamental public policy of the state where the statutes contain provisions that prevent franchisors from requiring franchisees to waive their protections under the statute.

For example, the Minnesota Franchise Act\textsuperscript{123} contains an anti-waiver provision that states:

Any condition, stipulation or provision, including any choice-of-law provision, purporting to bind any person who, at the time of acquiring a franchise is a resident of this state, or, in the case of a partnership or corporation, organized or incorporated under the laws of this state, or purporting to bind a person acquiring any franchise to be operated in this state to waive compliance or which has the effect of waiving compliance with any provision of sections 80C.01 to 80C.22 or any rule or order thereunder is void.\textsuperscript{124}

Thus, franchisors should be prepared for the reality that the choice-of-law provisions in their franchise agreements may not be entirely respected, even in the forum whose law was chosen to apply.

However, some courts have disregarded these statutory provisions and enforced choice-of-law clauses that were intended to override the state statute. In both Tele-Save Merchandising Co. v. Consumers Distrib. Co.\textsuperscript{125} and Modern Computer Sys. v. Modern Banking Sys.,\textsuperscript{126} the courts determined that, despite the non-waiver language of the state statutes at issue, the public policy supporting freedom of contract was at least as important as the public policy that favored applying a state's franchise protection statutes.

Applying the four-part test stated above, the Tele-Save and Modern Computer courts each examined the bargaining history and relative bargaining strength of the would-be franchisor and franchisee and concluded that, in fact, both parties were of relatively equal bargaining strength and had bargained in good faith. Both courts therefore found that the strong public policy favoring the parties' freedom of contract should prevail over strong public policy favoring enforcement of state statutes, and gave legal effect to the choice-of-law provisions because, in essence, the would-be franchisees had intentionally bargained away their statutory protection.\textsuperscript{127}

After Tele-Save and Modern Computer were decided, franchisee lawyers feared that other federal courts facing the issue might expand the holdings beyond their particular facts to conclude that choice-of-law provisions always prevail over otherwise applicable state statutes.

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\textsuperscript{123} Minn Stat. § 80C.01, et seq.

\textsuperscript{124} Minn. Stat. § 80C.21.

\textsuperscript{125} 814 F.2d 1120 (6th Cir. 1987).

\textsuperscript{126} 871 F.2d 734 (8th Cir. 1989).

\textsuperscript{127} See also Computrol, Inc. v. Newtrend L.P., 203 F.3d 1064 (8th Cir. 2000) (noting that "exculpatory or limitation of damages clauses are not favored and must be strictly construed against a benefiting party, but may be enforceable in certain circumstances where overriding, strong public policy exists").
Some case law addressing this issue has confirmed this fear. But not all jurisdictions have followed what these franchisee lawyers see as a particularly disturbing trend. The most comprehensive rejection of the Tele-Save/Modern Computer reasoning came in Wright-Moore Corp. v. Ricoh Corp., where the Seventh Circuit refused to apply the Modern Computer analysis, finding it contrary to the public policy of Indiana as evidenced by the Indiana Franchise Law and state choice-of-law rules. The court held that a party cannot opt out of the state statute by an indirect waiver, such as a choice of foreign law, at least where the franchisee’s state has a materially greater interest in the resolution of the dispute.

Other courts have since resisted enforcing choice-of-law provisions that effectively take away franchisees’ and dealers’ statutory protections. In Electrical and Magneto Serv. v.

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128 See JRT, Inc. v. TCBY Sys., Inc., 52 F.3d 734, Bus. Franchise Guide (CCH) ¶ 10,652 (8th Cir. 1995) (holding that a choice-of-law stipulation was not voided by the Michigan Franchise Investment Law’s anti-waiver provision because the Law’s provision did not expressly speak to stipulations); Comm. Prop. Inv., Inc. v. Quality Inns Intl, Inc., 1991 WL 122372 (8th Cir. 1991) (skipping its earlier four-step analysis entirely, the Eighth Circuit simply concluded that Modern Computer required it to uphold a choice-of-law provision in a distributorship agreement despite a franchise act’s anti-waiver provision); Perry v. TCBY Sys., Inc., Case No. LR-C-91-97 (E.D. Ark. Aug. 27, 1991) (holding that a choice-of-law provision in a form franchise agreement precluded applying an otherwise applicable franchise act, without employing the Modern Computer four-part analysis or even addressing the franchisee’s claim that the anti-waiver provisions of the franchise act should be given legal effect); Anderson v. United Air Specialists, Inc., Bus. Franchise Guide (CCH) ¶ 9,600 (D. Minn. 1990) (accepting that the choice-of-law provision eliminated the otherwise applicable franchise statute, without any finding that the provision was intentionally and freely negotiated by parties of relatively equal bargaining strength). See also Cherokee Pump & Equip., Inc. v. Aurora Pump, 38 F.3d 246, Bus. Franchise Guide (CCH) ¶ 10,594 (5th Cir. 1995) (holding that Illinois choice-of-law provision did not violate Louisiana public policy, despite the fact that Illinois law permitted termination of the distributorship in a manner Louisiana would not, because nothing in Louisiana law indicated strong public policy prohibiting these terminations); TCBY Sys., Inc. v. RSP Co., 33 F.3d 925, Bus. Franchise Guide (CCH) ¶ 10,518 (8th Cir. 1994) (enforcing an Arkansas choice-of-law clause over Minnesota law; ruling that the anti-waiver amendment to the Minnesota Franchise Act could not be applied retroactively; and holding that the Arkansas choice-of-law provision was valid because it did not violate Arkansas’s public policy); Cottman Transmissions Sys., Inc. v. Melody, Bus. Franchise Guide (CCH) ¶ 10,558 (E.D. Pa. 1994) (applying a two-part test concerning: (1) whether there was a reasonable relationship between the dispute and the Pennsylvania choice-of-law state; and (2) whether California, the franchisee’s state, had a materially greater interest in the case’s outcome and upholding the Pennsylvania choice-of-law provision, finding that (1) the parties’ contacts with both states were equal; and (2) applying Pennsylvania law to the dispute, rather than California law, would not produce a materially different outcome).

129 908 F.2d 128 (7th Cir. 1990).

130 The Indiana state statute at issue in Wright-Moore Corp. contains the type of general anti-waiver language found inadequate by the court considering the Minnesota state statute in Modern Computer, i.e., the Indiana statute prohibits contractual provisions “requiring the franchisee to prospectively assent to a release . . . waiver or estoppel which purports to relieve any person from liability to be imposed by this chapter.” Ind. Code § 23-2-2.7-1. The Minnesota anti-waiver language provided that “[a]ny condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of the [Act] . . . is void.” Minn. Stat. § 80C.21.

131 908 F.2d 128 (7th Cir. 1990).

132 See also Solman Distribs., Inc. v. Brown-Forman Corp., 888 F.2d 170 (1st Cir. 1989) (noting that the statutory protection sought to be avoided with the choice-of-law language in the contract reflected the strong public policy of the state and could not be waived).

133 Sutter Home Winery, Inc. v. Vintage Selections, Ltd., 971 F.2d 401, Bus. Franchise Guide (CCH) ¶ 10,002 (9th Cir. 1992) (interpreting a contractual choice-of-law provision providing for the application of California law “except as otherwise required by applicable law” to permit the court to apply an Arizona liquor franchise act to an Arizona distributor).
AMBAC Int’l Corp., the U.S. Court of Appeals for the Eighth Circuit, which had to that point been among the most aggressive in enforcing choice-of-law provisions in distribution agreements, departed from that trend. 134 In Magneto, the Eighth Circuit reversed the district court and held that a Missouri statute requiring 90 days prior written notice of termination represented a fundamental policy of the State of Missouri and therefore applied to the termination of a Missouri distributor, despite a contract provision selecting South Carolina law. 135 The trial court had attached no significance to the distributor’s claimed lack of bargaining power and had indicated in its opinion that it would enforce all choice-of-law clauses in form agreements unless either strong evidence existed that the agreement was an adhesion contract or unless the Missouri legislature amended the statute at issue to add an anti-waiver provision. 136

Franchisees should also be aware that choice-of-law provisions may be used offensively, as well, to afford them protection they would not otherwise have. 137 For example, franchisees may seek the protection of a California statute providing that non-compete clauses

134 941 F.2d 660, Bus. Franchise Guide (CCH) ¶ 9,888 (8th Cir. 1991).
136 See also Kinnard v. Shoney’s Inc., 100 F. Supp. 2d 781 (M.D. Tenn. 2000) (there is a general legislative policy against waivers of potentially applicable franchise laws through contractual choice-of-law provisions). But see Baxter Int’l, Inc. v. Morris, 976 F.2d 1189 (8th Cir. 1992) (abrogating its decision in AMBAC and applying the following three step process set forth in Restatement (Second) of Conflicts of Law § 187 in its entirety: (1) which state’s law would apply absent the provision; (2) which state has a materially greater interest in the outcome; and (3) whether application of the chosen law would be contrary to a fundamental policy of the default state); Unarce v. Staff Builders, Inc., 61 F.3d 912, Bus. Franchise Guide (CCH) ¶ 10,746 (9th Cir. 1995) (holding that California law governed the termination and release agreement of a franchisee notwithstanding a New York choice-of-law provision because the validity of the agreement itself had been questioned); Pride Tech., Inc. v. Sun Microsystems, Bus. Franchise Guide (CCH) ¶ 10,407 (N.D. Cal. 1994) (holding that New Jersey’s strong public policy to protect its franchisees trumped a contrary choice-of-law provision); Flynn Beverage, Inc. v. Joseph E. Seagram & Sons, Inc., 815 F. Supp. 1174 (C.D. Ill. 1993) (ruling that the strong public policy embodied in the arguably applicable Illinois Franchise Disclosure Act overrode the choice of New York law in the distributor agreement); Cherry Invs., Inc. v. Yogurt Ventures USA, Inc., Bus. Franchise Guide (CCH) ¶ 10,224 (E.D. Mich. 1992) (holding that the fundamental policy of the Michigan Franchise Investment Law overrode the choice of Georgia law in the franchise agreement); but see Banek v. Yogurt Ventures USA, Inc., 6 F.3d 357 (6th Cir. 1993) (enforcing exactly the same choice-of-law clause invalidated in Cherry).
137 See Burger King Corp. v. Austin, 805 F. Supp. 1007, 1022-23, Bus. Franchise Guide (CCH) ¶ 10,104 (S.D. Fla. 1992) (applying the Florida Franchise Act over a franchisor’s objection that the Act did not apply by its terms, since the choice-of-law provision demonstrated the intent of the parties for Florida law to govern the parties’ agreement). Tractor and Farm Supply, Inc. v. Ford New Holland, Inc., 898 F. Supp. 1198 (W.D. Ky. 1995) (upholding Michigan choice-of-law provision and Kentucky dealer’s Michigan Franchise Investment law claim, even though neither dealer nor manufacturer were located in Michigan at the time of the suit, because the agreement was drafted by the manufacturer and the manufacturer had substantial contacts with Michigan at the time the contract was created); Candleman Corp. v. Farrow, Bus. Franchise Guide (CCH) ¶ 11,635 (D. Minn. 1999) (applying Minnesota Franchise Act to non-Minnesota franchisee because Minnesota franchisor chose Minnesota law in the Franchise Agreement); Department of Motor Vehicles v. Mercedes-Benz, 408 So. 2d 627, 630 (Fla. 1981) (same); Diesel Injection Serv. v. Jacobs Vehicle Equip., 1998 WL 950986 (Conn. Super. Ct. 1998) (upholding choice-of-law provision and applying chosen state’s Franchise Act even though, under the plain language of the Act, it would not apply to an out-of-state franchisee).
that would restrain a person from engaging in a “lawful profession, trade or business of any kind” are void.\textsuperscript{138}

In drafting a franchise agreement, the inclusion of a detailed choice-of-law provision allows the parties to agree upon the law that will govern their relationship. The clause frequently preserves the statutory protections afforded to franchisees in the state where the franchise is located. Choice-of-law provisions are less likely to be overridden by a strong public policy of the state in which the franchise is located; rather, the public policy and the regulations that reflect it would be expressly incorporated into the parties’ agreement and the expectations of the parties would be protected.

Franchisors should be advised to consider carefully the effect of a choice-of-law provision, and be made aware that the franchise laws of the state where the franchise is located may apply to the agreement, despite the existence of a choice-of-law provision.

**IX. CONCLUSION**

New franchise companies and mature ones typically differ in the complexity of their respective franchise agreements. Generally, franchise agreements drafted years ago were shorter and simpler. Over the years, however, the complexity (and length in pages) of franchise agreements has increased, as franchisors and their counsel have tried to spell out rights and obligations that were not contemplated when the agreements were initially drafted. Although franchisors have the right to revise their standard form franchise agreements prospectively, franchisors generally face significant relationship issues from their franchisees when they seek to implement wholesale changes. Most successful franchisors change their franchise agreements with franchisee input, or on an “as needed” basis.

New franchisors, in contrast, are free (at least in theory) to create as complex a franchise agreement as they wish. However, their franchise sales forces will advocate for a shorter, less complicated form of agreement, or at least one that is similar to the new franchisor’s competitors. Many new franchisors will ask their attorneys for copies of their competitors’ agreements before drafting their own agreement. These new franchisors should understand that, while they may try to create an agreement that protects the franchisor in every instance, they often lack the leverage to insist that the agreement be signed by the franchisee without changes. Franchisees are much more likely to be able to negotiate perceived onerous provisions in the franchise agreements of new franchisors.

It would appear that—at least from the franchisor’s perspective—attempting to abbreviate a franchise agreement in order to make it more “sellable” carries with it a significant degree of risk. From the franchisee’s perspective, however, a concise agreement is far more desirable since franchisees often lack the knowledge, business sophistication and bargaining power of franchisors.

The lesson to be learned from virtually every case analyzed in this paper is this: while a lengthy franchise agreement, which addresses in detail each topic and contains a series of

\textsuperscript{138} Cal. Bus. & Prof. Code § 16600. See Budget Rent A Car Corp. v. G.M. Truck Rental, 2003 U.S. Dist. LEXIS 11323 (N.D. Ill. June 26, 2003) (applying California law over a franchisor’s objection that Massachusetts law should apply, and denying the franchisor’s motion for a TRO to enforce a post-termination non-compete because the covenant was “unlikely” to be enforced under California law).
extensive franchisee acknowledgments/disclaimers, may not be enforced as intended all of the
time, it will be enforced at least some of the time. Conversely, abbreviated franchise
agreements, while sometimes giving rise to judicial or arbitral decisions truly reflecting the
parties' intentions, often are construed by judges, juries and arbitrators in a fashion that neither
party truly intended at the outset of the contractual relationship. Without sufficient detail in the
franchise agreement, decision makers may utilize the implied covenant of good faith and fair
dealing to substitute for what the contracting parties actually intended.

In drafting franchise agreements, the same contractual precept should not be recited
over and over, and over yet again. However, while we are all believers in concise and
disciplined drafting, that discipline does not extend to abbreviating, or excising altogether,
contractual details and provisions merely for the sake of brevity. A happy medium must be
struck, so that the franchise agreement contains sufficient detail to appease franchisors, yet is
clearly and succinctly written in a way understandable to franchisees. Franchisees are
encouraged to “just say no” if a franchise agreement, by its terms, appears to be too
burdensome, for the marketplace allows for multiple franchisors who may offer more favorable
franchise agreements to their franchisees.

Above all, it is vital for the franchise agreement to evidence the true intention of the parties
and the meaning of the franchise relationship. Otherwise, unintended consequences may result
for both the franchisor and the franchisee. As it has been observed: “Silence is a text easy to
misread.”139

139 A. A. Attanasio, “The Eagle and the Sword.”
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