BEYOND THE FRANCHISE AGREEMENT: A LOOK AT THE "OTHER" AGREEMENTS BETWEEN THE FRANCHISOR AND FRANCHISEE

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I. INTRODUCTION

The franchise agreement is the principal contract between a franchisor and a franchisee, setting forth the essential terms of the franchise relationship. However, there are many other agreements that are integral to the franchise relationship, such as agreements involving real estate, lending, registration and disclosure, state-specific requirements, software, and technology licenses. The franchise relationship will also, inevitably, come to an end. All of the aspects of the franchise relationship require the franchisor and franchisee to enter into a variety of agreements beyond the core franchise agreement. These “ancillary” agreements are the focus of this paper.¹

The discussion of ancillary agreements is divided into three sections: (1) agreements entered into before the franchise agreement (confidentiality agreements, letters of intent, and exemption certifications); (2) agreements entered into at the same time as the franchise agreement (non-competition agreements, personal guaranties, state addendums, site selection agreements, collateral assignment of leases, technology agreements, and comfort letters); and (3) agreements entered into at the end of the franchise relationship (transfer agreements and termination agreements). For each of these agreements, this paper will describe the purpose and use of the agreement and, where appropriate, practice tips, relevant case law, and any disclosure requirements under Item 22 of the FTC Franchise Rule (as defined below), which requires franchisors to attach all proposed agreements relating to the franchise offering provided by the such franchisors.

II. “OTHER AGREEMENTS” ENTERED INTO BEFORE THE FRANCHISE AGREEMENT

A. Confidentiality Agreement

1. Purpose

Confidentiality agreements, often referred to as nondisclosure agreements, are legally binding agreements between parties that prohibit one or both parties from disclosing certain specified information. A confidentiality agreement requires recipients to agree to maintain the confidentiality of certain disclosed information and trade secrets.

Confidentiality agreements are necessary for franchisors to protect themselves and their proprietary information. Franchise systems rely heavily upon such information, which is often essential to ensuring business vitality and maintaining competitive advantage, industry leadership, and ultimately, market share.² Arguably, confidential information and the ability to prevent others from using that information in a competing enterprise is a franchisor’s most valuable asset.³

¹ For previous papers on this topic, see Alan R. Greenfield and Kathryn M. Kotel, Ancillary Agreements: The Other Contracts Needed in the Franchise Relationship, ABA 35th Annual Forum on Franchising W-20 (2012), and Nancy G. Gourley and David W. Koch, The Other Contracts in the Franchise Relationship, ABA 29th Annual Forum on Franchising W-24 (2006).


Protection of a franchise system’s confidential information and trade secrets not only benefits the franchisor, but also the franchisees. Without this protection, the information franchisees rely upon to operate their franchised outlets could become publicly available, and franchisees stand to lose the economic value of their franchise if competitors may easily duplicate the business and compete with them.4

Additionally, while franchise agreements may contain confidentiality provisions, a stand-alone document should be considered to emphasize the undertaking, particularly when the covenant obligations extend beyond the franchisee entity.5

2. Practice Tips

a. Drafting Tips

The confidentiality agreement should be signed as soon as the franchisor has determined that the prospect meets its financial and operational standards to purchase and operate a franchise.6 Generally, only the prospect who is agreeing to maintain the confidentiality of the information will sign the confidentiality agreement.7 However, when the prospect is a business entity, the franchisor should consider having the agreement signed by the entity’s directors and officers, as well as co-owners, affiliates, representatives, and agents who will personally acquire the information.8 It is important to ensure that relevant parties are bound by the agreement as confidentiality agreements do not cover information received through an unbound third party.9

A confidentiality agreement should define the information that the franchisor deems to be confidential. This will include information related to the franchise system, such as trade secrets, financial information, software, operating manuals, vendor information, development projections, marketing information, and the like. On the other hand, the agreement should also define the information to be excluded from the definition of confidential information. This is a matter of particular concern to franchisees, who are likely to negotiate this point. Specifically, confidentiality agreements typically do not apply to knowledge generally available to the public, information that was available to the franchisee prior to entering into the agreement, information received from an unbound third party, or information independently developed by a party to the agreement. Inclusion of such information in an agreement’s definition of confidential information may hinder enforcement of the agreement. Furthermore, the agreement may specify when disclosures of confidential information are permitted, such as court orders or other court proceedings. Franchisors should also make it a habit to retain the right to disclose any information, including any confidentiality agreement, required to be disclosed under franchise disclosure laws.

4 VanderBroek, supra note 2.
5 McElroy & Zellweger, supra note 3.
7 Id. at 44.
8 Id.
9 Id.
The agreement should also include a covenant by the potential franchisee not to disclose, copy, or transfer the confidential information. The agreement should further outline how the franchisee may use the confidential information acquired and with whom the information may be shared, such as with lenders, financial advisors, accountants, attorneys, or investors.

Finally, the agreement should include enforcement procedures, acknowledging the franchisor’s entitlement to injunctive relief in the event of breach as well as choice of law and choice of forum provisions.10

b. Enforcement Issues

i. Overly Broad Terms

In order to be enforceable, the scope of a confidentiality agreement must be reasonable. While judicial determination of reasonableness varies across jurisdictions, courts will typically consider the interest of the disclosing party, the burden on the receiving party, the public interest, and the period of time the information must be kept confidential.11 For example, in Trailer Leasing Co. v. Assoc’s Commercial Corp., a federal district court found a non-disclosure covenant to be overly broad for seeking to protect non-confidential information and containing no geographic limitations, ultimately holding the covenant to be unreasonable and unenforceable.12 To reduce the risk of a confidentiality agreement being overly broad, the drafter should avoid using catch-all clauses and instead be specific in what constitutes confidential information. Specifically, in Frosty Bites, Inc. v. Dippin’ Dots, Inc., the court found trade secret confidentiality agreements to be deficient for not identifying what constituted the franchisor’s trade secrets.13

ii. Secrecy

The information covered by a confidentiality agreement must actually be confidential or protectable, meaning that it should not fall into any of the categories of excluded information; otherwise courts may refuse to enforce the entire agreement. What constitutes “confidential information” is not defined by a statute; rather it will be defined within the confidentiality agreement and typically will include trade secrets. Trade secrets are a subset of confidential information that generally includes “any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others.”14 Trade secrets differ from confidential information in that the majority of states have adopted some formulation of the Uniform Trade Secrets Act (“UTSA”) to govern them. Further, trade secrets may last indefinitely, unlike confidential information.

There are also limitations on when trade secrets are protectable. Under the UTSA, information only qualifies as a protectable trade secret if it is not generally known to, or readily

11 Id.
ascertainable by proper means by the public or competitors. “Proper means” includes independent discovery, reverse engineering, observation in public use, and information from published literature. Note, however, that information may be a trade secret notwithstanding the fact that some of its components are well-known. This arises in the context of systems, methods, or formats unique to the franchise. Further, a combination of characteristics and components that alone are considered to be within the public domain may nevertheless exist as trade secrets when “the unified process, design and operation” of them afford a competitive advantage.

Further, if the franchisor fails to use reasonable efforts to maintain the secrecy of the information deemed confidential, an enforceability issue may arise. While reasonableness of efforts is context-specific, franchisors can exercise caution by utilizing and enforcing confidentiality agreements, limiting disclosures, keeping confidential information secured, and marking information as “confidential” or a “trade secret.” In a litigation context, the franchisor, as the disclosing party, would bear the burden of proving that reasonable efforts were taken. Again, this applies to trade secrets as well.

For example, in a Colorado district court case, despite including a confidentiality provision in the franchise agreement, a Colorado district court found that the franchisor failed to take sufficient precautions to guard the secrecy of its purported trade secrets because the franchisor’s business procedures were disclosed to any employee or manager who attended “Yogurt University,” who were never required to sign a confidentiality agreement. Further, the franchisor also divulged the information in a newsletter to franchise owners that did not contain any statement or warning the information as confidential. In another case, a Texas district court granted summary judgment against a franchisor for failure to take reasonable steps to maintain the secrecy of the alleged trade secrets, noting that employees “routinely discarded storage bags and boxes in public trash bins without restrictions on the methods of disposal.”

Additionally, the Defend Trade Secrets Act of 2016 (“Trade Secrets Act”), provides franchisors with additional protection for trade secrets. The Trade Secrets Act is a federal law that allows an owner of a trade secret to sue in federal court for misappropriation of its trade secrets.

iii. Term Length

The term of the confidentiality agreement should specify that the agreement survives the end of the franchise relationship. Proper drafting of the term and survival of the confidentiality agreement is crucial, as the available relief and enforcement of the agreement may depend on this. The term length should be specific and unambiguous. Courts will look to other provisions

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16 Id. § 1 cmt.
18 Id.
19 Id.
20 Id.
within the agreement when scrutinizing the term at issue, so drafters should be careful with terminology throughout the agreement. For instance, in *Hamden v. Total Car Franchising Corp.*, a franchise agreement with a fifteen-year term contained a confidentiality agreement with two clauses: one applicable “during the term of the Franchise Agreement and thereafter” and one triggered by “any termination of this Agreement.” The Franchisee did not renew at the end of the term. The Fourth Circuit held that while the first clause contemplated the natural end of the franchise agreement and thus bound the Franchisee into perpetuity, the second clause introduced “if there is any termination” in a manner that suggested it was different from the natural ending implied by the earlier clause. Thus, the franchisee was only bound by the first clause.

For trade secrets, no matter the term of the confidentiality agreement, the drafter should include language indicating that the franchisee’s obligations shall continue for as long as such information constitutes a trade secret.

### 3. Disclosure Requirements

If a franchisor requires a confidentiality agreement to be signed, the Federal Trade Commission’s regulations in 16 CFR part 436, Disclosure Requirements and Prohibitions Concerning Franchising (commonly referred to as the “FTC Franchise Rule”), require the confidentiality agreement to be attached in the franchisor’s FDD under Item 22 because the confidentiality agreement will be signed in connection with the offering of the franchise.

While applicable disclosure under Item 22 is broad in scope, the requirement to disclose the existence of confidentiality agreements under Item 20 is comparatively narrow. The FTC Franchise Rule only requires franchisors to disclose whether franchisees signed confidentiality agreements during the past three fiscal years. When this is applicable, the FTC Franchise Rule instructs franchisors to state:

> In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experience with [name of franchise system]. You may wish to speak with current and former franchisees, but be aware that not all such franchisees will be able to communicate with you.

The FTC Franchise Rule further states that franchisors “may also disclose the number and percentage of current and former franchisees who during each of the last three fiscal years signed agreements that include confidentiality clauses and may disclose the circumstances under which such clauses were signed.”

If the franchisor is claiming proprietary rights in other confidential information or trade secrets, the FTC Franchise Rule requires the franchisor to “describe in general terms the

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24 *Id.* at 845.
25 *Id.* at 849.
26 16 C.F.R. § 436.5(t)(7).
27 *Id.*
28 *Id.*
proprietary information communicated to the franchisees and the terms for use by the franchisee" under Item 14 of the FDD. The franchisor is not required to precisely delineate the information, but rather “need only describe the general nature of the proprietary information, such as whether a formula or recipe is considered to be a trade secret.”

B. Letter of Intent

1. Purpose

A Letter of Intent (“LOI”), often referred to as a Memorandum of Understanding or “MOU”, is a preliminary agreement entered into between a franchisor and franchisee setting out the general terms of the prospective franchise relationship. The purpose of the LOI is to memorialize the negotiations between the parties and to show a certain level of commitment to a potential future relationship. It is not intended to be a final, binding agreement between the parties, which is reserved for the actual franchise agreement. In fact, it is important to clearly state upfront in the LOI that the letter is “non-binding” and that all terms are subject to the parties entering into a formal, fully executed franchise agreement. An LOI can also be useful for lenders, as they often want to see some level of commitment by the franchisor before agreeing to make a loan to the franchisee.

An LOI will set forth the essential business terms of the deal, such as the initial fee, royalty fee, marketing fee, approved location/site selection, exclusive territory, construction schedule, and agreement term. The parties may also choose to include other terms if they differ from the standard form of franchise agreement contained in the FDD, such as the nature or venue of dispute resolution, liquidated damages calculation, construction deadlines, or the parties’ respective obligations. The LOI should also set forth the franchisee entity and the identities of the individual owners so that the franchisor can begin its due diligence.

The LOI will also address timing. A franchisor will normally send an unsigned LOI to a prospective franchisee, giving the prospect a specific period of time to review and sign the letter. Once returned to the franchisor and counter-signed, the LOI will be “in effect” for a certain amount of time. The parties must use their “best efforts” to enter into a formal franchise agreement within that time or the LOI will expire and the parties will either walk away, renegotiate the terms, or simply extend the effectiveness of the LOI (which is common if the parties are diligently pursuing execution of the agreement). There are different approaches to what is permitted and not permitted during the term of the LOI. One approach is to make that period “exclusive” for one or both parties, meaning the franchisee would agree not to contact or solicit information from a competitor of the franchisor, and the franchisor would agree not to enter into business discussions with another prospective franchisee for the purchase of a franchise within the negotiated territory. Another approach is to let both parties talk to any other party about a potential business transaction, regardless of the nature of that transaction or the location of proposed business. While this approach may show less of a commitment to each other, it can also motivate the parties to get a deal done as soon as possible.

2. Practice Tips

29 Id. at § 436.5(n)(7).
30 Id.
There are other general terms that should be included in a Letter of Intent. For example, the LOI should state that, in the event a franchise agreement is executed, the LOI will automatically expire and its terms are superseded by the terms of the franchise agreement. This, along with the integration clause in the franchise agreement, will help resolve any discrepancies between the terms of the LOI and franchise agreement. The terms of the LOI should also be confidential, with both parties agreeing not to disclose the terms (or even existence) of the LOI to any unauthorized third party. Also, the LOI should clearly state that it is not a franchise agreement and that the franchisor is under no obligation to grant a franchise to the prospective franchisee. A section regarding disclosure is also recommended. For example, “You acknowledge that you must receive a complete copy of our current franchise disclosure document prior to signing the Agreement or paying us any consideration for a franchised business.”

Sometimes a franchisor will charge a fee for an LOI. This allows the franchisor to recoup any legal costs incurred in preparing the LOI and also ensures the prospect is serious, i.e., has “skin in the game.” The fee may be refundable or non-refundable if the parties fail to come to terms on a final agreement. However, this may impact the franchisor’s disclosure requirements, as discussed below.

If the franchisor and franchisee are looking for a less formal preliminary agreement, an alternative to the LOI is a “term sheet.” A term sheet merely sets out the basic business terms of the prospective agreement between the parties, without getting into details regarding exclusivity, timing, dispute resolution, and so on. This is often done in just an outline or list format with bullet points. While it is useful to have the parties sign the term sheet to give it some weight, it is not necessary. Like the LOI, the term sheet is non-binding. A term sheet can be particularly useful where the franchisor is large and unlikely to modify the standard terms of its franchise agreement. By agreeing on the essential business terms, the franchise agreement can be drafted with the expectation that there will be minimal change or negotiations going forward.

3. **Select Cases**

An LOI drafted to avoid binding effect on the parties thereto often prevails over claims that the franchisor and franchisee otherwise entered into a definitive agreement where the franchisor chooses not to proceed with a deal after initial negotiations have begun. In a case in California, the prospective purchasers of a healthcare services franchise were deemed not to be “franchisees” within the meaning of the California Franchise Investment Law because they had not yet purchased the franchise. The court also ruled that there was no valid agreement for a franchise, despite their officers’ conclusion of initial negotiations with a handshake, because the parties subsequently had entered into a letter of intent specifically disclaiming the existence of any binding contract. A handshake could not override this express intention.

4. **Disclosure Requirements**


33 Id.
Occasionally, an LOI will be binding on the parties and/or require payment of a non-refundable fee. If this is the case, franchisors must be careful to comply with applicable federal and state registration and disclosure laws. A preliminary agreement that obligates the prospective franchisee to enter into a formal franchise agreement would likely be interpreted as a franchise agreement itself, requiring registration (if applicable) and pre-sale disclosure. Likewise, collection of a non-refundable fee will likely trigger these same requirements. Of course, even a non-binding LOI that does not require a payment of a fee may require the franchisor to comply with applicable registration and disclosure laws since it will constitute an “offer” under the FTC Franchise Rule and many state franchise laws.

Also, an LOI should be included in Item 22 of the FDD if the franchisor has a standard form that it is going to require every franchisee to sign.

C. Exemption Questionnaire or Certification

1. Purpose

There are many reasons why a franchisor may want to use an exemption from federal or state registration and disclosure laws. The franchisee may be closing on a loan or a real estate purchase and needs a signed franchise agreement in fewer than 14 days; the franchisor may be waiting for a state to approve its FDD registration (or the franchisor does not intend to register in a particular state); the franchisor may want to have a broader conversation with the prospective franchisee about performance metrics; or a franchisor may just want to use a belt-and-suspenders approach to limit potential exposure to federal or state franchise laws.

Regardless of the reason, a franchisor must first conduct due diligence to determine whether the franchisee, or the specific franchise sale, is exempt from federal disclosure requirements and any applicable state registration and disclosure requirements. Many exemptions require an assessment of the franchisee; for example, its net worth and experience in similar lines of business (sophisticated franchisee exemption), the percentage of anticipated revenue that will be generated by the franchised business (fractional franchise exemption), and the size of the franchisee’s investment in the franchise (large investment exemption). While the franchisor should independently verify this information as much as possible, through both the application process and requests for documentation, the franchisor should also require the franchisee to sign a form certifying that it meets the factual requirements or conditions of the exemption. This can be in the form of a questionnaire, certification, or other form. While not technically an “agreement” between the franchisor and franchisee, it is a crucial document to obtain prior to executing the franchise agreement.

2. Practice Tips

Importantly, a franchisor should avoid using a form that requires the prospective franchisee to certify or represent that they are “exempt” from a specific federal or state franchise law, since this is asking for a legal conclusion for which the applicant is most likely not qualified to give. Instead, the focus should be on the facts underlying the exemption, which the franchisor’s attorney can reasonably rely on to draw his or her own legal conclusion about whether the conditions of the exemption have been met.

Some exemptions require the franchisor to collect or file forms signed by the franchisee. For example, under the FTC Franchise Rule, to take advantage of the “large investment” exemption, the prospective franchisee must sign an “acknowledgment” verifying the grounds of
the exemption. The Rule even sets forth the specific language that is required to be in the acknowledgment. In Washington State, the accredited investor (large net worth) exemption requires the franchisor to file a certification signed by the franchisee. While not all exemptions require a signed certification, as discussed above, it is a best practice to have the franchisee sign a form certifying that it meets the factual requirements of the exemption.

3. Disclosure Requirements

Item 22 of the FTC Franchise Rule only requires a franchisor to attach to the FDD copies of “all proposed agreements regarding the franchise offering, including the franchise agreement and any lease, options, and purchase agreements.” Exemption forms are not technically “agreements” between the franchisor and franchisee and are not part of the franchise offering, so these forms are typically not attached to the FDD.

III. “OTHER AGREEMENTS” ENTERED INTO WITH THE FRANCHISE AGREEMENT

A. Non-Competition and Non-Solicitation Agreement

1. Purpose

A non-competition agreement, or a non-compete agreement, is typically an agreement between an employer and an employee that imposes post-employment restrictions on the employee, such as restricting the employee from working for competitors or opening a similar business for a stated period of time. In the franchise industry, a non-compete agreement will typically restrict the franchisee’s ability to operate a business that is similar to the franchise for a certain period of time after the franchisor-franchisee relationship ends. A non-compete agreement can be a valuable tool for a franchisor. During the course of the franchisor and franchisee’s relationship, the franchisor usually trains the franchisee in its confidential methods and processes and shares its trade secrets and other confidential business information with the franchisee. This information sharing is important to the franchise relationship because it allows integration of the franchisee into the franchisor’s overall business scheme. However, this integration and sharing of confidential information can create problems once the franchise relationship ends or is terminated. Non-compete agreements can be an effective means of protecting a franchisor’s trademarks, trade secrets, other confidential information, goodwill, and its market share by preventing the franchisee from using the franchisor’s training and business methods to become a competitor.

Non-solicitation agreements are also useful tools for franchisors because they can be used to prohibit the franchisee from contacting a specific group of people, usually customers or employees, to try and steer them away from the franchise system. While this section is focused

34 16 C.F.R. § 436.8(a)(5).
35 Id. (“The acknowledgment shall state: ‘The franchise sale is for more than $1 million—excluding the cost of unimproved land and any financing received from the franchisor or an affiliate—and thus is exempted from the Federal Trade Commission’s Franchise Rule disclosure requirements pursuant to 16 CFR 436.8(a)(5)(i).”
36 Revised Code of Washington, RCW 19.100.030(5).
37 16 C.F.R. § 436.5(v).
on non-compete agreements, adding a non-solicitation agreement to the franchise agreement should also be considered.

2. **Practice Tips**

   a. **Enforceability of Non-Competes**

   The enforceability of non-compete agreements is governed by state statutes and common law. Several states have enacted specific franchise statutes that govern the enforcement of non-compete agreements. Other states have general statutes addressing the enforceability of non-compete agreements that apply in the franchising context.

   States take different views on non-compete agreements. The majority of states use a reasonableness approach to determine the enforceability of non-compete agreements. A few states, including California, Oklahoma, and North Dakota refuse to enforce non-compete agreements altogether. Some states have adopted expanded enforcement of non-compete agreements, such as New Jersey, which has adopted the doctrine of inevitable disclosure. The doctrine of inevitable disclosure is defined as the "legal theory that a key employee . . . cannot avoid misappropriating the former employee’s trade secrets." Thus, states that follow this New Jersey approach will enforce non-compete provisions “if the employer can prove that the employee will inevitably disclose important trade information.”

   Although state law varies, there are a few common factors that courts will analyze to determine whether a non-compete agreement is reasonable and enforceable. First, the franchisor must seek to protect a legitimate business interest by using the non-compete agreement. Courts have recognized various legitimate business interests including protecting the franchisor’s trade secrets, protecting the franchisor’s goodwill interest, avoiding customer confusion, and refranchising (the idea that the franchisor should be able to benefit from the goodwill it has created in the market). Courts may balance the franchisor’s legitimate business interest against hardship on the franchisee and typically will require that the non-compete agreement not violate public policy or the public interest.

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39 Id.
40 Id. at 11-12.
41 See, e.g., TEX. BUS. & COM. CODE ANN. § 15.50(a) (2009); ALA. ADMIN CODE § 8-1-1 (2003).
42 See id. at 8; Murray, supra note 38 at 13.
43 See Benjamin Agee, *Would You Like to Reform That? Reexamining Noncompete Laws in Texas*, 49 TEX. TECH. L. REVIEW ONLINE EDITION 1, 7 (2017); see also CAL. BUS. & PROF. CODE § 16600.
44 Id. at 10.
45 Id.
48 See Brazener, supra note 46.
Second, the non-compete agreement usually must contain certain restrictions to make it enforceable and reasonable including: (i) a stated duration, (ii) restricted geographic area, and (iii) the scope of the activity must be restrained. The reasonableness of the restrictions is generally a question of law for the court to decide, taking into account the nature of the interest sought to be protected. Courts have found durations ranging from six months to five years to be reasonable, along with geographic restrictions up to 100 miles. A reasonable activity restriction may preclude a former franchisee from participating in a business similar to or in competition with the franchised business. These restrictions make sense in franchising because of the potential amount of confidential business information obtained by the franchisee during its business relationship with the franchisor.

Generally, a court may take one of three different approaches if it determines that one of the restrictions in the non-compete is unreasonable. First, a court can re-write the non-compete provision to make it fair to both sides. Second, the court may “blue pencil” the provision by striking out only the overbroad parts and keeping the rest. Third, the court may hold that the non-compete agreement is entirely unenforceable and void. In order to avoid having a court re-write the non-compete agreement, franchisors should strive for predictability in the enforcement of non-competes by closely adhering to state limits on reasonableness.

As mentioned above, the enforceability of a non-compete provision or agreement varies based on state law. Although some states still favor enforcement of non-compete agreements, most states disfavor them and continuously attempt to limit their reach and impose more franchisee-friendly non-compete legislation. Because of the currently changing landscape on non-compete agreement enforceability, it is important for franchisors to research relevant case law and legislation in order to determine which non-compete restrictions a court would likely deem reasonable. Franchisors should attempt to draft agreements that are narrowly tailored with regard to restrictions on duration, geographic scope, and prohibited activity by the franchisee. Additionally, it may be helpful to articulate the specific interest that the franchisor is seeking to protect through the use of the non-compete agreement. By doing this, franchisors indicate to the court that the restriction is not being put in place to eliminate competition, but to protect a valuable, legitimate business interest.

One way to potentially increase the likelihood that a non-compete agreement will be enforced is to add a forum selection clause that designates a state with favorable law, so long as the state selected bears a substantial relationship to the transaction or parties to the contract. However, even with a favorable forum selection clause, the state in which enforcement is sought may refuse to enforce a non-compete, otherwise enforceable under the law of the chosen state, if enforcement would offend public policy in the enforcing jurisdiction, or

49 Id.; see, e.g., Tex. Bus. & Commerce Code Ann. § 15.50(a), (c) (2009).
51 Dance, supra note 46, at 246; see, e.g., Techworks, LLC v. Wille, 770 N.W.2d 727 (Wisc. Ct. App. 2009).
52 Murray, supra note 38, at 13.
54 Murray, supra note 38, at 32.
55 See Restatement (Second) Conflicts § 187(1).
if the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties’ forum choice.\textsuperscript{56} In other words, a particular forum should not be selected based solely on such forum’s favorable law, as this forum selection may not be upheld in court.

\textbf{b. Importance of Consistency and Recordkeeping}

Although non-compete provisions within franchise agreements may be enforceable, it is typically the franchisor’s responsibility to take action to enforce the non-compete agreement if the franchisee is violating its terms.\textsuperscript{57} Failure to enforce a non-compete agreement against a former franchisee could raise two issues. First, it could result in the former franchisee hurting the business interests of the franchisor by using its confidential information to become a successful competitor of the franchisor. Second, selective or inconsistent enforcement could (i) give the franchisee the argument that the franchisor voluntarily waived its rights under the agreement based on an equitable estoppel theory, or (ii) undermined the franchisor’s justification for the non-compete agreement by persuading the court that no harm to the franchisor likely occurred based on franchisor’s failure to swiftly enforce the non-compete or failure to seek to enforce the non-compete altogether.\textsuperscript{58}

Thus, it is wise for franchisors to have a system in place to keep track of previous franchisees’ subsequent business actions post expiration or termination of their business relationship. By keeping an organized record system and strictly enforcing all covenants against franchisees, franchisors will more effectively utilize their non-compete agreements.

\textbf{c. Drafting Considerations}

The wording and defined terms in the non-compete provision of a franchise agreement are extremely important when it comes to enforcing the non-compete provision’s terms. For example, the distinction between the words “expiration” and “termination” could result in the court interpreting the non-compete provision narrowly, only prohibiting the franchisee from operating a similar business after either the expiration or termination, whichever applies.\textsuperscript{59} Thus, franchisors should clearly state that the non-compete agreement’s restrictions apply regardless of whether the franchise agreement expires or terminates. Franchisors should also ensure that non-compete agreements with franchisees are drafted in the context of a sale of a business rather than that of an employment relationship. Courts have a tendency to construe non-compete provisions restricting employment more strictly than non-compete provisions restricting the ability to purchase or acquire a business because buyers and sellers typically have relatively equivalent bargaining power and sophistication compared to an employer’s disproportionate bargaining power in a typical employer-employee relationship.\textsuperscript{60} Because franchisees sell products and offer services in accordance with methods and procedures prescribed by their franchisor, courts have generally upheld covenants not to compete in franchise agreements.\textsuperscript{61}

\textsuperscript{56} Id. at § 187(2).
\textsuperscript{57} Dance, supra note 46, at 253.
\textsuperscript{58} Id.
\textsuperscript{60} RESTATEMENT (SECOND) OF CONTRACTS § 188 cmt. b (1981).
Additionally, if there is a forum selection clause, the court will carefully review whether the language is exclusive or permissive, and whether the clause covers only certain stated claims.62 Thus, the clause should usually be drafted broadly (assuming that the applicable state will enforce a forum selection clause).63

d. Necessity of a Non-Compete Agreement

Franchisors should be wary of having low-level employees of franchisees sign non-competes as a condition of employment. As discussed further below, the trend among legislatures and courts disfavors non-competes for low-wage employees, with some states even making non-compete agreements with low-wage employees illegal.64 Additionally, requiring a non-compete agreement that protects the franchisor’s interest in addition to the franchisee may subject the franchisor to joint employment liability.65 Franchisors should implement an effective system for determining which employees require non-compete agreements based on their job function and an organized way of keeping two sets of documents for those that require non-compete agreements versus those that do not. Franchisors may consider other documents such as confidentiality and non-solicitation agreements as means to protect their legitimate business interests when lower-level employees seek employment elsewhere.66 Non-solicitation agreements will generally be more readily enforced, but franchisors should be cognizant of pending cases involving such agreements to ensure continued enforceability.

3. Select Cases

Recent case law on non-competes highlights that this is still an evolving area of the law. For example, in Cajun Global LLC v. Swati Enterprises, Inc., a Georgia court held that the franchisee violated the non-compete provision of a franchise agreement even though the franchisee never signed the franchise agreement.67 In this case, the franchisor had a typical non-compete provision in the franchise agreement that prohibited the franchisee from operating a similar restaurant post-termination. After the franchise relationship ended, the franchisee rebranded the franchised restaurant, but continued to sell fried chicken. The franchisor claimed that this violated the non-compete provision. The franchisee defended on the grounds that he never signed a franchise agreement containing the non-compete provision. The court held that, because of the franchisee’s long performance under the franchise agreement, and his acceptance of its benefits, equitable estoppel applied to prevent the franchisee from avoiding the non-compete agreement obligations solely because the franchisee never signed the agreement.68

Other courts have also bolstered the enforceability of non-compete agreements. For example, in Bud Anderson Heating and Cooling, Inc. v. Neil, the court found that Arkansas

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63 Id.

64 Matthew Hector, Jimmy John’s Settles Suit over Noncompete Agreements, 105 ILL. B.J. 14 (February 2017); 820 ILL. COMP. STAT. STAT. ANN. 90/10 (2017).


66 Id. at 56.


68 Id.
employers could enforce non-compete provisions against employees post-expiration of the non-compete period allowing the employer to receive the benefit of a longer non-compete period.

Additionally, the Florida Supreme Court in *White v. Mederi Caretenders Visiting Services of Southeast Florida, LLC*, concluded that referral sources in the home care health industry could serve as a legitimate business interest to justify enforcing a non-compete agreement against a former employee expanding the definition of a legitimate business interest.

4. Disclosure Requirements

Under Item 9 of the FTC Franchise Rule, a franchise agreement must describe a list of the franchisee’s principal obligations including any non-competition covenants in tabular format. The franchise agreement should cross reference a non-compete obligation with the agreement and with the relevant disclosure document provision. Additionally, under Item 17 of the FTC Franchise Rule, the franchise agreement must summarize common franchise agreement provisions including any non-competition covenants during the term of the franchise and any non-competition covenants after the franchise is terminated or expires in tabular format. Thus, the franchisor should ensure that the franchise agreement clearly explains the terms of the non-compete agreement including its duration, the geographical area restricted, and the scope of activity restrained in order to abide by the FTC Franchise Rule’s disclosure requirements. If the non-competition clause is contained in a separate agreement than the franchise agreement, the non-competition agreement must be disclosure under Item 22 of the FTC Franchise Rule.

B. Personal Guaranty

1. Purpose

In general, a personal guaranty makes an individual personally liable for a debt where the original party refuses to perform or is otherwise unable to do so. Frequently, franchisees create an entity to enter into the franchise relationship and serve as the franchisee, rather than enter into a franchise agreement in their own personal capacities, for reasons such as limitation of vicarious liability for the owners and tax considerations. However, franchisors are often concerned that these franchisee-entities may operate the business without regard to personal consequences if the individual owners are shielded from all liability. Because of this, franchisors typically require the owners of an entity that enters into a franchise agreement to provide a personally guaranty of the obligations of the franchisee entity. Without this protection, any judicial recovery that a franchisor would be entitled to would be limited to the capitalization of the company itself. Furthermore, a personal guaranty can be critical to the success of a franchise for many reasons, primarily because it raises the stakes for the franchisee owner to succeed, and incentivizes the owners to maintain and operate the business efficiently.

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70 226 So.3d 774, 777 (Fla. 2017).
72 Id.
73 Id.
74 Alison McElroy & Robert A. Smith, *International Development—Personal Guarantees and Other Mechanisms to Secure Franchisee Payment and Performance*, International Franchise Symposium, 50th Annual Legal Symposium, at 2 (2017) (stating that personal guaranties “protect the franchisor from a franchisee that is unable or unwilling to perform.”).
2. **Types of Guaranties**

When offered in connection with a franchise agreement, guaranties typically fall into three principal categories: financial guaranties, performance guaranties, and spousal guaranties and consents.

**a. Financial Guaranties**

A financial guaranty commits the guarantors to perform the franchisee's financial obligations, debts, and liabilities incurred in connection with the franchise agreement. By imposing personal financial liability on the owners, the franchisor reduces the risk that it will be unable to collect on the franchisee's debts in the event of default. Financial guaranties can be negotiated to have certain limits and thresholds. For example, franchisors and franchisees often negotiate a cap on the financial amount for which the franchisee will be liable under the guaranty.

Examples of obligations that a financial guaranty can be used for in the franchise context include royalty payments, advertising fund payments, claims brought by third parties which are indemnification obligations of the franchisee, and damages arising from breach of a non-compete or confidentiality agreement.

**b. Performance Guaranties**

Performance guaranties extend beyond financial obligations by securing the performance of non-monetary obligations pursuant to the franchise agreement, such as covenants to operate the business in an appropriate manner, protect the confidentiality of trade secrets and other intellectual property, and avoid competition with the franchisor and other franchisees within the system. Preventing the misappropriation of trade secrets, in particular, is critical for both the franchisor as well as all other franchisees. Should a franchisee breach a performance obligation contained in its franchise agreement, the performance guaranty would allow the franchisor to pursue similar remedies against the franchisee as if it had breached a financial guaranty. Therefore, a well-drafted personal guaranty should secure both the financial and performance-based obligations of the franchisee contained in the franchise agreement.

**c. Spousal Guaranties and Consents**

Because of the treatment of married couples' assets under state community property laws and the difficulty of effectively segregating the business property of a divorcing couple, many franchisors require that personal guaranties to be signed by the spouse as well. Spousal guaranties obligate a franchisee-owner's spouse to be contractually liable to the franchisor for the franchisee's debts and obligations. These guaranties often provide franchisors the right to

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75 See McElroy & Smith, *supra* note 74, at 2.
77 Id.
a claim of payment from the spouse, as well as providing access to such spouse’s personal assets and marital property as a remedy for breaches of the agreement.\footnote{Giller, \textit{supra} note 80, at 80.} Spousal guaranties are especially important in states that have adopted a “tenancy by the entirety” doctrine, whereby spouses own an undivided interest in marital property. In such a system, creditors of one spouse cannot attach or dispose the interest of a debtor spouse without that spouse’s consent. Thus, franchisors should avoid allowing franchisee-owners to negotiate a personal guaranty that applies only to them as an individual without regard to the spouse in states where the law provides for a tenancy by the entirety.\footnote{McElroy & Smith, \textit{supra} note 74, at 4.} This way, the couple’s assets may be secured in the event of default.

Spousal consents, on the other hand, cover financial concerns outside of the franchise agreement by shielding the franchisee interest from divorce.\footnote{Susan Meyer & Colleen M. Raimond, \textit{Spousal Consent—What Does That Mean?}, GREENSFELDER, http://www.greensfelder.com/media/publication/311_Meyer_Spousal-Consent_FranchiseLawyer_Spring2017.pdf (last visited May 30, 2018).} Spousal consents often require the spouse of a franchisee to consent to a waiver of such spouse’s community property interest in the franchise, the franchisee entity, and related assets, and acknowledge that any such claim by the spouse may lead to termination of the franchise agreement.\footnote{\textit{Id}.} By agreeing ahead of time as to how the interest will be handled in the event that the marriage ends, these consents can be used to bind “marital assets to, or shield them from, the franchise relationship,” as applicable.\footnote{Giller, \textit{supra} note 80, at 71.}

3. \textbf{Practice Tips}

Personal guaranties are more likely to be upheld when the parties enter into contracts with clear, definite terms that state the franchisee will be liable for all obligations acquired in the operation of the franchise, including financial and performance based obligations contained in referenced agreements.\footnote{\textit{KFC Corp. v. Wagstaff}, 502 B.R.484 (W.D. Ky. 2013) (holding that forum selection clause in an agreement referenced by the personal guaranty was not enforceable because the performance guaranty only involved financial obligations).} Typically, when courts fail to enforce a guaranty, it is due to unclear language, small print that is difficult to read, or disclaimers that are included as part of the guaranty.\footnote{Joseph F. Cudia, \textit{Personal Guarantees: Recent Cases Setting Dangerous Precedent}, 10 Ohio St. Bus. L.J. 1, 9 (2015).} Therefore, guaranties should be drafted using clear language, as well as an easy to read font, and contain no or limited disclaimers. Additionally, it is advisable to have a guarantor sign a guaranty in both corporate and personal capacities.\footnote{\textit{Id}.}

4. \textbf{Alternatives to Guaranties}

Although some form of personal guaranty should be executed by the owners of every franchisee that signs franchise agreement, alternative arrangements with respect to personal

\footnote{Giller, \textit{supra} note 80, at 80.}
\footnote{McElroy & Smith, \textit{supra} note 74, at 4.}
\footnote{\textit{Id}.}
\footnote{\textit{Id}.}
guaranties should be considered. Galliavanto, see McElroy & Zellweger, supra note 3, at 3 (“While franchisors usually take the position that the guaranty is not negotiable or that they have not negotiated it for others, options may exist to satisfy the franchisors concerns short of a full guaranty, including an alternative arrangement. . .”). Galliavanto


91 Id. at 8.

92 Id.

93 Id.

Specifically, franchisors should be informed about other modifications to personal guaranties, such as drafting guaranties with caps on liability, temporal limitations, or other forms of recovering the franchisees’ potential debt liability. Several alternatives to personal guaranties for franchisees and compromises to personal guaranties exist where the unique circumstances surrounding a franchisor-franchisee relationship warrant them, such as net worth covenants and limited financial guaranties, discussed below.

a. **Net Worth Covenants**

If a franchisor and franchisee determine that a personal guaranty is unsuitable, the parties may wish to enter into a net worth covenant. Net worth covenants are agreements that obligate the franchisee to keep profits or operating capital above certain thresholds. Should the franchisee fall below the stipulated amount, the franchisee defaults and the signatories to the agreement will be held personally liable. The unique benefit of a net worth covenant to franchisors, as compared to a personal guaranty, is that it allows franchisors to bring actions against franchisees prior to the actual depletion of funds while fulfilling the purpose of incentivizing the franchisees to operate the business to the best of their abilities. Net worth covenants also benefit franchisee owners because such owners do not have to place their personal assets at risk.

b. **Limited Financial Guaranties**

Limited financial guaranties place a cap on the total amount of assets the franchisor can claim, usually up to a certain percentage of ownership interest. Limited financial guaranties are useful because they spread the risk among the individual owners, “rather than placing all of the potential debt of the franchisee on one (possibly even minority) owner.” Limited financial guaranties also implement time restrictions on personal guaranties. Since the likelihood of failure is highest at the inception of the new business, “the franchisor may accept a guaranty that is limited to, for example, only the first five years of the franchise agreement.” Others may also have a clause that terminates the personal guaranty after a certain number of years. Alternatively, personal guaranties can be negotiated to terminate if the franchisee reaches a certain number of sales or net worth threshold. Due to the flexibility of this type of guaranty, limited financial guaranties are highly sought after by franchisees, and will be considered by franchisors where potential franchisees express particular concern over personal guaranties.

5. **Disclosure Requirements**

Although there are no specific disclosure requirements or prohibitions pertaining to the disclosure of guaranties in connection with franchise agreements, a personal guaranty should
nonetheless be attached to Item 22 of the FDD along with the Franchise Agreement and the other related agreements in accordance with the FTC Franchise Rule.\textsuperscript{94}

C. State Addenda to the Franchise Agreement

1. Purpose

While the FTC Franchise Rule sets forth the minimum disclosure requirements that apply to all franchise offerings, certain states impose additional (or different) requirements that supersede the requirements of the federal Rule.\textsuperscript{95} If a franchisor wishes to offer or sell franchises in any state that regulates franchising, then it must comply with any state-specific disclosure requirements that apply to that offer or sale, above and beyond what the FTC Franchise Rule might require.

For example, certain state franchise laws may: (a) require the franchisor to consent to jurisdiction within that state; (b) prohibit excluding the application of the state franchise law; (c) empower state regulatory authorities to review franchise disclosure documents to ensure compliance with applicable disclosure requirements; (d) provide a private right of action to franchisees harmed by a franchisor’s noncompliance; and (e) disclose additional risk factors associated with buying the particular (or any) franchise. This has led to many states requiring franchisors to not only supplement their FDD but to actually amend their standard form of franchise agreement to comply with state requirements.

Examples of state-specific modifications to the franchise agreement include: (a) cure periods for defaults; (b) notice periods for termination; (c) restrictions on out-of-state jurisdiction or venue provisions; (d) prohibitions on release language; (e) franchisor’s obligations to defend the franchisee’s use of trademarks; (f) governing law; (g) restrictions on a franchisee’s right to terminate for cause; (h) consent to liquidated damages; (i) waiver of jury trial; and (j) restrictions on transferability.

2. Practice Tips

While franchisors (and some franchisees) have often griped about the states imposing changes on a private party contract, without these changes, a franchisor’s state registration may not become effective, thereby precluding it from offering or selling franchises in that state. This issue has become pronounced with respect to the Federal Arbitration Act (“FAA”)\textsuperscript{96}, which

\textsuperscript{94} FTC Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R § 436.2 (2018).

\textsuperscript{95} California Franchise Investment Law, CAL. CORP. CODE, Div. 5, Parts 1-6, Section 31000 et seq.; Hawaii Franchise Investment Law, HAWAI'I REV. STAT., Title 26, Ch. 482E, Section 482-E1 et seq.; Illinois Franchise Disclosure Act, ILL. COMP. STAT., Ch. 815, Section 705/1 et seq.; Indiana Code, Title 23, Article 2, Ch. 2.5, Section 1 et seq.; Maryland Franchise Registration and Disclosure Law, ANN. CODE OF MARYLAND, Business Regulation, Title 14, Section 14-201 et seq.; Michigan Franchise Investment Law, MICH. STAT., Ch. 445, Section 445.1501 et seq.; Minnesota Statutes, Ch. 80C, Section 80C.01 et seq.; New York General Business Law, Art. 33, Section 680 et seq.; North Dakota Franchise Investment Law, N.D. CODE., Title 51, Ch. 51-19, Section 51-19-01 et seq.; Oregon Franchise Transactions Law, OREGON REV. STAT., Title 50 Ch. 650, Section 650.005 et seq.; Rhode Island Franchise and Distributorship Investment Regulations Act, R.I. STAT., Title 19, Ch. 28.1, Section 19-28.1-1 et seq.; South Dakota Franchises for Brand-Name Goods and Services Law, South Dakota Codified Laws, Title 37, Ch. 37-5B, Section 37-5B-1 et seq.; Virginia Retail Franchising Act, Virginia Code, Title 13.1, Ch. 8, Section 13.1-557 et seq.; Washington Franchise Protection Act, Wash. REV. CODE, Title 19, Ch. 19.100, Section 19,100.010 et seq.; and Wisconsin Franchise Investment Law, WISCONSIN STATS., Ch. 553, Section 553.01 et seq.

\textsuperscript{96} Federal Arbitration Act, 9 U.S.C. § 1 et seq.
courts have regularly held to preempt state laws that prohibit venue selection clauses in arbitration provisions. Despite this FAA preemption, some state regulators have continued to require franchisors to amend their franchise agreements to replace out-of-state venue clauses from arbitration provisions as a condition to obtaining registration of their FDD. Franchisors, therefore, face the Hobson’s choice of consenting to the state’s jurisdiction or not being able to sell franchises in that state.

Some states recognize the authority of the FAA and specifically allow for out-of-state arbitration, limiting their venue selection mandate to litigation. For example, the Illinois Franchise Disclosure Act of 1987 voids any franchise agreement provision that provides for jurisdiction or venue outside of the state, “provided that a franchise agreement may provide for arbitration in a forum outside this State.”

When drafting dispute resolution provisions and deciding between litigation and arbitration, franchisors should be cognizant of these state laws. Clearly, an arbitration provision will greatly increase the likelihood that the franchisor can successfully require the franchisee to resolve disputes in the franchisor’s home state.

3. Select Cases

The apparent conflict between the FAA and state franchise regulations was brought to a head in the recent case of Chorley Enters., Inc. v. Dickey’s Barbecue Rests., Inc. The issue on appeal in Dickey’s was whether the parties’ claims should be arbitrated in Texas, as set forth in the franchise agreement’s arbitration clause, or litigated in Maryland, due to the Maryland-required amendment to the franchise agreement, which stated that “the provisions of this Agreement shall not require you to waive your right to file a lawsuit alleging a cause of action arising under Maryland Franchise Law in any court of competent jurisdiction in the State of Maryland.” The Fourth Circuit took a “split the baby” approach and ruled that while the parties’ common law claims could be arbitrated in Texas, the Maryland franchise law claims would be litigated in Maryland.

The court in Dickey’s reconciled its decision with the FAA by noting that the franchisor and franchisee could have agreed on a single forum for resolution of all claims. However, what the court did not consider (presumably) is that the parties could not have agreed on arbitration of all claims in Texas because the Maryland franchise law prohibits that, and Dickey’s application for registration would not have been approved without the required Maryland dispute resolution language. This decision essentially requires all franchisors who wish to do business

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99 States that prohibit franchisors from requiring out-of-state dispute resolution include: California (CAL. BUS. & PROF. CODE § 20040.5); Michigan (MICH. STAT. § 445.1527); North Dakota (N.D. CODE § 51-19-09); Rhode Island (R.I. STAT. § 19-28.1-14); and Washington (WASH. REV. CODE § 19.100.180).

100 ILL. STAT. 815 § 705/4.

101 807 F.3d 553 (4th Cir. 2015).

102 Id. at 560.

103 Id. at 566.
in Maryland to give precedence to a Maryland venue over the parties’ private agreement to submit all disputes to arbitration outside of Maryland, which directly contradicts the language and intent of the FAA. Pending any legislative fix in Maryland or elsewhere, franchisors will need to carefully draft their arbitration provisions and make well-reasoned arguments to the state regulators to have them allow out of state arbitration.

4. Disclosure Requirements

Both supplemental disclosures and amendments to the franchise agreement that are required by states would need to be included in the FDD filed with the applicable state. While state-specific disclosures and addenda may not be required for FDDs issued or registered in other states, typical best practices involve rolling all state-specific requirements into a single FDD, or including separate state-specific disclosures and addenda for each of the applicable states in the FDD. This avoids having separate FDDs for different states, which can often lead to mistakes, such as the wrong FDD being issued or state addenda not being executed.

D. Site Selection Agreement (aka Territory Description)

1. Purpose

Within a franchise agreement, proficient site selection and territory provisions are essential to establishing a profitable franchise relationship. Well-drafted site selection agreements can curb litigation and increase the likelihood of success for both the franchisee and franchisor. Conversely, poorly drafted agreements can harm a franchise and lead to litigation.

a. Site Selection

Typically in franchise agreements, franchisors specify a geographical area within which the franchisee can select and ultimately locate its franchise, referred to as the site selection area. The process by which the franchisor and franchisee select the site selection area will be referred to as the site selection agreement, for purposes of this discussion.

The purpose of a site selection agreement is two-fold: (1) it controls the expectations of the franchisee, and (2) allocates responsibility and risk between the franchisor and franchisee. The site selection agreement generally identifies who is responsible for locating the site (either the franchisor or franchisee), the deadline for locating the site, and what rights, if any, are reserved to the franchisor to approve the location.

b. Territory Rights

In addition to setting forth the terms related to the site selection area, a franchise agreement should also address what rights the franchisee has in the territory surrounding its premises. A territory is the region around a specified location where the franchisor has given the franchisee specific rights. These rights include what the franchisor and franchisee can and cannot do regarding the territory.

Discussions concerning territorial rights are often the most contentious part of negotiating franchise agreements.\textsuperscript{104} Generally, there are two types of territorial rights,

\textsuperscript{104} Kerry Olson, Robin M. Spencer & Larry Weinberg, \textit{The Annotated Franchise Agreement}, ABA 33rd Annual Forum on Franchising W-3 (2010).
exclusive territory rights and non-exclusive territory rights. Exclusive territory rights give a defined area to the franchisee where the franchisor will not install another franchise to compete with the franchisee. In contrast, non-exclusive territory rights, among other things, define the area where the franchisee is authorized to operate, but do not give this right exclusively to the franchisee.\textsuperscript{105} In other words, a non-exclusive territory reserves the right for the franchisor to sell franchises to additional franchisees within the same territory.

The franchisee’s purpose in obtaining exclusive territory rights is to protect its interests and potential franchised business. Specifically, franchisees want assurance that their territory will not be encroached on by the franchisor or another franchisee. Furthermore, franchisees will want their territory to give them the capability to geographically expand and grow both the size and profitability of their business. This goal can be achieved by negotiating a larger territory or a right of first refusal for adjacent territories and sites.\textsuperscript{106}

Meanwhile, the franchisor’s purpose in granting exclusive territory rights is to provide the franchisee with a territory that is financially profitable yet small enough to maximize the franchisor’s profits. Both of these goals can be achieved in one of two ways. First, the franchisor, through research and due diligence, can weigh the two aforementioned considerations and negotiate an appropriately sized exclusive territory accordingly. Second, the franchisor can negotiate a non-exclusive territory. This allows the franchisor to add additional franchisees to the territory as circumstances in the territory change, potentially allowing multiple franchisees to occupy the same territory successfully. However, the franchisor must be mindful not to oversaturate the market.\textsuperscript{107}

2. Practice Tips

a. Site Selection

In determining how to structure the site selection agreement, franchisors should aim to limit their exposure to potential claims made by the franchisee that the franchisor selected a bad site, which resulted in the failure of the franchisee’s business.\textsuperscript{108} To help protect a franchisor from liability franchisors should consider including a provision in both their franchise agreement and franchise disclosure document (FDD) which states that the franchisee is responsible for selecting the site with the franchisor reserving the right to approve or disapprove the selected

\textsuperscript{105} In this context, the term “operate” refers to where franchisees may conduct business, including where they may sell products and advertise.


\textsuperscript{107} See Mark Sherry, The franchise territory – what does it mean?, https://www.harmans.co.nz/about-us/articles/the-franchise-territory-what-does-it-mean/ (last visited May 25, 2018) (The franchisee’s acceptance of such an agreement, which is clearly tipping the scale of power in favor of the franchisor, is contingent upon the franchisee trusting the franchisor to not over-saturate the market. If the franchisor breaches this trust and over-saturation occurs, the franchise business will become diluted to a degree where the franchise no longer provides an appropriate return. Thus, an astute franchisor will be mindful to not over-saturate the territory, understanding that saturation will lead to dissatisfied franchisees. This, in turn, can create major disruptions within the franchise system. Disruptions in a franchise can lead to a loss of profits).

\textsuperscript{108} Id. at 182.
location,¹⁰⁹ and a disclaimer that disclaims any representation or warranty of success related to the franchisor’s approval of the selected site.¹¹⁰

In addition to insulating risk, because choosing a successful site is instrumental to franchise success, franchisors should carefully consider how much involvement they have in the site selection process.¹¹¹ Specifically, in some instances, it could be beneficial for franchisors to take a leading role in site selection since franchisors typically have far more resources at their disposal than franchisees, which gives them an advantage in finding potentially successful sites for new franchise locations. Additionally, franchisors can employ in-house experts or brokers to identify and approve sites.¹¹² Through highly sophisticated software, these experts can generate a wide range of data on prospective sites and their surrounding areas.¹¹³ Furthermore, many franchisors have the knowledge and experience of choosing successful sites from previous franchise locations. In contrast, franchisees often have little to no knowledge or experience. Because a successful site is mutually beneficial, it is advantageous for both parties to structure the site selection agreement in a way that gives shared site selection responsibilities.

When structuring site selection agreements, franchisors often include various conditions which can restrict the site options available to the franchisee. For instance, the site may need to be a certain size, within a specified distance from a defining feature, the rent may need to be below a certain price, the site selection area may simply be small, or the franchisor may have to approve the selected site. While these conditions are not inherently problematic, they can become so if the franchisee cannot find a site that meets all requirements under the franchise agreement. For example, a franchisee may be unable to find an available site if under the site selection agreement the site must be within five miles of a school, but the rent for all possible sites exceeds what the franchisee can afford. If the contract cannot be terminated, the franchisee is unable to enjoy the benefits of the franchise agreement, but still remains liable for the obligations it owes the franchisor. This could lead a franchisee to sue for damages incurred under the inoperable site selection agreement or a refund of the franchise fee. Thus, to avoid litigation, a site selection agreement should include available remedies if a party is unable to meet the site selection agreements’ conditions. The best option is to provide both parties with a mechanism to terminate the franchise agreement if the required conditions are not met within a specified amount of time. This provision should include refunds of any franchise fees paid by the franchisee.

Another potential area of litigation arises when franchisors act inconsistently with their own written policies or site selection agreement.¹¹⁴ While this is a frequently litigated issue, it can easily be mitigated by the franchisor acting in accordance with its own policies and agreements. Therefore, franchisors should review any policies or site selection agreements prior to taking any action related to site selection.


¹¹¹ Once this is determined, the site selection process will be articulated in the site selection agreement.

¹¹² Id. at 182 (this is especially true with an established and successful franchisor).

¹¹³ Id.

¹¹⁴ See TCBY Systems, Inc. v. RSP Co., Inc., 33 F.3d 925 (8th Cir. 1994); see also J & R Ice Cream Corp. v. California Smoothie Licensing Corp., 31 F.3d 1259 (3d Cir. 1994).
b. Territory Rights

As with site selection agreements, it is preferable that the franchisor have most of the responsibility in determining territorial rights. Again, this is because franchisors benefit from having additional resources that allow them to better determine the ideal size and scope of a territory.

However, in making this determination, the franchisor should give away neither too much nor too little territory. Giving too large of an exclusive territory can hamper the franchisor’s ability to grow the franchise in the future. In contrast, giving away too small of a territory can set a franchisee up for failure. This harms the value of the franchise overall. Furthermore, giving away small of a territory can entice franchisees, eager to dip into a neighboring customer pool, to encroach upon the larger exclusive territories of other franchisees. Thus, in order to maintain an equitable franchise, it is necessary for the franchisor to employ the needed resources to adequately evaluate the appropriate size of a territory.

Once the size of a territory is determined, the franchisor must be mindful to succinctly describe the parameters of the territory. Typically, this involves identifying the territory on a map by postal codes, roads, geographical features, population, or other common means. However, it may be necessary for the territory boundaries to be defined by less common criteria. In determining the appropriate criteria for defining the territory boundaries, both the franchisor and franchisee should think critically about which factors will be vital to their businesses success.

The importance of succinctly drafting territory rights is evident by the fact that disputes over territory rights are one of the most commonly litigated areas of a franchise agreement. These territory disputes, often called encroachment, occur when a franchisee’s exclusive territory is encroached upon by either: (1) the franchisor, or (2) another franchisee. While many factors may play into why a franchisee encroaches, the most common reason is because the franchise has grown and saturated the market. This incentivizes franchisees to dip into the business pool of adjacent territories.

Encroachment can often be mitigated by openly communicating encroachment policies. These policies may include the rights and obligations of each party regarding encroachment. An example of these policies would be addressing how alternative modes of distribution, such as internet sales, have an effect on franchisee’s territory rights. While openly communicating franchise policies is helpful, the most effective way a franchisor can mitigate encroachment claims is by using clear language. This is done by unequivocally stating the franchisee has non-exclusive territory rights. By giving the franchisee non-exclusive territory rights, the franchisor avoids most encroachment claims because the franchisee has no exclusive territory rights that could be violated.

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115 Adler, supra note 109.
116 Id.
However, if the franchisor does choose to give the franchisee exclusive territory rights, the franchisor should still reserve distributive rights to itself, such as the right to distribute its products to customers through alternative means. Considering how fast markets and technology change, it is important that franchisors foresee how they may wish to distribute their products in the future. By reserving distribution rights, franchisors are not prevented by the franchise agreement from adapting to changing means of distribution.

3. Select Cases

As discussed above, territory disputes are one of the most commonly litigated issues between franchisors and franchisees. While clear and simple language can often preclude encroachment claims, some courts have looked past the franchisor’s clear denial of the franchisee’s exclusive rights and allowed the franchisee to bring encroachment claims. These claims often follow along a theory of breach of the implied covenant of good faith and fair dealings (the “Covenant”).

*Scheck v. Burger King* is the predominant case on the subject. In *Scheck*, the court held the franchisor did not have a complete right to develop new restaurants. Despite a clear agreement that the franchisee had no exclusive territorial rights, the court held the franchisor could not build new restaurants if it could hurt the franchisee’s business. The decision was largely based on Florida’s case law on the Covenant.

Since *Scheck*, courts have been split on whether such breach claims can be successfully brought when the franchisee is clearly denied exclusive rights. The difference in opinions may be a result of courts’ differing interpretations of given state laws regarding the Covenant. Therefore, it is important for franchisors to research and understand what the law is in their jurisdiction. If the jurisdiction regards the Covenant favorably, such as in *Scheck*, the franchisor should be aware that it may still be liable for harming the franchisee’s business even if the franchisee does not have exclusive territory rights. Thus, franchisors in these jurisdictions should not oversaturate a market, or grant a new franchisee the rights to occupy a location in close proximity to the initial franchisee. These acts could harm the franchisee’s business and the franchisee may still be able to bring suit against the franchisor on a breach of the Covenant theory.

In contrast, franchisors in jurisdictions that look upon the Covenant with disfavor, such as in *Barnes*, are advised to give franchisees non-exclusive territory rights and allow additional

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121 Id.

122 Id.

123 See, e.g., *Vylene Enterprises, Inc. v. Naugles, Inc.*, 90 F.3d 1472 (9th Cir. 1996) (following *Scheck*); *Camp Creek Hosp. Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396 (11th Cir. 1998) (following *Scheck*); *Barnes v. Burger King Corp.*, 932 F.Supp. 1420 (S.D.Fla.1996) (rejecting *Scheck*); *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999) (rejecting *Scheck*).

124 See *id.*
franchisees to locate within the same territory as they see fit. However, as stated above it is still advantageous for franchisors to not oversaturate the territory’s market.

4. Disclosure Requirements

Growing concerns among franchisees regarding encroachment led the drafters of the Amended FTC Franchise Rule to make dramatic changes to Item 12 in 2007. Under Item 12 of the FDD, entitled “Territory,” the franchisor must now disclose, among other things, each of the following:

- A disclaimer if the franchisee will be granted non-exclusive territory.
- Any territory rights granted to the franchisee, including exclusive territory, a right to relocate, a right to acquire additional territory, and others.

The provisions added to Item 12 help both the franchisor and franchisee. By helping curb comprehensive and ambiguous territory policies, litigation regarding a territory may be reduced.

E. Lease, Sublease, and Collateral Assignment of Lease

1. Purpose

For most traditional franchising concepts, location is paramount, and franchisors want to do whatever they can to hold onto “A” locations. Some franchisors purchase some or all of the real estate on which they grant third parties the right to operate a franchise, which gives the franchisor total control over where its franchises are located while at the same time creating valuable real estate investments. Other franchisors prefer a more “asset light” approach and leave real estate ownership up to the franchisee or another third party. Regardless of the approach, a franchisor has a vested interest in maintaining continuity and preserving a good location even after a specific franchisee’s agreement may expire or terminate. There are several agreements that help the franchisor achieve these goals, depending on who owns the real estate.

First, if the franchisor owns the real estate, then it can simply lease the premises to the franchisee for the term of the franchise agreement. The lease will spell out the franchisee-lessee’s obligations, which will include making the lease and the franchise agreement co-terminus. A default under the lease will constitute a default under the franchise agreement, and vice versa. This allows the franchisor-landlord to replace the franchisee upon termination of either agreement. The risk to the franchisor is that it relies on the franchisee for both the royalty

125 See 932 F. Supp. 1420.
127 FTC Compliance Guidelines, Bus. Franchise Guide (CCH) ¶ 5705; 2008 Franchise Registration and Disclosure Guidelines promulgated by NASAA (Bus. Franchise Guide (CCH) ¶ 5705 (NASAA Proposed Guidelines)).
and marketing payments under the franchise agreement as well as the rental payments under the lease. This creates a higher level of risk to the franchisor in the event the franchisee underperforms or has financial problems.

If a third party owns the real estate, then the franchisor has two options. It can lease the location directly from the landlord and then sublease it to the franchisee. This would allow the franchisor to terminate the sublease upon the termination (or expiration) of the franchise agreement and sublease the premises to another franchisee. The other option (and perhaps most common) is where the franchisee leases the premises directly from the landlord. The franchisor is neither the lessor nor lessee, which can be a good option for franchisors who have a low risk tolerance. However, in order to retain control over the property and maintain the location as part of the franchise system, the franchisor needs certain assurances. This typically takes the form of a lease rider or collateral assignment of lease.

A lease rider is a direct amendment to the lease itself. It is signed by the landlord and franchisee-lessee, not the franchisor. However, the franchisor will dictate the terms of the lease rider and, of course, should be made a third party beneficiary to the lease so that it can enforce its rights under the rider. A typical lease rider will allow the franchisee to operate the franchised business on the premises using the franchisor's marks and prohibit the franchisee from operating any other business under any other marks. The franchisor also will have the right to receive any default notices sent by the landlord to the franchisee and give the franchisor the right to cure any defaults under the lease. In addition, in the event of a default under the franchise agreement, the franchisor will have the right to enter the premises to cure such default. Finally, the franchisee will typically be restricted from amending the lease, or assigning or subleasing the lease, without the franchisor’s consent (in addition to the landlord’s consent). This allows the franchisor to ensure that the premises are only leased to another of its approved franchisees.

A popular alternative to the lease rider is the conditional assignment of lease. While this is an agreement between the franchisor and franchisee, the parties typically obtain the landlord’s express written consent to the terms of the collateral assignment in advance. Failure to obtain the landlord’s consent could lead to a situation where the franchisor is unable to exercise any of its “rights” under the collateral assignment, thereby making the document worthless. The primary purpose of the collateral assignment is to give the franchisor the option of having the lease assigned to it by the franchisee in the event the franchisee defaults under either the lease or the franchise agreement. If there is a default under the lease, the franchisor would normally be obligated to cure the default (but still have the right to seek relief from the franchisee). Once in control of the lease, the franchisor would then have the right to assign the lease to another approved franchisee. This gives the franchisor the ability to preserve the location as part of its system. Similar to the lease rider, the collateral assignment will typically restrict the franchisee’s ability to amend or assign the lease.

In a collateral assignment of lease, the landlord’s consent will usually include: (1) landlord’s agreement to notify the franchisor in writing of any failure by the franchisee to cure a default under the lease; (b) franchisor’s right (but not the obligation) to cure any default by the franchisee within a certain period of time after the franchisor receives notice from the landlord; (c) landlord’s express consent to the terms of the conditional assignment of lease, including the franchisor’s right to have the lease assigned to it; and (d) franchisor’s right to further assign the lease to another franchisee of the system who is reasonably acceptable to the landlord.
If the franchisee owns the real estate, the franchisor’s options are more limited. In some industries where franchisee ownership is common, e.g., hotels, the franchisor simply foregoes any control over the real estate. In most circumstances, the franchisor will rely on a covenant not to compete, to the extent it is enforceable.\textsuperscript{130} Although this may not enable the franchisor to retain the location in its system, it at least prevents the franchisee from opening a competing business. Of course, the franchisee can always sell the property to a third party, who would not be bound by the non-compete.\textsuperscript{131} To avoid that situation, a franchisor could include in the franchise agreement a purchase option, which would give the franchisor the option to purchase the franchised location upon termination of the franchise agreement.

2. Select Cases

Collateral lease assignments are generally upheld in the favor of franchisors. In the leading case of \textit{Snelling & Snelling v. Martin}, the court held that a provision in the franchise agreement requiring the franchisee to assign the lease to the franchisor upon termination of the franchise agreement was enforceable.\textsuperscript{132} The court acknowledged the value of the location to the franchisor, finding that the franchisor would “suffer irremediable loss of locational goodwill” if it was not able to maintain operations at the location.\textsuperscript{133}

The importance of having the landlord’s “buy-in” on a collateral assignment of lease cannot be overstated. In \textit{Danbury Mall Assocs. Ltd. P’ship v. Mazel Enters., LLC}, the franchisor looked to enforce a collateral lease assignment provision against the landlord after the franchisee abandoned the location.\textsuperscript{134} However, the franchisor was unable to show that the landlord consented to the conditional assignment of lease, and the court permitted the landlord to not accept the assignment.

3. Disclosure Requirements

If the franchisee will be required to sign any of the above agreements with the franchisor in connection with the purchase of the franchise – including a lease, sublease, lease rider or collateral assignment of lease – that agreement must be included in the FDD. However, any third party agreements, such as a direct lease from a landlord, would not have to be included in the FDD. While a lease rider may need to be customized to the specific lease between the landlord and franchisee, the substantive terms can – and should – be set forth in a sample lease rider agreement attached to the FDD.

F. Technology License Agreement

1. Purpose

\textsuperscript{130} See discussion, supra, Section III.A.
\textsuperscript{131} For further discussion on this issue, see Barnes, Meredith et al., “Protecting Real Estate Rights When the Franchise Relationship Ends,” Franchise Law Journal, Vol. 37, No. 4 (Spring 2018).
\textsuperscript{133} Id.; see Mark D. Shapiro, Ch. 6:Real ESTATE ISSUES, IN COLLATERAL ISSUES IN FRANCHISING: BEYOND REGISTRATION AND DISCLOSURE 180 (Kenneth R. Costello ed., 2014).
As an ever-growing number of franchisors are turning to technology as a way to bolster efficiency and cut costs, software in particular has emerged as a front-runner among cost-effective measures aimed at improving the performance of small businesses and large enterprises alike. While industry-wide adaptation of technology has eluded the franchising industry generally, cutting-edge point-of-sale ("POS") systems, customer relationship management ("CRM") platforms, online training programs, and web-based marketing software offer unprecedented opportunities to streamline day-to-day operations and mitigate overhead costs. With more and more franchisors endeavoring to offer unique software-based solutions to their respective franchisees, franchisors and their attorneys should place greater emphasis on ensuring that legal rights, obligations, and liabilities pertaining to applicable copyrights, trade secrets, patents and trademarks are thoroughly contemplated before engaging in such transactions with their franchisees.

In the franchising context, this is often accomplished through a software license agreement. Generally speaking, a software license agreement allows a developer to provide software access to an identified user while retaining the ability to enter into similar transactions with other parties under the terms it sees fit. While software licensing is not the only method of transferring rights to software, it is the predominant method due to the flexibility that it offers for the licensor. A software license agreement should be executed simultaneously with the Franchise Agreement if a franchisor has developed its own software or has procured such development with the aid of a third-party, and wishes to license the software to its franchisees for use by its employees and managers.

Determining the necessity of a software license agreement is just the first step that needs to be taken to protect a franchisor’s interest in its software. The franchisor should then look to define the parameters of the contract; in other words, who are the end users, what activity is allowed, where the license can be used, and how long the license lasts. Next, the franchisor should consider the business implications when allocating costs between itself and franchisees, such as the amount and frequency of payments for the license fee and responsibility for taxes. Lastly, the legal terms governing the license, such as representations and warranties, limitation of liability, and indemnification, will need to be carefully considered and discussed by franchisors and their counsel, as they could become the source of some pushback by the franchisees.

2. **Practice Tips**

   a. **Defining the Software: Source Code vs. Object Code**

When it comes to drafting software license agreements for use by franchisees, effective practitioners need to learn to “speak geek;” that is, they should possess a firm understanding of the jargon of the tech industry. Use of the appropriate terminology is not only relevant to the developers, coders, and engineers who create software solutions, but also for legal practitioners.

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137 *id.*

who assist licensors because the terminology ultimately dictates what legal rights are being transferred. Software is traditionally thought of as a combination of object code and source code. What you most likely think of when you hear “software” is termed “object code,” which refers to the machine-readable code that is read and executed by the end user’s computer, tablet, or other hardware device. Source code, on the other hand, is the human-readable version of a program that is created and interpreted by those proficient in programming languages such as Java, Python, or C++, and ultimately used to create the object code. In most license agreements granting software for a specific end use, such as in-store processing of purchase transactions by on-site employees, the object code should be the only “software” that is transferred. Indeed, exclusive control of the source code is important for many licensors, as it provides convenience of maintenance and helps impede prohibited behaviors under the software license agreement, such as modification, disassembly, and reverse engineering. Moreover, in most imaginable franchisor-franchisee licensing transactions, the franchisor should look to contract for the licensure of the object code itself, without including the source code as the need for the latter by licensee will rarely, if ever, arise in the course of business. Of course, the aforementioned definitional considerations are not subject to bright line distinctions; rather they constitute just one of several schools of thought used to describe software. Thus, astute franchisors will want to ensure that the description of software, warranties, and acceptance and testing provisions in their software license agreements are consistent with the functions performed by the software. The overall takeaway is that a prudent practitioner that advises franchisors should have more than “software” in his or her lexicon in order to avoid the risk of granting more rights in the software than the franchisor intended to give.

b. Intellectual Property Protection

Intellectual property law provides several avenues for protecting software, with copyright, trade secret, patent, trademark, and trade dress laws all providing various degrees of protections to software developers and programmers. Most software is protected with a combination of copyright and trade secret protection. Copyright law protects both the literal aspects (i.e. object and source code) and nonliteral aspects (e.g. structure, sequence, and organization) of software. However, courts have qualified the scope of protection for nonliteral aspects to require careful scrutiny. Franchisors may also rely on trade secret law to protect elements of software such as product feature lists, flow charts, protocol information, and source code. While not traditionally used in the context of software development, patent protection has recently emerged as an option for franchisors who need to protect software-based inventions. Trademarks can also be obtained to protect product names and product feature names. Lastly, trade dress protection may be available as an option to protect aspects like the design of the

139 NGUYEN ET AL, supra note 136, at 504.
140 Id.; MICHAEL A. EPSTEIN & FRANK L. POLITANO, DRAFTING LICENSE AGREEMENTS §13.01 (CCH Inc. ed., 4th Ed. 2007), CCH IntelliConnect.
141 Roger MILGRIM & ERIC BENSEN, MILGRIM ON LICENSING § 4-VI, n. 6 (2018), Matthew Bender, Rev. Ed.
142 But see NGUYEN ET AL, supra note 136, at 548.
143 EPSTEIN & POLITANO, supra note 140, at § 13.01.
144 Id. at § 13.03.
145 NGUYEN ET AL, supra note 136, at 506 (citing Lotus Dev. Corp. v. Borland Int’l, Inc., 49 F.3d 807, 815 (1st Cir. 1995), aff’d by an equally divided Court, 516 U.S. 233 (1996)).
146 NGUYEN ET AL, supra note 136, at 507; MILGRIM & BENSEN, supra note 141, at § 1-2B (citing Diamond v. Diehr, 450 U.S.175 (1981)).
user interface. It should be noted, however, that while trade dress protection may seem advantageous compared to copyright law in terms of protecting the “look and feel” of the franchisor’s software user interface, the former often requires a showing that users associate the user interface with such franchisor.\textsuperscript{147} With these considerations in mind, the features and functionality of a franchisor’s software should be discussed in depth with counsel so the franchisor is aware of the scope of protection afforded to it and the software license agreement is drafted with the appropriate protections in mind. Additionally, counsel for the franchisor should secure all applications and registrations, as appropriate, before engaging in software licensing transactions.

c. **Scope of the Agreement**

Even though the intellectual property protections discussed above appear to comprehensively address the use of software, the scope of the software license agreement actually has the biggest impact on the way software can be used by franchisees. The software license agreement determines details such as the number of computers on which the software may be installed and used, the authorized end users, and general and user-specific restrictions on use. Franchisors should always ensure that their software license agreements stipulate that (1) the transaction is characterized as a license as opposed to a sale, and (2) ownership of the software is retained by the licensor.\textsuperscript{148}

i. **Granting a License**

As discussed above, one of the major benefits of the software license agreement is the ability to tailor the grant of the license to the needs of the franchisee. Franchisors should always take care to provide a complete definition of the software, including any updated versions or separate modules, as applicable, and specify the term, exclusivity, and transferability of the license. Updates to software have caused problems where the rights to updated versions of the software were either neglected or improperly addressed in the license agreement. Where the definition of software should include subsequent updates, be sure to confirm that those updates are subject to the terms and conditions of the software license agreement.\textsuperscript{149} Also, because the purpose of a general franchise is to offer business opportunities to multiple franchisees, related software license agreements should not grant exclusive licenses.

ii. **Defining the End User**

Software license agreements should be drafted to avoid ambiguity regarding who is authorized to access the software. The franchisor will want to consider who it envisions as the end user and how it wants to address that in the software license agreement. For example, software developed for commercial use in a franchisee’s business will almost assuredly necessitate employee access, which means employees should be included in the software license agreement’s definition of licensee. But should the franchisee’s affiliates have access to the software? What about its lawyers, accountants, and other advisors? What if customers need to interface with the licensed software? The answer to these questions will vary depending on

\textsuperscript{147} See NGUYEN ET AL, supra note 136, at 508 (citing Apple Comput. v. Microsoft Corp., 35 F.3d 1435 (9th Cir. 1994); Data East USA v. Epyx, Inc., 862 F.2d 204 (9th Cir. 1988)).

\textsuperscript{148} EPSTEIN & POLITANO, supra note 140, at § 13.04(A).

\textsuperscript{149} See Id. at § 13.04(C).
the nature of the franchise and the franchisee’s needs, but in any event, should be clearly indicated in the license agreement.\(^\text{150}\)

### iii. Restrictions on Access

Generally speaking, licensors seek to limit software access to the minimum amount necessary to fulfill the contractual purpose, so franchisors too should carefully consider whether geographic, site, or numerical restrictions for the software are appropriate based on the software’s purpose in relation to the type of franchise being offered. This may be done by setting forth such terms on a schedule to the software license agreement, using defined terms, or otherwise providing so in the agreement. In the alternative, the franchisor may offer substitute sites as a compromise where operation of software at one location is impractical.\(^\text{151}\)

Where the proper functioning of the software is vital to the operations of a franchisee, the licensor should specify that certain hardware configurations and operating systems are allowed or prohibited in order to reduce the risk that the software interacts with incompatible hardware.\(^\text{152}\) This is especially true for POS systems, where deficient hardware or operating systems mean that the franchisee would have to temporarily shut down and cease operations without the ability to process transactions. Such provisions are standard in the context of custom-developed software, where such software often is created with specific computers or devices in mind, and should be included in the franchising context as well.\(^\text{153}\)

### iv. Restrictions on Use

Although Section 106 of the Copyright Act of 1976 gives the copyright owner the exclusive right to copy, reproduce, and prepare derivative works based upon the copyrighted software, a franchisee may nevertheless want to modify the source code in order to conform it to its particular use.\(^\text{154}\) However, franchisors should be wary of offering the ability to modify software because the changes could affect the franchisors’ representations and warranties and may make it more difficult to implement fixes, provide maintenance, and roll out updates.\(^\text{155}\) Still, a franchisor can still choose to permit a narrow category of modifications while prohibiting all others if the need for modifications is an essential term for such franchisee or an inherent feature of the software.\(^\text{156}\) Additionally, franchisees may seek to disassemble and “reverse engineer” software in order to access the source code. Despite seeming similar to the modification of software, express prohibitions on disassembly and reverse engineering are not preempted by the Copyright Act of 1976 because such prohibitions extend beyond the protection afforded thereunder, and thus, should be included in software licenses agreements to ensure comprehensive protection.\(^\text{157}\)

### d. Other Legal Considerations

\(^{150}\) See Epstein & Politano, supra note 140, at § 13.04(B).

\(^{151}\) Milgrim & Bensen, supra note 141, at § 4-VI, n.3.

\(^{152}\) Spratley, supra note 138.

\(^{153}\) Epstein & Politano, supra note 140, at § 13.04(A).


\(^{155}\) Milgrim & Bensen, supra note 141, at § 4-VI n.4.

\(^{156}\) See Epstein & Politano, supra note 140, at § 13.04(D)(2).

\(^{157}\) Milgrim & Bensen, supra note 141, at § 4-VI, n.11.
i. Indemnification

Indemnification obligations can present a conundrum for franchisors who license software. On one hand, the ability to control all related infringement and misappropriation actions is extremely important, given that the implications of any suit involving a franchisee could easily extend to a franchisor as well as all other franchisees who license the same software.\(^{158}\) Conversely, indemnification may not be preferred where franchisors do not want to be liable for risks that are out of their control.\(^{159}\) Indeed, indemnification may not be necessary where financial considerations make extensive control of legal actions practically implausible or economically unattractive. However, if a franchisor concludes that indemnification is in its best interest, it is important to remember that indemnification provisions should be drafted to ensure that all violations of applicable intellectual property law can form the basis of an indemnification claim. For example, patents and copyrights are infringed, while trade secrets are appropriated, so a well-drafted indemnification clause should reference both infringement and misappropriation.\(^{160}\)

ii. Limitation of Liability

Franchisors have several options available to allocate liability under the software license agreement. A common practice involves implementing a cap on the franchisor’s total liability under the agreement. Some software license agreements go as far as capping damages to the value of the agreement.\(^{161}\) Other agreements provide for liability to be reduced pro-rata in proportion with the number of years remaining on the term of the license.\(^{162}\) Considering the sizeable sums that can be awarded by juries, capping the damages to the value of the contract may receive pushback from franchisees. If a licensee refuses to accept such a cap, excluding damages relating to infringement or payments made pursuant to indemnification from counting towards the cap may serve as a compromise.\(^{163}\)

iii. Assignability and Sublicensing

Most software license agreements do not provide for assignment, and where assignment is allowed, consent of the franchisor should be required.\(^{164}\) While standard practice is to rely on defined terms in order to identify unspecified end users, other issues such as indemnification, risk allocation, or other legal concerns may require the assignment of rights under the agreement, or sublicensing. For example, a master franchisee who is receiving a license from franchisor cannot practically adhere to specific site requirements, and thus, needs to sublicense the software in order to retain some element of control over access to the intellectual property.\(^{165}\)

\(^{158}\) Epstein & Politano, supra note 140, at § 13.15.

\(^{159}\) Id.

\(^{160}\) See Milgrim & Bensen, supra note 141, at § 4-VI, n. 13.

\(^{161}\) Epstein & Politano, supra note 140, at § 13.13.

\(^{162}\) Milgrim & Eric Bensen, supra note 141, at § 4-VI.

\(^{163}\) Epstein & Politano, supra note 140, at § 13.13.

\(^{164}\) Epstein and Politano, supra note 140, at § 13.17.

\(^{165}\) Neil Wilkof, Why do People Sublicense: Let Me Count the Ways, THE IPKAT (April 29, 2012), http://ipkitten.blogspot.com/2012/04/why-do-people-sublicence-let-me-count.html (“[T]he structure of the commercial relationship with the licensor may be such that . . . only the sublicensee(s) are intended to exploit the IP. This is
iv. Software Maintenance and “Escrowing” the Source Code

Occasionally, potential franchisees may express concern over preserving access to the source code in the event that the franchisor becomes insolvent, dissolves, or otherwise becomes unable to maintain the software. Under traditional software licenses, the licensor and licensee resolve these concerns by entering into a source code escrow license agreement with an escrow agent. While many smaller franchisees lack the sophistication to reasonably request and take advantage of source code escrow license agreements, understanding the concern may be relevant for larger franchisees who insist on preparing for similar contingencies. Rather than entering into a complicated and costly three-party transaction, the franchisor and franchisee should enter into a source code license that is only exercisable upon a triggering condition or allow the franchisee to hold the source code, who covenants to not access it until the occurrence of a triggering condition.166

3. Disclosure Requirements

Although there are no specific disclosure requirements or prohibitions pertaining to the disclosure of software license agreements in connection with franchise agreements, a software license agreement should nonetheless be furnished along with the Franchise Agreement and the other related agreements in accordance with the FTC’s Franchise Disclosure Requirements and Prohibitions Concerning Franchising.167 Additionally, all applicable costs, expenses, restrictions, and other information required to be disclosed pursuant to Items 6, 8, 9, 11, 17 of the corresponding Franchise Disclosure Document should be included as well.168

G. Lender Comfort Letter

1. Purpose

As discussed in Section III.E. above, collateral assignments and other lease documents are a common method for a franchisor to preserve the value of a specific location by ensuring that it remains in its system and does not change brands. Similarly, lenders who are lending large sums of money to franchisees to help them build, renovate and/or operate their business often are looking for assurance, or “comfort,” that the franchisee is in good standing and the business serving as collateral for the loan (if applicable) will remain operational and not change brands. This is where a lender comfort letter comes in.

A comfort letter is a tri-party agreement between the lender, the franchisor, and the franchisee. It is sometimes referred to as an intercreditor agreement since both the lender and the franchisor are considered “creditors” to the franchisee. The primary purpose of the comfort letter is to give assurance to the lender that the franchise agreement is in full force and effect, the franchisee is not in default, and the franchisee is otherwise in good standing with the franchisor. A secondary purpose of the comfort letter is to give lenders the right to keep the brand to protect their investment, as a branded business is typically viewed as more valuable especially so . . . where the franchise is . . . structured to provide for a master franchisee . . . which does not directly operate any licensed units, but rather manages a chain of franchisees/sublicensees.”.166

166 NGUYEN ET AL, supra note 136, at 548.
168 See id. at § 436.5.
over a non-branded business. The comfort letter also provides certainty as to the respective rights and obligations of the lender, franchisor, and franchisee, and it provides a framework for a workout in the event the franchisee defaults under either the loan agreement or the franchise agreement. In the franchising context, since the objective of the comfort letter is to protect the value of the collateral, the need for such letters typically arises when the franchisee owns the property.

All three parties to a comfort letter stand to benefit from it. The franchisor has an improved probability of retaining the location in its system, and it facilitates the franchisee’s ability to get the lending it needs to acquire, build, or renovate the franchised business.

For the lender, it will receive notice of any defaults by the franchisee under the franchise agreement and be given an opportunity to cure the default. This allows the lender to avoid termination of the franchise and preserve the value of the collateral. The lender also receives certain rights if it forecloses on the property due to the franchisee’s default under the loan. Typically, if the lender commences a foreclosure or similar proceeding to acquire the franchised location, and the franchisee is not in default of the franchise agreement (or the lender has cured such defaults), then the lender will have the right to continue operating the location under the franchisor’s brand. The comfort letter may either allow the franchise agreement to be assigned to the lender, or it may require the lender and franchisor to enter into a new franchise agreement. Any subsequent transfer of the franchised business to a new franchisee would normally follow the standard transfer process outlined in the franchise agreement.

While comfort letters are primarily designed to preserve the brand identity of the premises which are acting as collateral for the loan, there may be circumstances where the lender determines that it is in its best interest to exit the brand. Most comfort letters will give lenders this right. The lender would be required to give the franchisor notice, and the franchise agreement would be terminated in accordance with the terms agreed upon in the comfort letter. The lender would be obligated for any fees that accrued from the date it acquired the location through the date of termination, and the lender would be required to comply with post-termination obligations, such as de-identification.

Another advantage to the comfort letter is that, while not necessarily enforceable in a bankruptcy proceeding, it can provide a roadmap to the bankruptcy court and lead to greater cooperation between the parties. In addition, certain obligations between the lender and the franchisor may be enforceable against one another in a bankruptcy proceeding.169

2. Practice Tips

Because franchisors do not have the same leverage over a lender as they may over a franchisee, it is important to draft a comfort letter that will be palatable to lenders. Failure to draft a fair and reasonable comfort letter that gives a lender the key rights it is looking for can lead to wasted time negotiating, at best, to a franchisee losing out on a loan, at worst. A franchisee’s failure to get lending can either lead to a lost deal (if it is a prospective franchisee) or the inability of an existing franchisee to perform important upgrades to its franchised business. It can also lead to a franchisee defaulting on its payment obligations to the franchisor. None of

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these circumstances benefit the franchisor. Within reason, it is typically in the franchisor’s interest to facilitate its franchisee’s borrowing efforts.

3. Disclosure Requirements

As discussed above, Item 22 of the FTC Franchise Rule requires a franchisor to attach to the FDD copies of “all proposed agreements regarding the franchise offering, including the franchise agreement and any lease, options, and purchase agreements.” Since a comfort letter is an agreement required by the lender, and not the franchisor, most franchisors will not include this agreement as an attachment to the FDD.

Also, while it may not be necessary to furnish an FDD to a lender at the comfort letter stage (since it is not being granted a franchise), franchisors should ensure the lender is given proper disclosure before entering into a franchise agreement down the road, for example, after a foreclosure.

IV. “OTHER AGREEMENTS” ENTERED INTO AT THE END OF FRANCHISE RELATIONSHIP

A. Transfer Agreements

1. Types and Purpose

A transfer occurs when a franchisee sells, assigns, or pledges its rights with respect to the ownership, control, or operations of the franchise. While franchise agreements typically provide for a five- or ten-year life span and are subject to renewal and extension options, transfer-related provisions within the agreement specify what the franchisee must do if it wants to transfer the franchise during the term of the contract. In effect, transfer agreements maintain the franchise system, while allowing for transactions that result in a change of control or ownership of the franchise. Whether stemming from a franchisee’s desire to retire, sell at a favorable price, breakup a partnership, or simply a wish to pursue other opportunities, transfer agreements set the process and conditions for the franchisee to assign ownership rights to a third party without violating the terms of the franchise agreement.

Regardless of the reasons for the transfer, it is important to understand both the common and competing interests of the franchisor, the transferor (franchisee), and the potential transferee (buyer). On one hand, the franchisor is interested in continuing its business and ensuring that the transferee is a good fit for the franchise system. The transferor, on the other

170 16 C.F.R. §436.5(v).
175 Id. at 12.
hand, is primarily concerned with exiting the system in a timely manner, while also getting the best available price for their franchised business. The transferee and franchisor, however, both share an interest in ensuring the longevity of the system and, of course, the transferee wants to obtain the new business for a fair price.

a. **Methods for Transfer**

There are two primary methods by which a transfer can occur. The first method of transfer is franchisor-driven and occurs when the franchisor signs a new agreement with a transferee without the franchisee’s consent. This type of transfer often arises when the franchisor is restructuring, refinancing, merging with a new entity, or is being bought out by another franchisor. In these circumstances, franchise agreements usually give the franchisor the unilateral right to transfer or assign the agreement for the benefit of the franchise system.

The second method occurs when a transferee steps into the shoes of the franchisee by assignment. In this scenario, the transferee either assumes all of the obligations and responsibilities of the transferor under the transferor’s franchise agreement, or executes a new franchise agreement with the franchisor. If the terms of the existing agreement would continue to benefit the incoming buyer, the transferee may choose to swap places with the transferor, subject to the franchisor’s discretion. A transfer event may also present the franchisor with an opportunity to amend an existing franchise agreement or to negotiate franchisor-friendly terms in a new contract.

b. **Transfer Requirements**

Franchise agreements generally define the obligations and restrictions regarding any transfer of the agreement. Though the contractual provisions vary by agreement, franchise agreements often require payment of a transfer fee and express written consent of the franchisor to the transfer, set qualifications for the transferee, outline transferee training requirements, obligate the franchisee to execute a release, and detail the notification requirements. The following subparts will address these transfer requirements and outline some of the major issues within the most common contractual provisions addressing transfers.

i. **Notice Requirements**

Typically, franchisees must give notice to the franchisor of their intent to transfer the business. Though this is normally detailed in the franchise agreement, many states require the

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176 *Id.*
177 *Id.*
178 *Id.* at 15; *see also* Goniea, *supra* note 174, at 372 (distinguishing between “Transfer by the Franchisor” and “Transfer by the Franchisee”).
179 *Goniea, supra* note 174, at 372.
182 For a comprehensive checklist of key transfer requirements, see Goniea, *supra* note 174, at 402.
183 *See Tractenberg, supra* note 173, at 286-87. *For a more detailed description of the common provisions in franchise agreements relating to transfers, see Id. at 288-90.*
franchisee to provide 30 to 90 days’ notice prior to the proposed transfer date.\textsuperscript{184} Failing to notify may provide sufficient grounds for withholding approval of the transaction.

c. **Consent to Transfer & Standards for Approval**

Most issues during transfer involve the approval or disapproval of the transaction by the franchisor. In franchisor-driven transfers (method one above), Franchise agreements normally allow the franchisor to transfer or assign the agreement without the consent of the franchisee. This flexibility allows a franchisor to refinance, restructure, merge, or execute a buy-out without delay.\textsuperscript{185}

When the franchisee attempts to assign the agreement to a potential transferee, however, a franchisee usually must obtain the franchisor’s express written consent. After all, franchisors have a substantial interest in ensuring that potential franchisees are qualified and meet the conditions of the agreement.\textsuperscript{186} To protect that interest, franchisors often prescribe certain conditions that both the transferor and the potential buyer must meet in order to effectuate the transfer. In addition, franchise agreements commonly require an existing franchisee to pay all outstanding debts, execute a general release, provide the right of first refusal, notify the franchisor of its intent to transfer, pay a transfer fee, set a reasonable purchase price, and execute a written guaranty of the buyer’s obligations under the agreement.\textsuperscript{187}

The high level of risk involved with approving a new franchisee results in this high burden for obtaining approval. Indeed, franchisor consent is often contingent on signing the then-current form of franchise agreement, completing required training, upgrading facilities, meeting criteria for capital and liquidity, correcting defaults of any material terms within the franchise agreement, maintaining a good credit rating, and maintaining a reputation of good moral character.\textsuperscript{188} Failing to meet the franchisor’s expectations relating to character, financial ability, language proficiency, or a lack of requisite business experience may result in withholding of approval.\textsuperscript{189}

On the other hand, withholding of approval may subject the franchisor to lawsuits if the franchisee perceives the franchisor’s decision as unreasonable or arbitrary.\textsuperscript{190} To minimize lawsuits arising from consent issues, franchisors should consider outlining minimum requirements to reduce subjectivity in the approval process and to weaken transferor claims complaining of disapproval.\textsuperscript{191} To do so, franchisors should require potential franchisees to

\textsuperscript{184} See \textit{Id.} at 300; \textit{IFA}, supra note 174, at 9.

\textsuperscript{185} Goniea, \textit{supra} note 174, at 372.

\textsuperscript{186} \textit{IFA}, supra note 174, at 12.

\textsuperscript{187} See Tractenberg, \textit{supra} note 173, at 286-87; Goniea, \textit{supra} note 174, at 376-77 (providing a list of conditions for franchisor consent).

\textsuperscript{188} \textit{Id.}

\textsuperscript{189} See Tractenberg, \textit{supra} note 173, at 292 nn.9-14 (providing examples of court decisions upholding the right of a franchisor to withhold approval due to the transferee’s lack of experience). For an example “Consent to Assignment of Franchise Agreement,” see Tractenberg, \textit{supra} note 173, at 332.

\textsuperscript{190} \textit{Id.} at 291.

\textsuperscript{191} \textit{Id.} at 291-92.
submit a formal application. And if the franchisor withholds approval, the franchisor should respond with an objective analysis noting the transferee’s deficiencies.

i. Restrictions on Withholding Consent

Often, provisions dealing with franchisor approval of a transfer state that consent must not be unreasonably withheld. The key question becomes whether, and to what extent, the law protects franchisees who desire to sell their operating assets and franchise rights. Courts have historically upheld the “sacrosanctity of the written franchise agreement” by allowing freedom to contract to govern the restrictions (or lack thereof) on franchisor consent to transfers. Thus, if the franchise agreement qualifies the franchisor’s level of discretion in approving a transfer—whether reasonable, not arbitrary, or unlimited discretion—the parties are generally bound by the standard they have agreed to. But, the power asymmetry underlying franchise agreements has increasingly proven to be a point of contention in the realm of franchisor consent.

Some state statutes require a franchisor to show good cause in order to withhold such approval. Good cause is often measured by the reasonableness standard – i.e. the franchisor must objectively be concerned about the sustainability and profitability of the franchise. If the franchisor withholds consent without having a business-related concern, the court may find the decision to be unreasonable. Factors demonstrating good clause include situations where: (1) the transferee is a competitor to the franchisor, (2) the transferee refuses to accept the terms of the franchise agreement, (3) the transferee fails to cure a default under the existing franchise agreement, (4) the agreement would create too large a territory to cover, or (5) the purchase price is such that the franchisor reasonable believes the transferee would be unable to successfully generate a sufficient cash flow.

Where state law is silent, common-law restrictions on a franchisor’s ability to withhold consent may apply via the implied “covenant of good faith and fair dealing.” The implied covenant simply means that franchisors must give fair consideration to the proposed transfer to ensure disapproval is neither arbitrary nor damaging to the interests of the franchisee. Generally, however, courts defer to the express words of the contract and afford limited relief under this theory. The implied covenant of good faith cannot be used to limit the franchisor’s

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192 *Id.* at 286.
194 *IFA*, *supra* note 174, at 16; *see also* Truby, *supra* note 172, at 6-12 (highlighting ten state-level franchise relationship laws which collectively illustrate “good cause” restrictions for a franchisor withholding transfer approval).
196 *Id.*
197 *IFA*, *supra* note 174, at 16.
198 *See Id.; see also* Dunn, *supra* note 171, at 236-37 (detailing opposing circuit court treatments of the implied covenant of good faith as it relates to franchise agreements that specifically permit arbitrary action).
199 *See IFA*, *supra* note 174, at 17; Dunn, *supra* note 171, at 236.
200 *See Perez v. McDonald’s Corp.*, 60 F. Supp. 2d 1030, 1035 (E.D. Cal. 1998) (holding that the implied covenant of good faith could not be imputed into a franchise agreement that expressly prohibited the franchisor from arbitrarily withholding its consent); *Burger King Corp. v. H&H Restaurants*, LLC, No. 99-2855, 2001 WL 1850888, at *7 (S.D. Fla. Nov. 30, 2001) (holding that the implied covenant of good faith failed to overcome the express term of the franchise agreement).
discretion so long as the plain language of the agreement specifies the standards for attaining consent. Nor can it alter the franchisor’s discretion on any matter not expressly addressed in the franchise agreement.\textsuperscript{201} In sum, franchisors must stay apprised of how state and common law measure the reasonableness standard and affect the franchisor’s discretion to withhold consent.

d. **Release from Prior Franchise Agreement**

Release agreements require the transferor to discharge all claims, demands, obligations, and liabilities against the franchisor.\textsuperscript{202} Courts generally uphold provisions in the franchise agreement that require the franchisee to execute a unilateral release prior to the proposed transfer.\textsuperscript{203} The franchisor’s consent is typically adequate consideration for releasing the right to bring claims in the future.\textsuperscript{204} For example, in *Franchise Management Unlimited v. America’s Favorite Chicken*, the court enforced a unilateral release requirement, finding that it was “commercially reasonable for a franchisor to require a franchisee to resolve all disputes...before the franchisor approves the transfer.”\textsuperscript{205} Some states, however, have anti-waiver provisions that expressly prohibit a franchisor from requiring the franchisee to sign a release of potential claims.\textsuperscript{206} Iowa law, for instance, expressly prohibits a franchisor from requiring a franchisee to “sign a release of claims that is broader than a similar release of claims by the franchisor.”\textsuperscript{207} In general, as long as the release agreement is tailored to claims arising out of the franchise agreement itself, courts tend to uphold a valid waiver of future claims.\textsuperscript{208}

e. **Assignment and Assumption**

In conjunction with the release of the previously existing franchisee, the transferee must often assume all of the obligations and duties of the prior franchise agreement.\textsuperscript{209} This can take two forms: (1) where the transferee takes an assignment of the existing franchise agreement for the remainder of the term or (2) where the transferee executes the franchisor’s “then-current” form of franchise agreement. Most commonly, franchisors prefer an agreement reflective of their then-current agreements because those agreements reflect any updates to the franchise system that have taken place since the signing of the transferor’s franchise agreement.\textsuperscript{210}

Two main factors are important when negotiating the terms of assignment and assumption. First, the franchisee must be aware of the duration and renewal options available in the existing franchise agreement. A narrow timeline may severely limit the extent to which the incoming franchisee can recoup the costs of the franchise purchase price.\textsuperscript{211} Second, the

\textsuperscript{201} Tractenberg, *supra* note 173, at 288.

\textsuperscript{202} Goniea, *supra* note 174, at 419 (providing an example of a “Transfer and Release Agreement” form).

\textsuperscript{203} Id. at 294.

\textsuperscript{204} Tractenberg, *supra* note 173, at 294.


\textsuperscript{206} See Truby, *supra* note 172, at 6-12, 40 (discussing state relationship laws that limit the franchisor from requiring a release of future claims).

\textsuperscript{207} Id. at 9 (citing IOWA CODE § 523H.5(9) (2014)).

\textsuperscript{208} Tractenberg, *supra* note 173, at 295.

\textsuperscript{209} Truby, *supra* note 172, at 36.

\textsuperscript{210} Id. at 37.

\textsuperscript{211} Id.
franchisor must be cognizant of disclosure and registration requirements that will be triggered if
the transferee is required to execute the then-current form of the franchise agreement. If the
then-current agreement contains “material changes” to the original form, the franchisor may be
obligated to provide an FDD in accordance with rules set forth by the FTC Franchise Rule.212
And, what might otherwise be exempt from mandated disclosures under the FTC Franchise
Rule, could be “converted” into a “sale” by the franchisor.213

2. Practice Tips

The transfer of franchises is subject to state-level franchise relationship laws or judicial
interpretations that may substantially affect the transfer process or the expectations of the
parties involved.214 Similarly, the level of scrutiny applied to related issues of consent and
unilateral release provisions varies widely from state to state. Notwithstanding the variance
among states, this section outlines a few practice tips below for limiting liability and mitigating
issues that may arise during the transfer process.

Perhaps most important, a franchisor should take steps to develop an exit strategy or
transfer policy. As noted above, transfers may occur for a variety of reasons. Problems in the
transfer process frequently arise because franchisors and franchisees (especially at the onset of
a franchise agreement) rarely revisit or consider the prospect of dissolution.215 Thus, it is critical
to manage party expectations by documenting and agreeing upon an exit strategy at the
beginning of the franchise relationship. Because the franchisee is heavily involved in the
assignment process, it is important that it fully understands the conditions necessary to obtain
approval.

In the event a franchisor withholds consent to transfer, the franchisor can mitigate
frustration of the transferor and transferee by detailing and providing an objective list of reasons
for disapproval. Accordingly, the potential franchisee can rectify delinquencies and the current
franchisee can optimize the vetting process. In addition, if the franchisor enters into the transfer
process after the franchisee has already begun negotiating with a potential buyer, the franchisor
should do its best to continue the process without frustrating the developments or causing an
unnecessary delay.216 By helping to locate buyers, being upfront about unqualified candidates,
and preparing a clear transfer policy at the front-end of the franchise arrangement, the transfer
process can better serve the needs of all parties involved.

3. Disclosure Requirements

The Federal Trade Commission Act mandates that franchisors make certain disclosures
of material information to prospective franchisees prior to the offer and the sale of a franchise.217
The rule states that “[i]n connection with the offer or sale of a franchise...it is an unfair or
defceptive act or practice in violation of Section 5” of the Act for a franchisor to “fail to furnish a

212 *Id.* at 2.
213 *Id.* at 37.
214 See Truby, *supra* note 172, at 6-12 (detailing ten states with franchise relationship laws that impact transfer
provisions in franchise agreements).
215 *IFA, supra* note 174, at 6.
216 *Id.* at 13.
217 Peter C. Lagarias & Edward Kushell, *Fair Franchise Agreements from the Franchisee Perspective*, 33 Franchise
prospective franchisee with a copy of the franchisor’s current disclosure document.”218 A prospective franchisee is defined as “any person...who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship.”219 Therefore, if a franchisor refers a potential buyer to the franchisee, then they will have to furnish an FDD.

But no FDD is required in a transfer by an existing franchisee “as long as the franchisor has not had ‘significant involvement’ with the prospective franchisee.”220 Providing approval or disapproval of a pending transfer, for example, does not constitute “significant involvement.”221 Supplying performance information to a potential franchisee, however, would require submission of the FDD. Thus, the amount of involvement the franchisor has in the assignment or transfer process will dictate if the FTC Franchise Rule’s disclosure requirement is triggered.222

If the franchisor’s involvement in the transfer process triggers an FDD disclosure, the franchisor must provide the FDD “at least 14 calendar-days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor” in connection with the sale, but disclosure of any release or assignment and assumption agreement are not required under Item 22.223

B. Termination and Release Agreements

1. Purpose

Inevitably, the franchise relationship will at some point come to an end. This may be due to the natural expiration of the franchise agreement, a mutual parting of ways prior to expiration, or a for-cause termination. Regardless of the reason, a termination and release agreement brings closure to the relationship while tying up any loose ends and allowing the parties to avoid costly litigation. It will not only terminate the franchise agreement but any ancillary agreements (such as those discussed in this paper) as well. This allows both parties to move on without lingering claims or liabilities hanging over their heads.

The termination and release agreement will typically include the following provisions: (a) effective date of termination; (b) payment of any monies owed by the franchisee, including damages if applicable; (c) re-statement of the franchisee’s post-termination obligations, e.g., de-identification and covenant not to compete; (d) mutual release (or unilateral release in favor of the franchisor if the franchisor has leverage, e.g., for-cause termination); and (e) standard legal terms, including dispute resolution and governing law. It is also important to include a confidentiality provision so that other franchisees cannot discover the terms of the termination. If the confidentiality provision is mutual, the franchisor should include language expressly permitting it to comply with any disclosure obligations, such as Item 3 or Item 20.

220 Truby, supra note 172, at 2 (citing 16 C.F.R. §436.1(t) (2007)).
221 Id.
222 Id.
When drafting a termination agreement, the franchisor should include the individual franchisee owners as parties. This will ensure that the individuals, in addition to the franchisee entity, are releasing the franchisor from any and all claims, and it will also ensure that non-competition, non-solicitation, and other covenants apply to the individuals. For the franchisee owners, they can obtain a release of their individual liabilities under any personal guaranty.

2. Practice Tips

An alternative to the termination and release agreement is a “forbearance,” or workout, agreement. This agreement can be used when a franchisee has received a notice of termination or the franchisor has the right to issue a notice of termination, but the parties come to an agreement whereby the franchisor will forbear – or refrain – from enforcing the termination. In this agreement, the franchisee will acknowledge and admit that it breached the franchise agreement and that the franchisor has the right to terminate the agreement. The franchisee will also agree to certain terms, such as payment of past due fees, a payment plan for such repayment, cease conduct that violates the franchise agreement, or take other necessary actions to be compliant. In return, the franchisor agrees to rescind the notice of termination (or agree not to issue a termination notice in the first place) so long as all conditions are met and provide for automatic termination in the event of a future default. This will make any future termination easier for the franchisor without the risk of a costly dispute. If the agreement includes a payment plan, the franchisor may require the franchisee to sign a promissory note that provides for confession of judgment in the event the franchisee fails to make a future payment.

3. Select Cases

Since a termination agreement terminates the franchisee’s right to operate the franchised business and releases any claims it might have against the franchisor, it is important that franchisors avoid any impropriety, such as pressuring the franchisee to sign the agreement, making oral assurances outside of the agreement, and so forth. Although the franchisor cannot force the franchisee to retain an attorney, it will make the enforcement of the termination agreement easier. For example, in Kinnard v. Shoney’s Inc.224, a former franchisee sought to invalidate a termination agreement on the grounds it signed the agreement under economic duress. The franchisee argued that it owed the franchisor so much money that it had no choice but to sign the termination agreement. However, the court held that the franchisee was not under economic duress when it signed the agreement because, among other things, it had over a year to review it and was represented by counsel.

If a franchisee declines to hire an attorney, the franchisor should include a provision in the settlement agreement that the franchisee knowingly and voluntarily chose not to seek the advice of counsel.

4. Disclosure Requirements

Because a termination agreement is not “regarding the franchise offering”, it is not required to be included in Item 22 of the FDD. Also, the termination agreement will be unique based on the nature of the termination and the agreement of the parties.

V. CONCLUSION

224 100 F. Supp.2d 781 (M.D. Tenn. 2000).
While the franchise agreement is, and will always be, the primary contract between a franchisor and a franchisee, as indicated herein, there are numerous other agreements that are essential for addressing issues ancillary to the core franchise relationship. The need for these “other” agreements can arise before the franchise agreement is entered into, at the same time as the franchise agreement, or at the end of the franchise relationship. Franchise practitioners must not only recognize the need for these agreements, but also pay careful attention to the terms of the agreements and any potential disclosure obligations, including the need to attach them to the FDD to comply with the FTC Franchise Rule (and state franchise laws).
Biography of Suzie Trigg

Suzie Trigg, recently selected as one of the Best Lawyers in Dallas in Franchise Law, and also selected as Best in Supply Chain Negotiations by Acquisition International, is a go-to lawyer for franchise systems tackling complex transactions or supply chain changes. Suzie has led significant supply chain initiatives for several franchisors, including, most recently, a franchisor with over 4,000 stores in the U.S. and a franchisor with over 7,500 stores in the U.S. Suzie also leads restaurant chains and other companies through mission critical crises, such as food safety investigations and high stakes disputes with multi-unit franchisees or supply chain partners. Suzie frequently contributes to publications and conferences and currently serves on the Marketing Committee of the ABA Forum on Franchising and the Food and Dietary Supplements Committee of the Food and Drug Law Institute.

Biography of Christopher J. Wallace, CFE

Chris Wallace has been Vice President and Assistant General Counsel, Global Franchising, at Choice Hotels International, Inc. in Rockville, Maryland, since 2012. Mr. Wallace manages Choice's Franchise and Contracts Administration Division and is responsible for overseeing Choice's franchise compliance function and advising the Company on franchising legal issues. He oversees the preparation of all Franchise Disclosure Documents, franchise agreements, renewals and relicensings, and franchise defaults and terminations. Mr. Wallace also has oversight of the Company's global franchise-based contractual and regulatory matters in those international markets where Choice maintains direct franchising operations. He is also the Company's lead franchise advisor on mergers and acquisitions. Previously, Mr. Wallace was Counsel in the Franchising & Distribution group of the law firm of Nixon Peabody LLP in Washington, DC from 2004 to 2012. Prior to that, he was a litigation attorney in both Washington, DC and New York City. Mr. Wallace is a Certified Franchise Executive™ (CFE) who has been practicing law for over 20 years and is an active member of the ABA Forum on Franchising and International Franchise Association. He is a graduate of Colgate University and Pace University Elisabeth Haub School of Law (magna cum laude).