STRUCTURING THE NEW FRANCHISEE EVALUATION AND APPROVAL PROCESS

Van Lam
Regal Nails, Salon & Spa, LLC
Baton Rouge, Louisiana

and

Nicole Liguori Micklich
Urso Liguori Micklich
Westerly, Rhode Island

and

Stephanie Russ
Children’s Lighthouse Franchise Company
Fort Worth, Texas

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I. INTRODUCTION

A franchise system of “qualified” franchisees should equate to a healthier system in the long run. However, start-up and emerging franchisors sometimes offer franchises based on quantity versus quality, because sometimes, a monetary check matters more than a background check. In other cases, franchisors are chasing the goal of a certain number of units. And sometimes, the selection of franchisees is solely dependent on the preferences and whims of founders or other company leaders who grant franchises based on personal relationships. All of these “methods” of granting franchises are practiced every day. However, standing alone, none of them provides franchisors a reasoned process designed to select qualified franchisees with the goal of only granting franchises to those who will contribute to the long-term success of the system.

Recognizing the challenges in qualifying candidates to become franchisees, this paper provides an overview of certain processes a franchisor can implement to assess the qualifications of a prospective franchisee and laws relating to those processes, and then identifies the stakeholders involved and the risks inherent in the process.

II. BACKGROUND CHECKS AND EXPERIENCE

If a franchisor elects to conduct background checks on prospective franchisees, the two types that are typically conducted are credit and criminal.¹

A. Financial Statements and Credit Background Checks

While a franchisor should be able to partially assess the potential creditworthiness of a prospective franchisee by reviewing the financial statements provided, a review of the prospect’s credit history may be a better indicator of future performance. That is not to say that reviewing financial statements is not worthwhile, especially audited financial statements, but undertaking both provides franchisors a more complete financial position.

At a minimum, to gain insight into a prospect’s financial position, franchisors should review a prospect’s financial statements (balance sheet, income statement (or P&L statement), and cash flow statement). The balance sheet provides a franchisor a summary of the prospect’s assets, liabilities, and equity. Failure of the balance sheet to “balance” (assets should equal liabilities plus equity), or a negative net worth (liabilities are more than assets), serves as an immediate red flag to franchisors. Franchisors can use the income statement to review the prospect’s revenue and expenses to help determine how efficiently a prospect may operate the franchise. In reviewing the cash flow statement, a franchisor can measure a prospect’s liquidity, ability to pay expenses, access to cash, and cash management. The financial statements are meant to be reviewed together, and doing so provides franchisors with the most comprehensive picture of the prospect’s financial position. Reviewing the information simultaneously uncovers another red flag if information provided in one financial statement contradicts information provided in another. If a

¹ Franchisors that wish to go beyond a general vetting of prospective franchisees may utilize third-party providers for customized scoring of candidates based on behavioral assessments and other predictors gathered from customized tests administered to prospects. See e.g., https://www.zoracleprofiles.com (last visited Sept. 3, 2019) and https://www.ttisi.com/ (last visited Sept. 3, 2019). See also Section VI. of this paper for additional information about such assessments
franchisor elects to rely only on financial statements to determine whether a franchisee is financially qualified, the franchisor should, at a minimum, require the submission of CPA-prepared financial statements. The better option is to require the statements to be audited. Along with financial statements, franchisors should request that prospects submit bank statements, tax returns, and evidence of certain assets that appear on the balance sheet, such as 401k or other investment statements.

Franchisors should keep in mind that a less sophisticated prospect is less likely to engage a CPA, or any accountant, and may present financial statements that are inaccurate or incomplete. Additionally, if the prospect is an individual, not an entity, he or she may not be familiar with preparing individual financial statements. Faced with such prospects, or as a supplement to well-prepared financial statements, a franchisor may want to rely on a credit check performed by a third party.

Obtaining a third-party-provided credit check provides many advantages over relying on financial statements alone. Credit checks provide more information than the snapshot that financial statements reflect. Credit checks allow a franchisor to determine if a prospect has a solid history of timely payments or a past of unpaid and/or late credit card, mortgage, and other payments. Credit checks also allow a franchisor to set an objective goal by requiring prospects to have a specific credit score to be considered qualified. However, a prudent franchisor should review the credit history to determine if the credit score is low because of a pattern of untimely payments and not a lack of credit history.

While a stated credit score from a particular credit rating agency may be an objective qualification, a franchisor could potentially grant a franchise to a prospect who does not meet this qualification by requiring a person who does not have an equity interest in the franchisee entity to guaranty the financial obligations under the franchise agreement. If a franchisor chooses to permit a third-party guarantor to ensure a prospect’s performance when a prospect does not have a qualifying credit score or is otherwise considered not financially qualified, the franchisor should run a criminal and credit check on the guarantor as well. Otherwise, a franchisor may end up with a third-party guaranty that does not provide the franchisor the security it is seeking.

B. Criminal Background Checks

Conducting a criminal background check should be part of a franchisor’s due diligence when evaluating a prospective franchisee. There is no federal or state law preventing a felon from owning a franchise, but the publicity surrounding a franchisee convicted of a felony may reflect poorly on the brand and may harm the franchisor and other stakeholders in the franchisee approval process. A criminal background check usually involves gathering information from both state, county, and local authorities and from court records and can take up two weeks for results. Such background checks are time and money well-spent, and whenever feasible, franchisors should retain a third-party background check company to complete the checks of prospective franchisees. Contracting with a legitimate third-party can help a franchisor objectively evaluate prospective franchisees and provide the franchisor with support for a decision not to approve a prospect. Background screening companies offer a variety of services, from basic criminal background checks to in-depth criminal searches, health and drug screenings, employment and

2 Franchisors should be aware that expungement of a criminal record allows a prospective franchisee to honestly state that he or she has not been convicted of a crime.
education verification, and credit reporting. Companies like GoodHire and Sterling provide screenings that include a basic background check.\(^3\) For more comprehensive vetting of candidates, some businesses turn to Gig BigWig, a newer company that performs in-depth background screening and can provide comprehensive reports beyond just public records search results.\(^4\) Larger, more sophisticated franchisors may wish to run checks internally and may subscribe to resources for conducting investigations in-house. These resources may include vendors such as Thomson Reuters and Lexis Nexis, whose products may be supplemented by court record searching databases and other platforms.

Franchisors should not have a blanket policy that prohibits awarding a franchise to anyone with a criminal record. As discussed later, such a blanket policy may put the franchisor in the position of having to defend against a discrimination-based claim, and the franchisor may be excluding otherwise excellent candidates. Franchisors should determine the types of information in a criminal background check that are a red flag in the franchisor’s selection process.

For example, a prospective franchisee’s conviction of tax evasion would most likely give a franchisor pause during the approval process. Failure to file a tax return may result in a misdemeanor, while filing false tax returns may result in a felony conviction. For most franchisors, misdemeanors may not automatically disqualify prospects. However, a franchisor might consider that a person who failed to file a tax return might also be a person who might fail to report sales.

The type of crime may also be relevant to the franchisor. A felony conviction can prevent a person from obtaining certain insurance or bonding, which are typically required of auto dealers, but may not be necessary for a fitness center. Therefore, certain convictions may be universally disqualifying. Most franchisors, not only those in the business of childcare or education, will disqualify a prospective franchisee who was convicted of child molestation or sexual assault. A fraud conviction is also likely to disqualify a prospect in every franchise system.

Consider a scenario where a high-school student recklessly operated a motor vehicle and caused a serious accident that took the life of a good friend. The accident led to a criminal conviction. The student is now a 45-year old, married, father of two children, who owns and operates a successful small business with his wife and regularly speaks to high school classes about the importance of the decisions they make. This man now wants to become a sandwich shop franchisee. A blanket policy that prohibits franchisees with any criminal record would foreclose this individual’s franchise application. Still, this prospect’s background could cause the franchisor to scrutinize the applicant closely. It may be relevant whether the sandwich shop chain offers delivery or plans to do so in the future.

Franchisors should also take note if a prospective franchisee fails to disclose a felony or misdemeanor on the franchise application. Such failure calls into question the prospect’s general character and honesty.

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C. **Fair Credit Reporting Act**

1. **Definitions and Notices**

As discussed later, there are both civil and criminal penalties for not properly complying with the Fair Credit Reporting Act of 1970 (15 U.S.C. § 1681 et seq. (2018)) ("FCRA"). Thus, it is important that franchisors wishing to perform a background check or credit check comply with the FCRA and secure written authorization from prospective franchisees, if the franchisee(s) is an individual, or from each individual owner of the franchisee entity. If an individual's spouse is not a named owner of the franchisee entity, then franchisors should also obtain written authorization from each named owner's spouse, since franchisors will not know in advance if any of the information it obtains through the search will contain information about the prospective franchisee’s spouse. The consent should be broad enough to include the release of information without restriction, including authorization to procure an investigative consumer report, general background criminal and credit checks, and any other specific investigative report the franchisor intends to secure. For purposes of this section of the paper, references to a prospective franchisee also mean “consumer.”

Generally, the franchise relationship does not fall under the FCRA. However, to avoid unnecessary litigation, franchisors should have a passing knowledge of the FCRA and, at the very least, obtain written authorization to conduct a credit and criminal background checks. Franchisors should also note that the term “employment” in the FCRA is not as limited as the term is used in other contexts and has been construed to apply to independent contractors.\(^5\)

Credit and criminal background checks may be subject to state sales practices and credit reporting acts,\(^6\) and both credit and criminal background checks are generally subject to the requirements of the FCRA, as both could be considered “consumer reports”:

…any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer’s credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living which is used or expected to be used or collected in whole or in part for the purpose of serving as a factor in establishing the consumer’s eligibility...\(^7\)

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\(^5\) See Advisory Opinion to Allison (02-23-98) available at https://www.ftc.gov/policy/advisory-opinions/advisory-opinion-allison-02-23-98 (last visited Sept. 3, 2019) ("we conclude that a trucking operation that uses consumer reports to evaluate whether to engage individuals as drivers must comply with the applicable provisions of the FCRA pertaining to consumer reports obtained for employment purposes, including the disclosure and authorization provisions of Section 604(b), Section 606, and Section 615. If the trucking operation were not to obtain consumer reports on prospective drivers for "employment purposes," it would appear to have no permissible purpose under the FCRA for obtaining such reports, absent the drivers' written authorizations.") citing Hoke v. Retail Credit Corporation, 521 F.2d 1079, 1082 (4th Cir. 1975).

\(^6\) See e.g., Ohio Consumer Sales Practices Act, R.C. § 1345.01 - § 1345.13; Vermont Fair Credit Reporting Statute, 9 V.S.A. § 2480e.(a)(2).

\(^7\) 15 U.S.C. § 1681a(d)(1) (2018). The eligibility is limited to (A) credit or insurance to be primarily used for personal, family, or household purposes; (B) employment purposes; or (C) any other purpose authorized under section 1681b of this title.
A consumer reporting agency (“CRA”) may furnish a consumer report only if doing so falls within one of the permissible purposes. The FCRA does not apply where a consumer report is used for a commercial or business purpose, rather than a consumer purpose. In *Ippolito v. WNS, Inc.*, the court held that “evaluating prospective franchisees does not fall within one of the consumer purposes set forth in the FCRA.” The FCRA is designed to protect “consumers.” The court stated that a prospective franchisee is not a consumer under the FCRA, because, while the FCRA broadly defines a consumer as an individual, the franchise relationship is one based on a business transaction not involving one of the consumer purposes for eligibility of personal credit, insurance, employment purposes, or a license granted by a governmental instrumentality.

In a July 2000 informal advisory opinion letter to a lender who had similar concerns but in the credit industry, the Federal Trade Commission (“FTC”) initially stated that a business creditor could not obtain a consumer report, even if the individual was a principal, owner, officer, or guarantor of the commercial credit applicant. However, in a subsequent June 2001 opinion letter, the FTC reversed course and concluded that it would be reasonable to identify a business transaction in which an individual accepts personal liability for a business debt as a consumer transaction and thus permissible for a commercial lender to obtain a consumer report.

Franchisors should obtain written instructions as a permissible purpose to obtain a consumer report, because a court could apply the same reasoning as the FTC did in its June 2001 opinion letter and determine that a franchisor that offers financing options to a prospective franchisee, or requires the franchisee entity’s owners to personally guaranty the franchisee’s obligations, would be permitted to obtain a consumer report under the FCRA.

Before procuring a consumer report from a CRA, the franchisor must certify to the CRA that the franchisor is doing so under a permissible purpose and solely for that purpose. However, the CRA must maintain reasonable procedures to identify qualified users and their certified permissible purposes. These procedures are usually routinely dealt with when a user is

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9 See *Hall v. Phenix Investigations, Inc.*, 2016 WL 1238602, at *2-3 (5th Cir. 2016) (no consumer report was involved where law firm used information in a commercial lease dispute); *Cavaliere v. Burke*, 50 F.3d 1033, at *3–4 (5th Cir. 1995) (per curiam) (citing *Ippolito* favorably and noting that “not every credit report is a consumer report” under the FCRA); *Bacharach v. Suntrust Mortg., Inc.*, 2015 WL 6442493, at *3–4 (E.D.La. Oct. 23, 2015) (“[T]he FCRA does not apply where a consumer report is used for business purposes.”).


12 *Ippolito*, 864 F.2d at 451.

13 https://www.ftc.gov/policy/advisory-opinions/advisory-opinion-tatelbaum-07-26-00 (July 26, 2000)


contracting with the CRA to provide consumer reports for its business operation. Further, the CRA is required to furnish to users a notice of the responsibilities of the user under the FCRA.\(^\text{18}\)

As described above, authorization should be in writing, and should be written in detailed and clear language to negate any argument a prospective franchisee may use at a later date that disputes its consent. For example, a franchisor could include the following language in a franchise application, to be signed by both the prospective franchisee and spouse:

**Acknowledgements**

By my signature below I represent, acknowledge, and agree that I understand that the granting of a franchise is at the sole discretion of [COMPANY]. I understand that any information I receive from [Company] or any of its employees, agents, franchisees, or affiliates is highly confidential and valuable and has been made available to me solely because of this Application. I agree to treat and maintain such information as confidential and will not at any time disclose, publish, divulge, disseminate, or share with any person, firm, corporation, or other entity that confidential information, directly or indirectly, for any reason whatsoever.

I hereby instruct and authorize [COMPANY] or its designee to procure a credit check, an investigative consumer report, a general background search, a criminal background check, and an investigation in accordance with anti-terrorism laws. I understand that these investigations may reveal information about my background, character, general reputation, lifestyle, mode of living, finances, association with other persons or entities, creditworthiness, litigation history, criminal history, driving record, educational history, job history, and job performance. I understand that, upon written request and within a reasonable period of time, I am entitled to information concerning the nature and scope of these investigations and what they reveal. I agree that a copy of this authorization is as valid as, and shall be treated as, an original.

I acknowledge that there has been no assurance nor representation that the franchise approval will be granted pursuant to this application. In consideration of the acceptance for processing of this application by [COMPANY], I waive, release, and discharge [COMPANY] from any claims or actions, known or unknown, whatsoever existing prior to the date of this application, except those arising from representations in [COMPANY’S] franchise disclosure document and exhibits and amendments thereto.\(^\text{19}\)


\(^{19}\) According to FAQ 34 in the "FTC’s Amended Franchise Rule FAQ’s," a general release of claims violates Section 436.9(h) of the Franchise Rule unless the general release expressly excludes claims arising from representations in the FDD, and this prohibition applies to "any general release of claims that a prospective franchisee is required to sign as a condition of obtaining a franchise, whether in the franchise agreement or some other document." Amended Franchise Rule FAQ’s, https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs#31 (last modified Dec. 2013). See also Hall, et al., v. Burger King Corp., 912 F.Supp. 1509, 1521 (S.D. Fl. 1995) (holding that there was sufficient consideration in the form of acceptance and processing of the application for a valid release, even if the franchise was ultimately not granted to the plaintiffs).
I agree that any claims, disputes or controversies arising out of or relating to this Application will be by binding arbitration only. I agree that such arbitration will be administered by the American Arbitration Association under to its Commercial Rules, and judgment on the award rendered by the arbitrator(s) may be entered in any court in the State of [STATE] having jurisdiction. I agree that the site of the arbitration will be [City, State]. I further agree that the arbitrator(s) will have the sole authority, to the exclusion of any court, to determine all questions and resolve any disputes concerning jurisdiction, and the enforceability or scope of this arbitration provision.

I hereby represent that everything stated in this Application is true and I understand that [COMPANY] will rely on the information provided by me.

To run the consumer report, the following information is needed: full name, social security number, date of birth, and current or past addresses. Most of this information will be collected through the franchise application. Given the recommendation to obtain written permission, franchisors should include in the franchisee application specific language in which the prospective franchisee consents to the franchisor obtaining a consumer report.

A franchisor can also elect to require the prospect to complete, date, and sign a separate authorization form. However, the FCRA only requires a separate authorization form, which should include a clear and conspicuous disclosure that a consumer report may be obtained, for employment purposes. While the FCRA requires this extra step for employers, it does not bar other users from also using a separate authorization form. However, there may be a risk to taking this additional step. An enterprising plaintiff’s counsel might use a franchisor’s use of a separate authorization form as evidence that an employer-employee relationship exists between franchisor and franchisee, especially in connection with those franchise models that experience a high number of allegations of an employer-employee relationship between the franchisor and the franchisee.

In certain circumstances, consumers can receive a copy of their consumer report prepared by the CRA. Certain states require that consumers be informed of this right. A sample of these disclosures follows:

**California, Minnesota, and Oklahoma residents please note:** In connection with your application, your consumer report may be obtained and reviewed. Under California, Minnesota, and Oklahoma law, you have a right to receive a free copy of your consumer report by checking the appropriate box below.

___ YES, I am a California resident and would like a free copy of my investigative consumer report.

___ YES, I am a Minnesota resident and would like a free copy of my consumer report.

___ YES, I am an Oklahoma resident and would like a free copy of my consumer report.

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California residents please note: In connection with your application, your credit report may be obtained and reviewed. Under California law, if your credit report is ordered, you have a right to receive a free copy of your credit report by checking the appropriate box below. (Your credit report will be mailed to you either by the relevant credit bureau or the consumer reporting agency above.) Please note that if you elect to receive the entire investigative consumer report, this will include your credit report, if one was ordered.

___ YES, I am a California resident and would like a free copy of my credit report.

Franchisors that use a CRA to obtain an investigative consumer report must provide additional disclosures to the consumer. The FCRA defines an investigative consumer report as a consumer report or a part of the consumer report that includes the following:

...information on a consumer’s character, general reputation, personal characteristics, or mode of living is obtained through personal interviews [emphasis added] with neighbors, friends, or associates of the consumer reported on or with others with whom he is acquainted or who may have knowledge concerning any such items of information. 21

Franchisors obtaining an investigative consumer report on their prospective franchisees must inform the prospective franchisee in writing that such consumer report can be obtained no later than three days after the report was first requested, as well as a statement informing the consumer of its right to request additional disclosures 22 about the nature and scope of the investigation requested 23 and to dispute the information found in the investigative consumer report. 24 The user may not procure the investigative report until it has certified to the CRA that it has made the aforementioned disclosures to the consumer 25 and that it will, upon request by the consumer, make a complete and accurate disclosure of the nature and scope of the investigation within five days of the consumer receiving notice of its right to receive such disclosure or of the consumer request, whichever comes later. 26

Franchisors must notify the prospect if an adverse action is going to be taken based on the consumer report. The notification of the adverse action to be taken by the franchisor may be provided in writing, orally, or by electronic means. 27 Further, franchisors must, in writing, orally, or

by electronic means, provide the name, address, and telephone number (toll free if it is a nationwide CRA)\(^{28}\) of the CRA that provided the consumer report and a statement that the CRA did not make the adverse decision and will be unable to explain why the decision was made.\(^{29}\) The prospective franchisee must also be notified in writing, orally, or by electronic means that it has the right to obtain a free disclosure of its file from the CRA, if requested by the prospective franchisee, within 60 days\(^{30}\) after notice of the adverse action to the prospective franchisee, and that it has the right to dispute directly with the CRA the accuracy or completeness of the consumer report or the information contained in the consumer report.\(^{31}\)

If the credit score was a reason why an adverse action was taken, the franchisor must disclose, in writing or by electronic means: (1) the numerical credit score the franchisor is using to take the adverse action,\(^{32}\) along with the range of possible credit scores under the model used by the CRA, (2) no more than four key factors that adversely affected the credit score (these factors are listed on the credit report under the credit score), (3) the date on which credit score was created, and (4) the name of the person or entity used by the CRA that provided the credit score or file upon which the score was created.\(^{33}\) The problem with the FCRA requiring the user (the franchisor) to furnish this information to the consumer (the prospective franchisee) is that not all of this information is readily available to the franchisor. In fact, the FCRA states that the CRA will supply this information to the consumer upon the request of the consumer, but not upon the request of the user.

Guarantors are also consumers under the FCRA, and franchisors should require guarantors to also provide written authorization for the consumer report.

2. **Adverse Actions**

A denial of a franchise or granting of a franchise but on disadvantageous conditions based, even partially, on a consumer report may be an adverse action, and proper notification should be given to the prospect. Likewise, if a franchisor orders a consumer report for a guarantor, and the franchisor determines that, based on the information provided in the report, the guarantor is not acceptable, then the franchisor should take steps to inform the guarantor of the adverse action in the same manner as it would a prospective franchisee and dispose of the guarantor’s consumer report and information properly, as described below.

The denial of a franchise may not technically fall within the stated categories of adverse actions because it is not a denial or cancellation of, or an increase in premium, or reduction in


coverage for an insurance policy\textsuperscript{34}, an adverse employment decision\textsuperscript{35}, or an adverse decision concerning a government-issued license or benefit,\textsuperscript{36} but, having obtained information about a prospect from a consumer reporting agency, franchisors that take an action based in whole or in part on any information contained in such a report should make certain disclosures when taking actions adverse to the prospective franchisee based on information contained in the report.\textsuperscript{37} Recall, too, that the term “employment” in the FCRA has been construed to apply to independent contractors.\textsuperscript{38} Franchisors should also familiarize themselves with applicable state franchise relationship laws and state consumer laws, which may provide additional rights to prospective franchisees.

Franchisors should also be aware that the FTC expressly considers using consumer reports to make a leasing decision as being covered under the FCRA\textsuperscript{39}.

Under the FCRA, “adverse action” has the same meaning as it does in the Equal Credit Opportunity Act. The Equal Credit Opportunity Act provides that an adverse action is:\textsuperscript{40}

\textit{…a denial or revocation of credit, a change in the terms of existing credit arrangement, or a refusal to grant credit in substantially the amount or on substantially the terms requested. Such term does not include a refusal to extend additional credit under an existing credit arrangement where the applicant is delinquent or otherwise in default, or where such additional credit would exceed a previously established credit limit.}\textsuperscript{41}

\section{Disposal of Consumer Reports; Penalties}

The FCRA requires various national agencies to consult with each other and coordinate regulations regarding the disposal of consumer reports.\textsuperscript{42} Under the Fair and Accurate Credit Transactions Act of 2003, the Federal Trade Commission retains the responsibility for the consumer report disposal rules.\textsuperscript{43}

\begin{footnotesize}
\textsuperscript{37} See 15 U.S.C. 1681m(a) and (b).
\textsuperscript{38} See supra, n. 5.
\end{footnotesize}
A franchisor must properly dispose of the consumer report by “taking reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal” 44 (“Disposal Rule”). Reasonable measures can be taken internally through the implementation of procedures that provide for the proper method to dispose of consumer information, or franchisors can contract with suppliers that specialize in the disposal of such information.45

If franchisors choose to adopt internal procedures, the procedures should contain the steps that must be taken to dispose of the consumer report or electronic media that contains the consumer information such that such information cannot be read or reconstructed.

If franchisors contract with third-party providers, then franchisors should conduct due diligence to determine if such providers are in compliance with the Disposal Rule.46 The FTC suggests that due diligence included reviewing an independent audit of the provider’s Disposal Rule practices, checking references, requiring that the provider be certified by a recognized trade association or similar third party, reviewing and evaluating the provider’s internal Disposal Rule policies and procedures, or taking other independent measures to determine the provider’s compliance and competency.47

Whether franchisors elect to dispose of information that falls under the Disposal Rule internally or through a third party, franchisors should monitor compliance with the requirements of the Disposal Rule.

Violations of the FCRA have civil and criminal penalties. Franchisors can be liable to the prospective franchisee and the CRA for up to $1,000 each, plus attorneys’ fees, for willful noncompliance with the terms of the FCRA.48 Franchisors are also liable to the prospective franchisee for actual damages and attorneys’ fees for negligent noncompliance with the terms of the FCRA.49 It is a criminal offense, punishable by fines, up to two years of imprisonment, or both, for any person to knowingly and willfully obtain a consumer report from a CRA under false pretenses.50

D. Prospective Franchisee’s Experience

Franchisors should also evaluate a prospective franchisee’s work and life experience. There is no one-size-fits-all set of requirements that is applicable to all franchise systems. In some industries, the lack of experience in the industry is not an automatic disqualifier, or a disqualifier at all. Nor do the authors of this paper think it should be. Some systems do not require franchisees to have experience in the field itself, as the franchisee can employ those with experience. For example, a school photo franchisee most likely does not need to have professional photographer

44 16 C.F.R. 682.3(a) (2018).
45 16 C.F.R. 682.3(b) (2018).
47 Id.
skills. It may be more important for the franchisee to have experience in sales and the ability to build connections within the community.

On the other hand, if a franchisor has experienced a significant number of distressed franchisees or closed units, the franchisor should analyze its vetting process to determine if lack of industry experience is a cause. If yes, then the franchisor should re-evaluate its requirements for experience in the industry when determining if a candidate’s qualification. For example, if the franchised concept is a nail salon or another type of business that requires state licensing, and if employees with the required license are scarce, the principal owner of the franchise may be required to do most of the work. If that is the case, then the franchisee’s experience in the industry may be more critical, if the skill cannot easily be taught by the franchisor during initial training. Additionally, obtaining certain licenses can be difficult. Having the experience in obtaining such licenses may be critical. Therefore, franchisors should consider the likelihood of the franchisee’s ability to obtain the required license when determining if the prospective franchisee is qualified to become a franchisee.

A prospect’s experience in running a business may be more important than his or her experience in the industry. A prospect with a prior history of owning or managing a business will be more accustomed to the beyond-9-to-5-needs of a franchised business, such as managing payroll, marketing activities, and expenses.

III. PERSONALLY IDENTIFIABLE INFORMATION

A. Personally Identifiable Information

As described above, franchisors that obtain consumer reports must comply with the Disposal Rule. However, franchisors most likely obtain, store, and transmit prospective franchisees’ personally identifiable information that is gathered outside of a consumer report. Personally identifiable information (“PII”) is generally understood to be a collection of sensitive material that, if used together, is sufficient to locate, contact, or otherwise identify a single person. Therefore, it is easy to see that it does not take much for a franchisor to find itself possessing the PII of hundreds, if not thousands, of individuals.

Examples of PII are an individual’s full name, street address, social security number, passport number, driver’s license number, credit card number, bank account number, telephone number, biometric data, place and date of birth, race, and religious affiliation.

In addition to the FCRA, Congress has enacted several other statutes relating to data privacy.

- Gramm-Leach-Bliley Act – financial information
- Health Insurance Portability and Accountability Act (HIPAA) – health care
- Health Information Technology for Economic and Clinical Health Act (HITECH) – health care
- The Family Educational Rights and Privacy Act (FERPA) – student educational records
- The Children’s Online Privacy Protection Act (COPPA) – privacy of children under the age of 13
• The Privacy Act of 1974 – PII held by government agencies and companies that contract with government agencies

As noted above, these statutes are often industry-specific and will most likely impact a franchisor’s ongoing business practices, but not the collection of data obtained during the franchisee qualifying process. However, franchisors should be aware of laws relating to data privacy and should determine if the data protection practices described below are applicable.

B. Policies and Processes Designed to Protect Data

The Disposal Rule described above applies not only to consumer reports, but also to PII. At least 35 states and Puerto Rico have enacted laws that require either private or governmental agencies or both to destroy, dispose, or otherwise make personal information unreadable or undecipherable, and at least 25 states have enacted laws that address data security practices of private sector entities. Globally, at least 120 countries have enacted data privacy laws, and franchisors should be aware of applicable laws in the countries where they do business.

When structuring a franchisee qualifying process or evaluating an existing process, franchisors should consider or review their existing data collection and privacy policies and practices to ensure they comport with the Disposal Rule and all other state and local laws.

For example, is PII emailed to parties (other than a CRA) that have no role in approving the prospective franchisee? Are the franchisor’s employees transmitting PII through their personal devices rather than through the franchisor’s? Are the communications secured? Does the franchisor have a written policy regarding the collection, treatment, and destroying of PII?

These questions obviously do not provide franchisors with a comprehensive data privacy plan, which goes beyond the scope of this paper. However, franchisors should include appropriate data privacy and disposal steps into the prospective franchisee qualifying process. The FTC provides helpful information and advice through its website, including Protecting Personal Information: A Guide for Business.

IV. DISCRIMINATION VERSUS DIVERSITY

The franchise organization may or may not have a formal diversity program when seeking out qualified franchisees. But casting a wide net in the franchisee selection process not only increases the pool of candidates, but also provides franchisors the opportunity to onboard a diverse group of franchisees that reflect the customer base of the business that is being franchised.


If a franchisor promotes or fails to promote diversity in its franchisee selection process, is it creating liability for the company? Discrimination claims in the franchisor-franchisee context relating to a franchisee prospect’s race are often brought under 42 U.S.C. § 1981, or other similar state statutes, such as California’s Unruh Act.55

A. § 1981 Claims

1. Discrimination Under § 1981

The franchisor-franchisee relationship is not an employer-employee relationship that is governed by Title VII of the Civil Rights Act (“Title VII”) or other federal or state employment-related laws. However, prospective franchisees may bring racial discrimination claims related to a franchisor’s application process. Such claims brought at the federal level must be brought under 42 U.S.C. § 1981 (2018) (“§ 1981”). Section 1981 prohibits discrimination on the basis of race in the making, performing, and modifying of contracts, which includes franchise agreements. Section 1981 states:

All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws and proceedings for the security of persons and property as is enjoyed by white citizens, and shall be subject to like punishment, pains, penalties, taxes, licenses, and exactions of every kind, and to no other.

For purposes of this section, the term “make and enforce contracts” includes the making, performance, modification, and termination of contracts, and the enjoyment of all benefits, privileges, terms, and conditions of the contractual relationship.

The rights protected by this section are protected against impairment by nongovernmental discrimination and impairment under the color of State law.

Franchisors that deny a franchisee prospect’s application may be questioned as to why. Regardless of the legitimate business reasons a franchisor may have, the candidate may accuse the franchisor of discriminatory practices. As employers, franchisors and their employees are typically aware of Title VII, which prohibits employer practices that discriminate, or have the effect of discriminating, against individuals based on race, color, national origin, sex, (including pregnancy and gender identity), or religion.56 Since Title VII claims (or what are more commonly called “EEOC claims”) relate to employer-related actions, franchisors are not required to apply the same analysis to the franchisee application process as they do when analyzing employment-related practices and policies. It is important to know the differences between § 1981 and Title VII and the protections they provide.

• The statutes are separate, and any cause of action brought under either statute remains a separate cause of action. Individuals who bring § 1981 claims do so directly without first having to proceed through any administrative process or agency, such as the EEOC, and the EEOC does not prosecute claims under § 1981 as it does with some Title VII claims.

• As described above, Title VII specifically provides for the prohibition of acts and policies that have a discriminatory disparate impact, whereas § 1981 does not.

• The U.S. Supreme Court has established a four-year statute of limitations period for § 1981 claims, which is significantly longer than the limitations period provided by Title VII and similar state law statutes.

• § 1981 does not provide for a monetary cap as to damages, whereas Title VII does.

• § 1981 applies only to claims of racial discrimination. It does not apply to claims of discrimination based on national origin. However, claims related to national origin can be brought under § 1981 if the issue of national origin is tied to the claimant’s race. In Torgerson v. City of Rochester, the court stated, “§ 1981 protects ‘identifiable classes of persons who are subjected to intentional discrimination solely because of their ancestry or ethnic characteristics.’” The court also stated, “For example, if an individual is ‘subjected to intentional discrimination based on the fact that he was born Arab, rather than solely on the place or nation of his origin ... [then] he will have made out a case under § 1981.’”

While claims of racial discrimination brought by white franchisee prospects are not as common, at least one Court ruled in favor of a white female who brought a claim of racial discrimination under § 1981 in connection with Chrysler Motor Corporation’s minority incentive program. The Court analyzed the § 1981 claim as it would any claim of racial discrimination (as described below).

2. Burden of Proof

If a prospective franchisee brings a § 1981 claim against a franchisor for racial discrimination in the franchisor’s application process, the claimant has the initial burden of proof. Even though § 1981 claims and Title VII claims remain distinct and separate, when analyzing evidence of discrimination in § 1981 claims, Courts use the McDonnell-Douglas burden–shifting framework that is used in Title VII cases.


61 Id.

62 The authors note that this section provides only a broad overview of § 1981 claims and the legal analysis and framework that must be undertaken by the parties that litigate such claims.
Under the *McDonnell-Douglas* framework, the claimant carries the initial burden of establishing a prima facie case of discrimination by showing that (a) claimant was treated less favorably than others because of race, (b) it submitted an application that met the requirements for an available contract, (c) the application was ultimately rejected, and (d) the contract was eventually awarded to an individual who is of a different race than the claimant.\(^{63}\)

If the claimant establishes a *prima facie* case, the burden of proof shifts to the defendant franchisor to put forth a legitimate, nondiscriminatory reason as to why the application was rejected.\(^{64}\) If the franchisor is successful, then the rejected prospective franchisee must show that race was a determinative factor in the franchisor’s decision or that the franchisor’s explanation was merely a pretext.\(^{65}\)

In order to establish a *prima facie* case of discrimination, the claimant must show, among other things, that the claimant is a member of a protected class and was replaced by a person outside the protected class.\(^{66}\) A rejected prospective franchisee who is white and who is claiming racial discrimination must show that he or she was intentionally discriminated against despite his or her majority status.\(^{67}\)

### 3. Standing

In addition to meeting its burden of proof, the prospective franchisee must also have standing to bring a § 1981 claim. § 1981 states that all “persons” within the United States shall have the same right to make and enforce contracts as is enjoyed by white citizens.\(^{68}\) On its face, it appears that only natural persons have standing to pursue claims under § 1981. Additionally, the U.S. Supreme Court has noted in dicta that corporations cannot have a racial identity.\(^{69}\) Notwithstanding the language of the statute and non-binding court dicta, courts have held that in certain circumstances, corporations (or legal entities) can acquire a racial identity for purposes of suing under § 1981.\(^{70}\)

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\(^{64}\) *Id.*

\(^{65}\) *Id.*

\(^{66}\) *Arendale v. City of Memphis*, 519 F.3d 587, 603 (6th Cir. 2008).

\(^{67}\) *Id.* (citing *Murray v. Thistledown Racing Club, Inc.* 770 F.2d 63, 67 (6th Cir. 1985)).


\(^{70}\) *See Calderon v. SW Bell Mobil Sys.*, 390 F. Supp. 2d 871 (N.D. Ill. 2005), where the Court allowed the franchisee corporation, which was majority owned by a Hispanic and the President was Hispanic, to sue under § 1981 when all of the alleged acts of discrimination related to the franchisee corporation’s business operations. The court also held that the individual owner did not have standing to sue because the alleged discrimination was directed at the corporation, not the individual.
B. State Laws and Franchisee Applicants

Franchisors should be familiar with the franchise relationship laws that govern transfers, terminations, and renewals in twenty-one states. And while the laws in six of these states specifically include anti-discrimination statutes, these specific statutes, along with the general relationship laws, apply to the franchisor-franchisee relationship after a franchisee candidate has signed a franchise agreement. Two states, however, California and Iowa, include anti-discrimination provisions prohibiting discrimination based on race and other protected characteristics when reviewing the application of prospective franchisees.

Iowa’s franchise relationship law prohibits franchisors from discriminating against “a proposed transferee of a franchise on the basis of race, color, national origin, religion, sex, or disability.”

Under California’s Unruh Civil Rights Act (not California’s franchise relationship laws), franchisors are prohibited from discriminating when granting franchises on the basis of “sex, race, color, religion, ancestry, national origin, disability, medical condition, marital status, or sexual orientation” of the prospective franchisee. The Unruh Civil Rights Act specifically applies to franchising and protects franchisors from certain other claims by statutorily authorizing franchisors’ diversity initiatives, as long as the alleged discriminatory conduct was in connection with the franchisor’s affirmative action program:

No franchisor shall discriminate in the granting of franchises solely on account of any characteristic listed or defined in subdivision (b) or (e) of Section 51 of the franchisee and the composition of a neighborhood or geographic area reflecting any characteristic listed or defined in subdivision (b) or (e) of Section 51 in which the franchise is located. Nothing in this section shall be interpreted to prohibit a franchisor from granting a franchise to prospective franchisees as part of a program or programs to make franchises available to person lacking the capital, training, business experience, or other qualifications ordinarily required of franchisees, or any other affirmative action program adopted by the franchisor.

V. STAKEHOLDERS IN THE EVALUATION AND APPROVAL PROCESS

To understand the importance of offering only qualified candidates the opportunity to become franchisees, it is important to understand who the stakeholders are in the franchise

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71 Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin have state franchise relationship laws that govern transfers, terminations, and renewals, which are applicable to the franchisor-franchisee relationship after a candidate becomes a franchisee.


74 Cal. Civ. Code §§ 51(b), (c), (e) (2016).

relationship and in the process of maintaining a healthy system. Of course, the franchisor and the franchisee applicant are the obvious stakeholders. But, often the family members of the prospective franchisee are also necessary parties to the application and eventual franchise agreement.

A. Consideration Provided by Family Members of Franchisee

In many systems, the spouse and children of a franchisee are required to provide consideration for the franchise.

1. Guaranty

For example, frequently the individual owners of the franchisee entity and their spouses must guaranty the franchisee’s economic performance under the franchise agreement, even if the spouse is not a signatory to that agreement. An example of a guaranty that binds spouses as well as signatories, but only to the extent of assets of the marital estate is, as follows:

Each of your direct and indirect owners during this Agreement’s term and your and their spouses will execute a guaranty in the form we prescribe undertaking personally to be bound, jointly and severally, by all provisions of this Agreement and any ancillary agreements between you and us. Our current form of Guaranty is attached herein as Exhibit C. We confirm that a spouse who signs Exhibit C solely in his or her capacity as a spouse (and not as an owner) is signing that agreement merely to acknowledge and consent to the execution of the guaranty by his or her spouse and to bind the assets of the marital estate as described therein and for no other purpose (including, without limitation, to bind the spouse’s own separate property).

A broader guaranty could make the spouses jointly and severally liable for all obligations by not limiting exposure to marital assets. But, in to be bound by such a guaranty, the spouse must sign the guaranty in his or her individual capacity and acknowledge the extent of the guaranty.

2. Covenants Against Competition and Solicitation

Another area where both contracts and case law have expanded stakeholders beyond franchise agreement signatories is non-competition obligations. Notably, non-signatory family members have been held bound by provisions in the franchise agreement based on the theory that one cannot do through one’s spouse an action that a non-compete agreement prohibits.

Franchisees and former franchisees generally may not work with their non-franchisee children to operate a business or solicit customers in violation of an enforceable non-competition or non-solicitation agreement with the franchisor. Courts have enjoined franchisees and their children from operating business in violation of non-competition and non-solicitation provisions in franchise agreements, even where those children did not sign the franchise agreements.\(^76\)

Franchisors have also succeeded in enjoining non-signatories to franchise agreements from operating a competitive business in violation of the franchisee's covenant not to compete, even where the non-signatory is not a family member in cases where the franchisor can show that the franchisee conspired with the non-signatory to operate the competitive business. However, “a familial or close relationship substantially increases the odds of success.”

Often franchise agreements include covenants against competition and solicitation during the term of the franchise agreement and a period of time following the expiration or termination of the franchise agreement. Such covenants may expressly extend to non-signatories, with language such as:

It shall be deemed a breach of this Agreement if your spouse or children engage in any of the prohibited conduct.

For purposes of this Article only, “Franchisee” shall mean and include the individual Franchisee; Franchisee’s spouse and minor children; Franchisee’s shareholders, officers, and directors, if Franchisee is a corporation; and any one or more partners, members or participants in Franchisee, if Franchisee is a partnership, joint venture, or limited liability company.

3. **Non-Disparagement**

Non-disparagement obligations to a franchisor might also extend to the franchisee’s family. For example:

**Non-Disparagement:**

You agree not to (and to use your best efforts to cause your current and former shareholders, members, officers, directors, principals, agents, partners, employees, representatives, attorneys, spouses, affiliates, successors and assigns not to) disparage or otherwise speak or write negatively, directly or indirectly, of us, our affiliates, any of our or our affiliates’ directors, officers, employees, representatives or affiliates, current and former franchisees or developers of us or our affiliates, the … brand, the Franchise System, any … Restaurant, any business using the Marks, any other brand or service-marked or trademarked concept of us or our affiliates, or which would subject the … brand or such other brands to ridicule, scandal, reproach, scorn, or indignity, or which would negatively impact the goodwill of us, the … brand or such other brands.

**B. Existing Franchisees Are Stakeholders**

Franchisors are not the only stakeholders who benefit from the protections afforded by guaranties, non-competition, and non-disparagement provisions. Franchisees enter the franchise relationship seeking a benefit. The benefit is generally the economic success of the existing

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brand. For a franchisee, economic benefits derivative of the existing brand include consumer awareness, existing know-how, existing intellectual property and continuing developments, existing goodwill and reputation, and relationships. Threats to the existing brand threaten the economic success of franchisees. Thus, existing owners are stakeholders in the franchisor's acceptance or rejection of prospective new franchisees.

The interest of existing owners includes maintaining brand strength, but can also include reducing or minimizing competition. A franchisor may be justified in refusing to permit a franchised location that it believes will cannibalize existing locations, which could potentially ruin an existing franchise and consequently weaken the entire chain. In the event of claims resulting from such a decision, courts should not second guess the business decisions of franchisors based on reasonable business justifications.

C. Other Stakeholders

When a prospective franchisee is seeking to buy an existing location or seeking approval for assignment of an existing franchise agreement, the seller of the franchise is also a stakeholder in the franchisor's approval decision. If the seller is financing any part of the transaction, the seller will also be interested in the continued success of the brand and the location.

Other prospective franchisees, brokers, and customers also have a stake in the approval of prospects. In franchises that are not rapidly growing, there may be limited opportunities for prospective franchisees. Thus, each prospect has a stake in which individuals are approved. On the other hand, in rapidly growing chains, multiple franchisees may be approved in a single geographic area. Each prospect has a real interest in the capabilities and eventual success of the other franchisees because the customer experience and sensory elements of one outlet will reflect on the others.

Consumers are also stakeholders in the process, as their experience is derivative of the effort and ability of each franchise owner. Some consumers that suffer an injury or damage as a result of a franchisee's action or inaction, may have a claim against a franchisor for awarding a franchise to a prospect that was not qualified.

VI. FRANCHISOR'S OBLIGATIONS TO DENY A PROSPECTIVE FRANCHISEE'S APPLICATION

A single franchise owner can have a serious impact on the brand equity. Franchisors may be obligated to deny certain applications. A franchisor's own internal policies may compel denial. In addition, the potential negative effect on other stakeholders might be the basis for a franchisor's application denial.

Franchisors are obligated to deny a prospective franchisee's application in certain specific circumstances for legal reasons. For example, a franchisor must refrain from selling in states where it is not registered. A franchisor must also refrain from selling without the proper disclosures.

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78 See e.g., Big Apple BMW, Inc. v. BMW of North America, Inc., 974 F.2d 1358 (3d Cir. 1992).


80 Id. at 774.
Franchisors may also have a duty to protect the health of the system, whether by virtue of franchise agreements that promise the franchisor will develop, use, and control the franchisor’s marks to represent certain standards, or as a matter of law, or both. To that end, a franchisor must adhere to any existing business and expansion plans. These plans may preclude a specific franchise sale; but, may protect the franchisor from selling too many franchises too soon and creating a situation where new franchises are not fully supported and are not successful, consumer-based equity diminishes and the brand suffers. Franchisor strategy may similarly protect the franchisor from expanding too far geographically, too quickly, and without the ability to properly support new locations.

Internal policies, procedures, and practices regarding potential franchisee selection may be set forth online, in a franchisor’s operations manual, or in unpublished guidelines. Requirements for the transfer of an existing franchise are typically set forth in the franchise agreement.

For example, the franchisor may have a requirement that franchisees be individuals and not entities. Where an applicant is an entity, the franchisor must either deny the application or determine whether an exception is appropriate. If the franchisor seeks to make an exception, it should do so carefully and with appropriate documentation to protect itself from claims by other stakeholders, including other applicants who may claim disparate treatment. Other examples of existing policies or requirements affecting the franchisor’s approval of a new franchisee include financial requirements, moral character requirements, training requirements, and the requirement that applicants successfully complete standardized tests.

At times, the results of a franchisor’s investigation into a prospect may convince the franchisor to deny an application. For example, information obtained through a background check might implicate an internal requirement that franchisees be of good moral character. Less subjective criteria may relate to the applicant’s ability to obtain and maintain licenses necessary to the operation of the franchise business. On the other hand, if a license is preferred but not mandatory, the franchisor should analyze whether to accept or deny the application and consider other criteria in its analysis. Such considerations can include the image of the brand, protection of the marks, and the overall success of the system. Franchisees’ and consumers’ identification of the brand’s products and outlets can result from their notions of the brand’s image and values. A franchisor might reasonably consider whether a prospective franchisee meets those notions when evaluating the prospect’s application.

In applying these internal requirements and considerations, franchisors should consider brand uniformity and the interests of all stakeholders and make sure the requirements are reasonable. A franchisor may choose to deny an application to serve the interests of its shareholders, existing franchisees, and customers. Reasonable requirements can include that the prospect:

- Be an individual and not an entity;
- Be a citizen or permanent resident of the country in which the franchise will be located;

81 Schnell and Gardner, Battle over the Franchisor Business Judgment Rule and the Path to Peace, 35 Franchise L. J. 167, 168 (Fall 2015); Dunkin’ Brands Canada Ltd. v. Bertico Inc. 2015 QCCA 624 (CanLII).
- Be of good moral character;
- Satisfy the franchisor’s training requirements;
- Pay in full all sums due to the franchisors;
- Meet the franchisor’s economic requirements;
- Meet the franchisor’s educational and/or experience requirements;
- Hold or be able to obtain licenses such as are required to operate the franchised business; and,
- Provide required releases to the franchisor.

Additionally, the franchisor may have other reasonable requirements or considerations necessary to protect the image of the brand. In certain circumstances, this might include meeting the franchisor’s expectations upon the franchisor’s review of a prospective franchisee’s business plan and detailed budget, or upon the administration of certain tests. These requirements may include parameters set out in the FDD, relevant provisions of the operations manual, requirements of shareholders, and input from franchisee associations. As franchisors establish requirements for approval, they should be careful to document that the acceptance of a candidate is not a guaranty or endorsement of the prospect’s ability to succeed or to meet financial plans or projections provided by the prospect.

Many franchisors use aptitude tests to screen prospects. If a franchisor opts to use such tests, it is good practice to first prepare a written statement setting forth the legitimate business reasons for preparing and requiring the test. Then, the franchisor should hire a reputable third-party to prepare the test based on the written statement of purpose. Finally, the test should consistently be administered in a fair, standardized manner.

Other requirements or considerations for approval of prospective franchisees may be deemed unreasonable by some prospects. Chick-fil-A reportedly prefers franchise operators who play an active role in their church, are devout Christians, and share Christian values. While franchisees of the chain need not be Christian, reportedly, franchisees of the chain must be willing to participate in group prayers during training and management meetings.\footnote{Reifowitz, Ian, \textit{Chick-fil-A: Franchise Operators Must “Espouse Christian Values” and Must “Participate in Group Prayer,”} HuffPost (Aug. 6, 2012) available at https://www.huffpost.com/entry/chickfila-franchise-christian_b_1737408 (last visited Sept. 4, 2019); \textit{see also Odds Stacked Against Chick-fil-A Franchisee Aspirants}, Blue Mau Mau (Oct. 28, 2018) available at https://www.bluemaumau.org/news-summary/2018/10/27/odds-stacked-against-chick-fil-franchisee-aspirants (last visited Sept. 4, 2019).} Perhaps this should not surprise prospective franchisees of the Chick-fil-A franchise system. The chain’s corporate purpose is, “To glorify God by being a faithful steward of all that is entrusted to us and to have a positive influence on all who come into contact with Chick-fil-A.”\footnote{https://www.chick-fil-a.com/about/who-we-are (last visited Sept. 4, 2019).} Reportedly, in some instances, Chick-fil-A contacts friends, family, and former business partners of prospective franchisees to assess the prospective franchisees business acumen and suitability.\footnote{Odds Stacked against Chick-fil-A Franchise Aspirants, supra, citing Wilson, Renwick, \textit{Why opening a Chick-fil-A franchise is nearly impossible}, Fox Business, Oct. 27, 2018 available at https://www.foxbusiness.com/retail/open-chick-fil-a-franchise-impossible (last visited Sept. 4, 2019).} It is not hard to imagine a scenario where a prospect’s past behavior is inconsistent with Chick-fil-A’s Christian values. Other likely scenarios include a prospective franchisee that the chain finds appropriate, but whose
spouse may not be someone whom the chain believes shares Christian values. Conceivably, this could hurt a prospect’s chances of approval.

VII. **CLAIMS RELATING TO A REJECTED PROSPECTIVE FRANCHISEE**

A. **Claims a Rejected Prospective Franchisee Might Bring**

Prospective franchisees rejected by a franchisor may realize that the business was not appropriate, or the concept was not an appropriate fit; or, they may believe the denial by the franchisor was wrongful, unlawful, and actionable in civil court. In the latter instance, there are a variety of claims prospects may bring, as well as defenses the franchisors can assert.

As a preliminary matter, the prospective franchisee must establish standing to bring a claim against the franchisor. A prospective franchisee may be able to utilize a state franchise relationship law to establish standing and secure damages and even specific performance, when appropriate. In *VW Credit, Inc. v. Coast Automotive Group, Ltd.*, a prospective transferee of the assets of a Volkswagen and Audi dealership had standing to intervene in an action between the franchisor and existing franchisee on the limited issue of whether the franchisor Volkswagen and Audi distributors wrongfully withheld consent to the transfer of the franchise. In that case, the prospective transferee was the holder of a $5,000,000 promissory note executed by the existing franchisee and was the purchaser under an asset purchase agreement and real estate sales agreement. The Court found that, therefore, the prospective transferee had “a substantial interest in the transfer” of the franchises. The Court held that the prospective transferee had standing as an indispensable intervening party to proceed in the action to compel transfer under the New Jersey Franchise Practices Act. The Court held that specific performance is an appropriate remedy under the Act where a franchisor unreasonably withholds consent to transfer and affirmed an order approving the prospective transferee as the franchise transferee of the franchises.

The existence of a statute alone may not afford standing, however. For example, in *Key v. Chrysler Motors Corp.*, the New Mexico Supreme Court reversed a trial court’s determination that Chrysler unreasonably withheld consent to the transfer of a Chrysler/Plymouth dealership franchise to Key in violation of the New Mexico Motor Vehicle Dealers Franchising Act. The New Mexico Supreme Court held that the Act does not afford standing to all prospective franchisees and concluded that Key failed to state a cause of action under the Act.

In *Key*, the prospective franchisee was an existing Jeep/Eagle dealer and Chrysler rejected him as a potential franchisee because he failed to meet the minimum sales requirements.

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86 787 A.2d 951, 956.
87 *Id.*
88 *Id.*
89 *Id.* at 962-63.
for the Jeep/Eagle line under his Jeep/Eagle franchise. According to the Court, the minimum sales responsibility was “Chrysler’s measure of a dealer’s sales ability.” 91 The Court held that there is no significant difference between having standing to sue and having a cause of action under the Act. 92 The Court then concluded “that the Act does not grant standing to all prospective franchisees.” 93 Taken as a whole, and considering federal and state acts from other jurisdictions, the Court found that “the Act cannot be said to afford protection to every prospective purchaser of an automobile franchise.” 94 Even though the transaction pursuant to which Key was to purchase the Chrysler dealership was a “franchise offering” for purposes of the Act, the Court found that “the Act does not govern manufacturers’ dealings with prospective franchisees, nor does it provide in explicit terms protection for that class.” 95 The Act “provides for standing in broad terms, but it links standing to forbidden conduct and articulates forbidden conduct in specific terms” with respect to the relations between manufacturers and dealers and between dealers and customers. 96 But, “[t]he Act does not provide any standard against which specific conduct by a manufacturer might be challenged by a prospective franchisee or measured by a court.” 97 Notably, the Court also found that Key did not state a cause of action under the Act as an existing dealer complaining about actions taken by the franchisor. 98

Similarly, in Roberts v. General Motors Corp., 99 the New Hampshire Supreme Court affirmed a trial court ruling that a prospective franchisee has no standing to sue under either the New Hampshire Regulation of Business Practices Between Motor Vehicle Manufacturers, Distributors and Dealers Act or the New Hampshire Consumer Protection Act. The New Hampshire Court held that “the clear intent of the non-consumer-oriented provisions is to protect the investment and property interests of those who are already dealers.” 100

91 918 P.2d at 352.
92 Id. at 354.
93 Id.
94 Id.
95 Id. at 355.
96 Id. at 355-56.
97 Id. at 356.
98 Id. at 354.
100 643 A.2d 956, 959.
If a prospective franchisee can establish standing, other claims available might include violation of an anti-discrimination law,\(^{101}\) violation of anti-trust regulations,\(^{102}\) conspiracy,\(^{103}\) or tortious interference with prospective or existing contractual or economic relations.\(^{104}\)

Although courts will generally not second-guess a franchisor’s business decisions, courts will also not permit intentional discrimination. As discussed above in Section IV.A., racial discrimination claims related to a franchisor’s application process that are brought at the federal level must be brought under 42 U.S.C. § 1981. Where a prospective franchisee presents a prima facie case of discrimination based on race and presents sufficient evidence that all of the franchisor’s stated reasons for rejecting a franchisee application are pretextual, the fact-finder is entitled to reasonably infer that the franchisor intentionally discriminated against the prospect on the basis of race, in violation of 42 U.S.C. § 1981.\(^{105}\) In \textit{Tyler v. Re/Max Mountain States}, Re/Max had seven written reasons for its decision not to approve the plaintiff’s franchise application.\(^{106}\) Mr. Taylor did not present any direct evidence of discrimination, but he had indirect evidence of discrimination and presented sufficient evidence that each of the reasons that Re/Max propounded for his application’s denial was pretextual.\(^{107}\) After the jury found in Mr. Taylor’s favor, Re/Max moved for judgment as a matter of law.\(^{108}\) The district court denied the motion, and the court of appeals affirmed.\(^{109}\) The court of appeals was “mindful” that it “must not sit as a super-personnel department that second-guesses the company’s business decisions, with the benefit of twenty-twenty hindsight.”\(^{110}\) But, it found that Mr. Taylor presented sufficient evidence that Re/Max’s reasons for rejecting his franchise application were pretextual and that, as such, the jury could have reasonably inferred that Re/Max intentionally discriminated against Mr. Taylor on the basis of his race.\(^{111}\)


\(^{102}\) \textit{See Martino v. McDonald’s System, Inc.}, 81 F.R.D. 81 (1979) (certifying class antitrust action related to McDonald’s requirement that in order to obtain a McDonald’s franchise, prospective franchisees must agree to sign a lease agreement with an affiliate of McDonald’s and a license with Coca Cola).

\(^{103}\) \textit{See Williams v. Nevada}, 794 F.Supp. 1026, 1032 (D.Nev.1992) (given the commonality of interest between franchisor and franchisee, and the franchisor’s degree of control, the defendants were a single enterprise, incapable of conspiring for purposes of Section 1 of the Sherman Act), aff’d, 999 F.2d 445 (9th Cir. 1993).

\(^{104}\) \textit{See Burger King Corp. v. Collins}, Case No. 90-0987-Civ-Aronovitz, slip op. at 7 (S.D.Fla. June 1, 1994) (“Because any prospective assignment by [the counterclaim plaintiff] required BKC’s consent, BKC was not a disinterested third party but rather the source of the business opportunity [it] allegedly interfered with. Consequently, no claim for tortious interference exists against BKC.”).

\(^{105}\) \textit{Tyler v. Re/Max Mountain States}, 232 F.3d 808 (10th Cir. 2000).

\(^{106}\) 232 F.3d at 813.

\(^{107}\) Id. at 812.

\(^{108}\) Id.

\(^{109}\) Id. at 816.

\(^{110}\) Id. at 813-814.

\(^{111}\) Id. at 816.
Statutory claims can also include allegations of violation of state anti-discrimination laws. For example, New York has enacted laws to protect individuals from discrimination in securing premises in which to operate businesses. Those laws include a prohibition on owners, lessees, sublessees, or managing agents of those, from refusing to sell, rent, or lease commercial space on the basis of sex, age or marital status. In *DiPilato v. 7-Eleven, Inc.*, a federal magistrate found that a 7-Eleven franchise falls within the meaning of commercial space in those statutes.\(^{112}\) The magistrate then concluded that a prospective 7-Eleven franchisee stated an actionable claim for violation of the New York statute by asserting that a 7-Eleven representative told the prospect that the prospect’s franchise application should be denied because the applicant was a single woman over the age of forty.\(^{113}\)

On the other hand, in *Smith v. Molly Maid, Inc.*,\(^{114}\) the plaintiff sued Molly Maid after her attempt to become a Molly Maid franchisee failed. The plaintiff claimed that Molly Maid discriminated against her based on her race, in violation of 42 U.S.C. Section 1981, and violated the Illinois Franchise Disclosure Act and breached a franchise agreement.\(^{115}\) The district court held that no franchise agreement existed between the parties and, even if a contract did exist, the plaintiff could not prove anticipatory breach.\(^{116}\) It held that the plaintiff failed to prove Molly Maid discriminated against her, failed to prove violation of the Illinois Franchise Act, and that “Molly Maid made the decision to terminate its relationship with the plaintiff for financial reasons, not because she was an African-American.”\(^{117}\)

Other claims may be equally difficult to sustain. For instance, a tortious interference claim is difficult to prove because a franchisor generally cannot tortiously interfered with a contract or business in which it has an interest.\(^{118}\) Furthermore, such a claim will typically require a showing of improper motive or improper means.\(^{119}\) However, if a franchisor uses improper methods in refusing to consent to a transfer, even if the franchisor’s motive was not purely malicious, a tortious interference claim by an unsuccessful prospect might succeed.\(^{120}\) For a deeper discussion of disputes arising from assignments, including bringing and defending claims for wrongful withholding of franchisor’s consent to transfer, see “Transfers of Franchises: Disputes Arising from Assignments” published for the 2013 Annual Forum on Franchising.\(^{121}\)

\(^{112}\) *DiPilato v. 7-Eleven, Inc.*, 662 F.Supp.2d 333 (S.D.N.Y. 2009).

\(^{113}\) *Id.*

\(^{114}\) 415 F.Supp.2d 905 (N.D. Ill. 2006).

\(^{115}\) 415 F.Supp.2d 905, 906.

\(^{116}\) *Id.* at 911, 918.

\(^{117}\) *Id.* at 917.

\(^{118}\) See *Burger King Corp. v. Collins*, supra; *PCJ Franchising Co., LLC v. Newsome*, No. 7:08-CV-41-BO, 2008 WL 4772191, at *3 (E.D.N.C. Oct. 27, 2008).

\(^{119}\) See *e.g.*, *Luso Fuel, Inc. v. BP Prods. N. Am., Inc.*, No. 08-CV-3947, 2009 WL 1873583, at *6 (D.N.J. June 29, 2009).

\(^{120}\) See *KMS Restaurant Corp. v. Wendy’s Int’l, Inc.*, 361 F.3d 1321, 1328 (11th Cir. 2004).

It is also sometimes difficult for a disappointed prospective franchisee to succeed in a promissory estoppel claim against the franchisor. Prospective franchisees often speak with agents of the franchisor about their interest in becoming a franchisee. This can lead to a claim that the agent of the franchisor promised approval of the franchise application and a cause of action for promissory estoppel. Franchisors might avoid liability for promissory estoppel by advising applicants in writing that neither party is bound to the other until final documents are executed and delivered to both parties or by clearly communicating to applicants that no franchise agreement will exist until acknowledged in writing, putting the applicant on notice that the applicant cannot reasonably rely on alleged promises by the franchisor’s agents or employees. Franchisors should also make it clear to franchise applicants that none of the franchisor’s agents or employees have authority to grant a franchise.

The franchise application and the discussions surrounding the application may be contracts. Disgruntled prospects might claim that the franchisor breached the contract in its handling of the application. In a recent case, a federal district court concluded that a franchise application did not contain any promises on the part of the franchisor. In that case, the district court found that the franchisor did not even promise to review or consider the franchise application. Therefore, the district court held that there was no consideration and no enforceable contract. On appeal, the franchisor successfully argued that there was an enforceable contract. The Second Circuit Court of Appeals held that there was consideration for an agreement to arbitrate contained in the application, because the franchisor reviewed the application and considered the applicant for a franchise, just as the applicant requested the franchisor do when the applicant filed the application. The franchisor thus provided the prospect with a benefit in exchange for promises made by the prospect in the application, including promises to maintain confidentiality and to arbitrate all disputes arising out of the application process.

If the prospect is an existing franchisee, as the Court suggested in Key, statutory claims may be available, as well as breach of contract, breach of the implied covenant of good faith and fair dealing, misrepresentations (negligent or fraudulent), and fraud. In Bertera Chrysler Plymouth, Inc. v. Chrysler Corp., 992 F. Supp. 64 (D. Ma. 1998), the court granted summary judgment on franchisee’s claims of fraud, breach of contract, breach of the covenant of good faith and fair dealing, and bad faith under Massachusetts law. In that case, the plaintiff, an existing

124 See id.
126 Id. at 311.
127 Id.
129 Id. at 18-19.
130 Id.
Massachusetts Chrysler dealer wanted to bid on the assets of another Massachusetts Chrysler dealer. Repeatedly, the franchisor refused the plaintiff's requests to purchase the other franchisee's assets. The plaintiff alleged that Chrysler's refusal to permit him to bid on the other franchisee's assets violated the Massachusetts Motor Vehicle Business Practices Act.\textsuperscript{131} Chrysler argued that a prospective purchaser of a motor vehicle dealership has no standing under the Act to assert a claim against a manufacturer for withholding approval of the proposed purchase, even if the prospective purchaser is an existing dealer.\textsuperscript{132} Supporting that argument was the fact that the plaintiff never submitted a formal application for approval to acquire the assets at issue. Therefore, the court determined that he never became an “Applicant” with standing to invoke Chrysler's guidelines.\textsuperscript{133} The Court found that the plaintiff sat on his hands, unlike other prospective purchasers of the assets at issue, and “waited until the eleventh hour to prevent its competitor from acquiring the dealership it desired.”\textsuperscript{134} As such, the plaintiff could not maintain an action under the Act and summary judgment entered for Chrysler.

If a prospect intended to buy or take assignment of an existing contract, he might bring a declaratory judgment action to enforce the transfer provision in that contract.\textsuperscript{135}

While prospective franchisees might seek specific performance, they may also demand money damages, and statutory damages if available. Prospective franchisees may also seek to recover lost profits even though that type of damage may be deemed speculative.

\begin{itemize}
  \item \textbf{B. Claims Others Might Bring}
\end{itemize}

If the prospect intended to buy a franchise from an existing franchisee, the seller may assert claims against the franchisor for wrongful withholding of consent to transfer. These claims often take the form of breach of contract, breach of the implied covenant of good faith and fair dealing, tortious interference, and violation of a state franchise protection act. These claims face the same challenges as those brought by the disgruntled applicant, although typically standing is less of a challenge for the plaintiff.

In \textit{Perez v. McDonald's Corp.},\textsuperscript{136} the plaintiffs claimed the McDonald's refused to approve prospective purchasers for their McDonald’s franchise on four occasions because of the prospective purchaser's failure to complete the McDonald's mandatory applicant training program. The plaintiffs claimed breach of express contract, fraudulent misrepresentation, and statutory violations. The court granted summary judgment for McDonald’s on all counts. Interestingly, the court found that “McDonald’s had no obligation to admit prospective purchasers into its training program, and plaintiffs could not have reasonably expected that McDonald’s would enroll every “qualified” prospective purchaser in its applicant training program.”\textsuperscript{137}

\begin{footnotes}
\item[131] 992 F. Supp. 64, 67-70.
\item[132]  Id. at 68-69.
\item[133]  Id. at 73.
\item[134]  Id. at 71.
\item[136]  60 F.Supp.2d 1030 (E.D. Cal. 1998).
\item[137]  60 F.Supp.2d 1030, 1035.
\end{footnotes}
Satisfactory completion of the applicant training program is a factor McDonald's “shall” consider in deciding whether to grant or withhold its consent to sales or assignments of franchise interests. Accordingly, McDonald’s decision not to consent to the proposed sales of plaintiffs’ restaurant on the ground that their prospective purchasers had not completed the applicant training program was not arbitrary. Moreover, insofar as McDonald’s did not have a duty to either the prospective purchasers or to plaintiffs to enroll the prospective purchasers in the applicant training program, McDonald’s decision not to admit them into the applicant training program was likewise not arbitrary.\textsuperscript{138}

Furthermore,

Because the court finds that (1) McDonald’s did adequately disclose that satisfactory completion of the applicant training program is a factor considered in deciding whether to approve sales or assignments of franchise interests, and (2) access to the applicant training program was not a matter contracted to by the parties, plaintiffs cannot state a claim for fraudulent or negligent misrepresentation as a matter of law.\textsuperscript{139}

Similarly, in DeWalshe \textit{v. Togo's Eateries, Inc.},\textsuperscript{140} the court granted summary judgment in favor of defendant Togo’s. In that case, the plaintiff was an existing franchisee seeking to sell the franchise to a buyer who did not pass the English proficiency exam required by Togo’s. The court found that “undisputed evidence” showed that the current Togo’s franchise agreement at the time of the proposed transfer included an English proficiency requirement. The express terms of the franchise agreement provided Togo’s with “absolute discretion” to require that a prospective buyer of the existing franchise agree to the terms of Togo’s “then current” franchise agreement. The court found that therefore Togo’s was entitled to impose the English proficiency requirement for qualifying Buyers on the plaintiff’s proposed transfer and granted summary judgment in Togo’s favor.

In \textit{Hannon v. Exxon Co., U.S.A.},\textsuperscript{141} summary judgment was entered in favor of Exxon on plaintiffs’ claims that Exxon wrongfully destroyed the value of a service station operated by the plaintiffs and violated the PMPA and Maryland Gasohol and Gasoline Products Marketing Act by unreasonably withholding consent to the assignment of the franchise. In that case, the court carefully considered Exxon’s rejection of a proposed transferee and found that Exxon had the contractual right to approve or reject the candidate and that it rejected the candidate based on its Dealer Selection System, which evaluated candidates based on “fixed objective criteria as well

\begin{footnotes}
\item[138] Id.
\item[139] Id. at 1037.
\item[140] 567 F. Supp. 1198 (C.D. Cal. 2008).
\item[141] 54 F.Supp.2d 485 (1999).
\end{footnotes}
as some subjective criteria.” Even to the court’s analysis was that the plaintiffs did not put forth any evidence, “aside from their speculative argument” that Exxon had a pretextual motive for rejecting the candidate. The candidate had a low score on the application. At his interview with an Exxon panel, the applicant could not “articulate a satisfactory business plan and was unfamiliar with the competition in the area.” Thus, the court found that a reasonable jury correctly applying the law to the facts could not reasonably conclude that Exxon acted unreasonably in its rejection of the candidate at issue.

Even where the franchise seller succeeds in a claim that the franchisor wrongly failed to grant the application of a prospective purchaser, the damages for that failure may be limited. In Tunis Bros. Co., Inc. v. Ford Motor Co., the plaintiffs claimed that they had a deal to sell their Ford dealership, that Ford convinced them to resign as franchisees before closing on that sale, and that Ford subsequently denied the buyer’s franchise application, preventing closing. A jury reached a verdict in favor of the plaintiffs and awarded damages to the plaintiffs including $4,000,000 in punitive damages. On appeal, the Third Circuit Court of Appeals entirely vacated the punitive damage award. The Appellate Court wrote, “An election not to grant a franchise application…does not justify punitive sanctions.”

Like prospective franchisees, other claimants affected by the franchisor’s refusal to approve a prospect may seek specific performance or declaratory relief. They may also seek money damages and statutory damages. Absent outrageous conduct, though, punitive damages are unlikely.

The cases described in this section demonstrate the legal challenges faced by existing franchisees when franchisors refuse to consent to transfers. Perhaps because of these types of challenges, existing franchisees seeking to transfer their agreements have been known to be very creative in their claims against franchisors that withhold consent. Another reason for this creativity may be that specific performance is not always an appropriate remedy. Franchise litigation can take years. During the pendency of a case, prospective purchasers are likely to lose interest or invest elsewhere. Where the would-be transferor remains a franchisee in good standing, it is often difficult to find an appropriate remedy because, while the franchisee was deprived of one opportunity to sell its franchise, it still holds the asset. The franchise agreement can still be sold or be used to continue to profitably operate the franchise business. The would-be transferor’s damages, if any, are, therefore, difficult to quantify. For these reasons, sometimes the existing franchisee finds a way to partner with the prospect in litigation against the franchisor. This kind of partnership can take various forms, but since the existing franchisee has privity with the

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142 54 F.Supp.2d 485, 496.
143 Id.
144 Id.
145 Id.
146 Id.
148 952 F.2d at 717.
149 Id. at 741-742.
150 Id. at 741.
franchisor, and the prospect has quantifiable losses, working together the two can overcome many of the typical difficulties in cases arising from the franchisor’s refusal to approve a prospect. By working together, the potential transferor and transferee also ensure the availability of witnesses, documents, and information to support their claims.

The kind of partnership described above can take various forms. There are many considerations for counsel. One critical consideration for counsel is whether a conflict of interest exists between the transferor and transferee, and, if so, whether it may or should be waived. Another consideration is whether both the transferor and transferee are appropriate claimants, or whether one is a more suitable claimant than the other. Of course, a critical consideration is how, and by whom, the attorneys will be paid. Finally, counsel should review the franchise agreement to determine whether the agreement prohibits the franchisee from joining additional parties to a dispute with the franchisor, and if so, whether the prohibition applies under the circumstances. These are all fact specific inquiries that will require serious exploration. Disputes arising from the disapproval of a prospect often require investigation and creativity.

VIII. CONCLUSION

Challenges in the process of qualifying candidates to become franchisees are unavoidable. Franchisors have no choice but to accept some risk in order to properly vet prospective franchisees and necessarily approve and disapprove some applicants. In addition to adhering to applicable laws and regulations, franchisors can mitigate risk by adopting and adhering to clear and sound policies that govern the franchisee evaluation and approval process and using pro forma application documents in accordance with those policies. By doing so, franchisors should be able to reduce claims of disparate treatment by prospective franchisees for qualities unrelated to qualifications for the franchise or claims of damages by other stakeholders.
Biographies

Van Lam is the General Counsel for Regal Nails, Salon & Spa, LLC (“Regal Nails”), based in Baton Rouge, LA. Mr. Lam manages all aspects of Regal Nails’ legal matters, including reviewing and drafting disclosure documents, franchise and other agreements, and leases; dealing with compliance, employment, intellectual property, and litigation matters; and serving as point of contact for outside counsels.

Nicole Liguori Micklich has spent more than fifteen years successfully representing franchisees and development agents at every step of the franchise relationship and in litigation with franchisors, and she routinely advises franchisees about all aspects of their businesses. Nicole represents clients nationwide and internationally across many industries. Nicole enjoys teaching Franchise Law as an adjunct professor at Quinnipiac University Law School, in Hamden, Connecticut, and she is a frequent author and lecturer on franchise law. Nicole is a partner in the firm of Urso, Liguori & Micklich, in her home state of Rhode Island.

Stephanie Russ is Vice President and General Counsel for Childrens Lighthouse Franchise Company (“Childrens Lighthouse”), based in Ft. Worth, Texas. Before joining Childrens Lighthouse, Stephanie served as Counsel as Baker & McKenzie LLP where she represented franchisors in franchise regulatory and relationship matters and franchise-related commercial agreements. Prior to her time at Baker & McKenzie, she was a partner at Mullin Russ Kilejian PC (nka Mullin Law PC), where she represented both franchisors and franchisees in franchise-related and business-related matters. Before attending law school, Stephanie worked in business roles with the TCBY, KFC, and Burger King. In addition to being admitted to the State Bar of Texas, she is also admitted to practice before the Supreme Court of the United States.