WORDS MATTER: A LITIGATOR’S PERSPECTIVE ON DRAFTING AND INTERPRETING KEY PROVISIONS IN THE FRANCHISE AGREEMENT

Eric D. Stolze
Paul Hastings LLP
Atlanta, Georgia

Elizabeth M. Weldon
Snell & Wilmer, L.L.P.
Costa Mesa, California

and

Michael J. Boxerman
Marcus & Boxerman
Chicago, Illinois

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I. INTRODUCTION

As the band Vampire Weekend once famously asked:

Who gives a #@% about an Oxford comma?  
I've seen those English dramas, too  
They're cruel  
So if there's any other way  
To spell the word, it's fine with me  
With me\)

And we know that courts do care about the Oxford comma as seen in the O'Connor v. Oakhurst Dairy case, discussed more below. Franchise cases can rise or fall on the interpretation of a single word or phrase in the franchise agreement, as well as on the placement of commas.

Issues of interpretation often arise in the context of interpreting and enforcing dispute resolution provisions, and there have been entire papers and programs written on that subject. In this paper, however, we shift our focus and discuss some of the more commonly litigated franchise agreement provisions that arise in the context of franchise operations. We review case law concerning territories and exclusivity, non-competition, renewal, termination, supply, restrictions on offering and menus, net sales, marketing and advertising, indemnity and attorneys' fees. We review what to consider when drafting a franchise agreement, and what to rely upon when litigating one. At the end of every section, we propose best practices for the drafting attorney to consider on these subjects. And at the end of the paper, we propose some further big picture suggestions to aid in drafting franchise agreements, with an eye toward avoiding future disputes.

In reviewing this paper, the reader will likely consider the arguments in the disputes that are presented and summarized as ranging from compelling to crafty (if not absurd), and the final decisions ranging from reasonable and predictable to surprising anomalies (if not outright “wrong”). A frequent element in the fact-finder's analysis is a threshold finding of ambiguity, which clears the way for unbridled introduction and debate regarding parol (outside the contract’s “four corners”) evidence. Ambiguity empowers judges and arbitrators to consider and assign varying weights to materials and testimony that would have otherwise never entered the merits of a case.

Without an “ambiguity,” a word or phrase has only one reasonable meaning, as a matter of law. With an ambiguity, litigation or other dispute resolution mechanisms become channels for choosing amongst multiple possible meanings to arrive at the parties’ purported, original intent. The existence of an ambiguity is a turning point in disputes, truly a make-or-break issue for at least one party’s case. Without an ambiguity, cases might be resolvable on the papers; with an ambiguity, a fact issue exists that must be decided on the merits, after taking evidence on the virtual entirety of the parties’ pre-dispute relationship.

The best defense against ambiguity is a good offense, in the drafting phase of a relationship or by having solid off-the-shelf form agreements. Drafters of franchise (and ancillary) agreements will benefit from seeing how claims of ambiguities have been resolved, and litigators will likewise find value in the endless creativity of counsel, particularly when arguments find their mark.

1 VAMPIRE WEEKEND, Oxford Comma, on VAMPIRE WEEKEND (XL Recordings 2008).
II. THE CASE OF THE MISSING SERIAL, OR OXFORD, COMMA

“For want of a comma, we have this case.” So wrote Judge David Barron of the First Circuit in the decision O’Connor v. Oakhurst Dairy.2 O’Connor exemplifies how a multi-million dollar dispute can turn not on the meaning—or absence—of a word or phrase, but on punctuation alone. The absence of a single, or Oxford, comma brought this case to the Court of Appeals.

In O’Connor, several dairy delivery drivers filed a class action seeking to recover overtime pay from their dairy employer. The dispute centered on whether the delivery drivers were exempt from Maine’s overtime law.3 The overtime law does not separately define the term “employee,” but instead relies on the definition of “employee” set forth elsewhere in Maine’s broader wage and hour statute.4 Some workers who fall within the statutory definition of “employee” fall outside the protection of the overtime law due to a series of express exemptions from that law.5 At issue in O’Connor was whether the delivery drivers fell within “Exemption F,” which covers employees who handle certain enumerated food products.6 As written at the time, Exemption F provided that the overtime law does not apply to employees whose work involves:

The canning, processing, preserving, freezing, drying, marketing, storing, packing for shipment or distribution of:

(1) Agricultural produce;
(2) Meat and fish products; and
(3) Perishable foods.7

The parties’ dispute concerned the meaning of the words “packing for shipment or distribution” found in Exemption F. The delivery drivers argued that, in combination, these words refer to the single activity of “packing,” whether the “packing” is for “shipment” or for “distribution,” and given that the drivers do not engage in “packing,” they fall outside of Exemption F.8 The employer, on the other hand, argued that the disputed words refer to two distinct exempt activities, namely “packing for shipment” and “distribution” of dairy products and, therefore, the delivery drivers fall within Exemption F and are not protected by the overtime law.9

The court, after examining interpretive aids and the law’s purpose and legislative history, concluded that Exemption F is ambiguous, and construed the ambiguity in favor of the drivers in

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2 851 F.3d 69 (1st Cir. 2017).
3 Id. at 70.
4 Id.
5 Id. at 70–71.
6 Id. at 71.
7 Id.
8 Id.
9 Id.
order to further the overtime law’s remedial purpose. The court noted that if the exemption statute “had used a serial comma to mark off the last of the activities that it lists,” then the exemption would clearly encompass an activity that the drivers perform, and the drivers would “plainly fall within the exemption and thus outside the overtime law’s protection.”

After the O’Connor decision, the Maine Legislature addressed the punctuation problem by replacing the commas with semicolons and adding one semicolon after the phrase “packing for shipment” to make clear that employees engaged in “distributing” food products fall within Exemption F. The statute now reads:

The canning; processing; preserving; freezing; drying; marketing; storing; packing for shipment; or distributing of:

(1) Agricultural produce;
(2) Meat and fish products; and
(3) Perishable foods.

The use of an Oxford comma (or semicolons used in the same manner) could have avoided this costly dispute. Other careful drafting techniques discussed in this paper can also be used to avoid similar costly and easily avoidable disputes.

III. CASES CAN TURN ON SINGLE CONTRACT TERMS OR PHRASES

A. Territories and Exclusivity

Franchise exclusivity and territories are ripe with disputes over contract language, often focusing on how the territory is (or is not) defined. Case law shows that great pains should be taken to define an exclusive territory with specificity and certainty, and even to define what is permitted to happen within that territory.

1. Defining the Place

When we think of territory disputes in franchising, we often think of disputes over the use of the territory and who is infringing on that territory right. But, some of these disputes start at an even more preliminary point—the definition of the territory itself.

In Victory Lane Quick Oil Change, Inc. v. Hoss, the meaning and existence of the purported territory was ambiguous. The franchise agreement granted the franchisee “the exclusive right to own and operate a Victory Lane Quick Oil Change Center under the Victory Lane System and a license to use the Marks in the operation of the Center at the following

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10 Id. at 72.

11 It should be noted that the state of Maine Legislative Drafting Manual drafting conventions omit the serial comma from lists. Maine State Legislature Office of the Revisor of Statutes, MAINE LEGISLATIVE DRAFTING MANUAL 113.

12 O’Connor, 851 F.3d at 70.


location: Howell”—the city where the franchisee established its oil change center was established.\textsuperscript{15} When the franchise expired and the franchisee continued to operate under a different name, the franchisor sued to enforce its non-competition agreement and sought a preliminary injunction.\textsuperscript{16} But the matter became complicated, as the franchisor established another location just a few miles from the franchisee’s location, shortly before the subject franchise agreement expired. The franchisee argued that this new store violated its exclusive territory rights during the agreement, and thus barred the franchisor from enforcing the non-competition provision after the agreement expired.\textsuperscript{17} A dispute arose over what was meant by “Howell” in the territory provision because the franchisor argued that the agreement did not provide the franchisee with an exclusive territory; rather the franchisee was only allowed to operate out of the single location that happened to be in Howell.\textsuperscript{18}

The court viewed this dispute as creating a larger issue of reasonableness. Essentially, if the franchisee was right, "how reasonable is Plaintiff’s competitive business interest in enforcement of the non-compete clause in light of the fact that Plaintiff opened a competing business within the same area as the former franchise owned by Defendants which was allegedly barred by the franchise agreement.”\textsuperscript{19} Because the territory language was ambiguous and both parties offered reasonable interpretations, the court denied the motion for preliminary injunction on the ground that the franchisor did not show that it had a likelihood of success.

2. Defining Activity

Other times the definition of the territory may be clear, but the parties may dispute who can take what action and when in that territory. In other words, they may dispute what is an infringement of the territory.

In \textit{Maintainco, Inc. v. Mitsubishi Caterpillar Forklift America, Inc.},\textsuperscript{20} a dispute over the right to exclusivity arose in two separate ways—in the meaning of the phrase “best efforts” and in the use of the word “an” in dealer agreements. The plaintiff franchisee and defendant franchisor, Mitsubishi, entered into various dealer agreements over a period of years. The franchisee was a dealer for Mitsubishi, but was historically allowed to sell other brands and lines. Eventually, Mitsubishi wanted to grow its market share and informed the franchisee that it was going to have to increase its market share. When the growth did not happen in Mitsubishi’s view, Mitsubishi brought in another dealer to the franchisee’s purported territory (which had never happened elsewhere in the system). The franchisee believed Mitsubishi effectively or constructively terminated the franchise and sued for breach of the agreement. The trial court ruled in favor of the franchisee, as did the appeals court.

\textsuperscript{15} Id. at *3.
\textsuperscript{16} Id.
\textsuperscript{17} Id. at *5.
\textsuperscript{18} Id.
\textsuperscript{19} Id.
Mitsubishi argued that the franchisee breached its dealer agreement because the franchisee’s sales of Toyota products (which were well known to Mitsubishi) meant that it could not comply with the best efforts clause because “best” is a superlative that allowed no sharing of effort.21 “Best efforts” was not specifically defined in the agreement, but the franchisee was required to “[u]se its best efforts to develop the market for the Products in the APR [area of prime responsibility].”22 Based on how the parties acted, including that the franchisee was repeatedly given annual sales awards for its performance and that the franchisee was in compliance with the annual sales programs established by Mitsubishi, the court found the franchisee had made best efforts.23 Even Mitsubishi’s dealer development manager testified that the term did not have a meaning other than meeting annual marketing plans, despite being used throughout the industry.24

Mitsubishi also argued that the agreement did not provide any exclusive territory because it stated that the franchisee was appointed as “an” (instead of as “the”) dealer in the area of prime responsibility.25 Mitsubishi argued “the use of the word ‘an’ . . . could be read to mean that [franchisee] was appointed as one of the sixty-nine United States distributors of [franchisor] rather than one of potentially many distributors in a particular [area of prime responsibility].”26 The appeals court found the use of “an” to be ambiguous and, looking at parol evidence, found that the trial court was right that the agreement gave the franchisee an exclusive area. The parties had removed a paragraph from the agreement that had been in a predecessor agreement, which stated Mitsubishi could change the area of prime responsibility at any time and appoint more than one dealer to an area. Also, Mitsubishi’s personnel repeatedly assured the franchisee and other dealers that the removal of this paragraph meant the franchisee had exclusivity.27 This, coupled with the facts that Mitsubishi had never appointed a second dealer in an area and had tried to eliminate exclusivity in stalled contract negotiations with the franchisee, showed that the franchisee indeed had exclusivity for its area of prime responsibility and that Mitsubishi breached it.28 While words certainly mattered here, this case also showed that actions matter too and can impact the meaning of the words in an agreement.

In Pro Golf of Florida., Inc. v. Pro Golf of America, Inc.,29 the territory was not disputed,
rather the dispute focused on what the franchisor could do in the territory. The court denied plaintiff franchisee’s motion for reconsideration of the denial of its motion for summary judgment, which asserted that the franchisor violated its exclusive territory with its internet sales that allegedly occurred in the franchisee’s territory.\(^{30}\) The parties’ agreements include language such as:

1. **APPOINTMENT OF DISTRIBUTOR.** PRO GOLF hereby grants to DISTRIBUTOR and DISTRIBUTOR hereby accepts from PRO GOLF a non-exclusive, non-transferable right to utilize the trademarks and trade names “PRO GOLF OF AMERICA”, “PRO GOLF DISCOUNT” or PRO GOLF DISTRIBUTORS” and to receive the services set forth in Paragraph 3 hereof. During the term of this Agreement, PRO GOLF agrees (subject to the terms of Paragraph 12 hereof) that it shall not establish or grant to any other person or entity a distributorship within the Territory defined in Paragraph 2 hereof without the written consent of DISTRIBUTOR. In no event, however, shall PRO GOLF be liable for sales to persons or entities within the Territory made by any other distributor of PRO GOLF, except such as are made directly by PRO GOLF or its employees or agents.

2. **TERRITORY.** The territory covered by this Agreement shall consist of and be limited to the geographical area comprising the City of Brentwood and a fifteen (15) mile radius surrounding the initial store opened by DISTRIBUTOR (the “Territory”). The City of Brentwood is located in the State of Tennessee. The location of the store to be operated by DISTRIBUTOR shall be on the corner of Bakers Bridge Road and Mallory Road. A PRO GOLF distributor is currently operating at 1661 Gallatin Pike North, Madison, Tennessee 37115 (“Existing Store”). DISTRIBUTOR shall not locate a store within the area contained within a twelve (12) mile radius of the Existing Store. PRO GOLF has no obligation to develop, promote or sustain other PRO GOLF distributors in any geographical territory or market including any geographical area surrounding or in proximity to the Territory. The DISTRIBUTOR understands and expressly acknowledges and agrees that PRO GOLF has the unrestricted right to engage directly and indirectly, through its distributors or otherwise in the sale of golf equipment or related products in any geographical area outside the Territory utilizing the trademarks licensed herein or other marks unless specifically restricted by some other written provision of this Agreement. PRO GOLF shall have the right to license other PRO GOLF distributors within the Territory, upon the terms and conditions set forth in Paragraph 12 of this Agreement.\(^{31}\)

The court found that issues of fact existed as to where the internet sales occurred.\(^{32}\) Moreover, the court found the agreements were not ambiguous, because they only barred the

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\(^{31}\) Id. at *4 (emphasis added).

\(^{32}\) Pro Golf Reconsideration supra note 29 at *2.
franchisor from making sales inside their territories or having a distributorship in the territories. The agreements did not bar the franchisor from soliciting business from individuals located in the territories. The franchisee argued on reconsideration that the meaning of “distributorship” encompassed many activities, but the court found this did not change what rights the franchisor retained, which specifically included making sales outside the territory, whether directly or indirectly. Also, the court rejected the argument that the franchisor established a distributorship by sending promotions and ads electronically to an entity in the territory and found that the franchisee did not establish that shipping goods to people in the territory was the same as establishing a distributorship. The court refused to “alter the parties’ agreements by adding words, such as ‘sell,’ or ‘offer to sell’” to the definition of distributorship.

In *Interim Health Care of Northern Illinois, Inc. v. Interim Health Care, Inc.*, there was a similar dispute over what the franchisor could do in the territory. The parties disputed whether the franchisee had an exclusive territory in which only the franchisee could provide the franchised business services (healthcare in this case)—which the plaintiff franchisee contended—or just an exclusive territory in which the only the franchisee could maintain an office—which the defendant franchisor contended. After the trial court granted summary judgment in favor of the franchisor, the franchisee appealed, but the court of appeals affirmed the decision on exclusivity in favor of the franchisor.

The franchise agreement did not use the word “exclusive” in relation to the territory. Rather, at paragraph 1, the agreement stated:

Company hereby grants, and Licensee hereby accepts, for the period, within the area hereinafter described . . . the right and license . . . to operate a temporary help service franchise for the sole purpose of furnishing and supplying individuals or group services of personnel, in office, clerical, nursing, dental and medical occupations. This franchise shall not extend to the operations of a temporary help service in any other occupations or for any other purpose, which is specifically reserved to the Franchisor.

Then paragraph 2 stated:

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33 Id.
34 Id.
35 Id. at *3.
36 Id.
37 Id.
38 225 F.3d 876 (7th Cir. 2000).
39 Id. at 880.
40 Id.
This franchise is for the area described as follows [geographic terms found here] and Company agrees that, as long as Licensee shall not be in default hereunder, neither it nor any person or firm authorized or licensed by it shall establish an office for the purposes heretofore described, within the foregoing area.41

The franchisor argued that, in paragraph 2, the comma between “described” and “within the foregoing area” meant that the phrase “within the foregoing area” modified the entire clause before it and not only the word “purposes.”42 This would mean that the franchisor was prevented only from opening an office that provided healthcare in the franchisee’s territory, and it was still allowed to provide healthcare in the territory.43 Conversely, the franchisee argued that “within the foregoing area” modified the phrase “for the purpose heretofore described.”44 This would mean that the franchisor could not provide healthcare services in her territory, and the franchisee argued this made sense in light of paragraph 1, which allowed the franchisor to provide non-healthcare services in her territory.45 Also, reading these two paragraphs together, the franchisee argued that both parties were left with certain exclusive rights—the franchisee had the exclusive right to provide temporary healthcare services in her territory, while the franchisor had the exclusive right to provide other temporary services in the territory.

The court reviewed law on both intrinsic and extrinsic ambiguity, but ultimately found neither existed. In interpreting clear contract language, the court had to interpret it with its “ordinary and natural meaning” and not delve into the logic of that meaning.46 While the court did not rely on the franchisor’s argument about the comma placement, it did find that the phrase “for the purposes heretofore described” was descriptive and modified the prior word of “office.”47 Reading it together, the language meant that the franchisor could not establish a certain kind of office in the territory.48 Because that is all the language said, and it did not bar the establishment of an office outside the territory, the court reasoned the language meant that the franchisor could provide healthcare services in the territory though from an office outside the territory.49 Critically, “[h]ad the parties wished to wholly restrict the provision of health care in the territory, they could have said so.”50

41 Id. (emphasis in original).

42 Id. at 880.

43 Id.

44 Id.

45 Id.

46 Id. at 879–80.

47 Id. 880.

48 Id.

49 Id. at 880–81.

50 Id. at 881.
The court recognized this was a literal approach and cited supporting case law that used the same approach. The franchisee pointed to another provision of the franchise agreement that stated the franchisor would provide her with national account leads, arguing this was inconsistent with the franchisor being able to do business in her territory. But, the court found this language did not create an exclusive territory as, among other reasons, it did not prevent other franchisees from developing an office outside the territory to provide services in the territory. Moreover, the court rejected the argument that the contract was extrinsically ambiguous on the argument that the home healthcare industry is not location sensitive, so office protection alone would be of little value. The court found this was self-serving and not evidence of objective ambiguity between the language and reality.

Finally, the court rejected the franchisee’s argument that the franchisor acted inconsistently in that it discouraged cross-border servicing of patients by franchisees and even sometimes called for reimbursement when that happened. While that sometimes did happen, at other times it did not, and the option in a contract to take an action does not create an obligation to do so in the future. The court recognized that if a contract was silent on an obligation, but a party does it regularly, that party may assume the obligation. That said, that did not happen here. The contract gave the franchisor the right to provide the services in the territory, but it did not uniformly follow a policy to stop poaching. Also, the contract did not provide an obligation for the franchisor to stop poaching.

These cases show that defining what is meant by and what can happen (or not happen) in an exclusive territory is an important element in creating a franchise or distribution agreement. The parties should think through application of territory provisions and know what would happen in various scenarios. As they do this, the parties will be able to determine if their contract language matches their intent.

3. **Best Practices for Drafting Territory and Exclusivity Rights and Obligations**

The above cases tell us that it is important to spend time and thought drafting territory and exclusivity rights and obligations. Some take-aways are:

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51 Id. at 881.
52 Id.
53 Id.
54 Id.
55 Id.
56 Id. at 882.
57 Id.
58 Id. at 882–83.
59 Id.
• Clearly define the confines and meaning of a territory in terms of geography. Consider whether it is determined by state, by zip code, by population, by town, etc. Also consider how the definition could be interpreted later in various factual situations, and how it might be unclear or ambiguous, so that the drafter can refine the definition.

• Define what actions can and cannot be taken by the relevant parties. Simply having a geographical area defined may not be enough if certain actions are not prevented by franchisor or franchisee.

• Consider whether the business is a location-sensitive business by nature. If not, protections over party actions can be critical to giving effect to geographic restrictions.

Similar to the real estate mantra, territory is about definition, definition, definition. Parties should define the place of the territory and the acts allowed in the territory, in order to have a clear idea of what can or cannot happen in the territory.

B. Non-Competition Provisions

Non-competes are some of the most commonly litigated franchise agreement provisions. While the majority of the decisions addressing the enforceability of non-competes involve the customary analysis of temporal and geographic scope as well as an examination of the scope of prohibited activities, a number of cases turn on the meaning of a single word or phrase contained in a restrictive covenant. Careful drafting would obviate much of this litigation, as would a review of ambiguities that courts have addressed.

Most commonly, disputes arise when the restrictive covenant is silent on, or ambiguous with respect to, questions such as whether the non-compete applies in the case of “termination” and “expiration”; how to define a “competing” or “similar” business; and whether certain non-enumerated activities are encompassed within broader, catch-all terms.


Most post-termination non-competition provisions found in franchise agreements take effect upon the franchise agreement’s “expiration or termination.” Surprisingly, however, a number of non-competition provisions provide that they take effect only upon “termination.” In such instances, a franchisee seeking to evade a non-compete’s enforceability typically argues that, under the plain language of the franchise agreement, the post-termination restriction is not triggered upon expiration of the agreement, while the franchisor argues that “expiration” is one type of termination. When these issues are litigated, the court must determine whether an agreement’s natural end constitutes “termination” for purposes of enforcement of the non-compete. The results are mixed with no defined pattern. Based on the cases analyzed below, however, the simple way to avoid unnecessary litigation is to state that the post-termination non-competition provision takes effect upon “expiration or termination, for any reason.”
In *Naturalawn of America, Inc. v. West Group, LLC*, a former franchisee argued that the post-termination non-competition provisions in its franchise agreements should not be enforced because they were operable only upon “termination” of the franchise agreements, and not where the franchise agreements ended by their “expiration.” Examining the plain and ordinary meaning of the terms “termination” and “expiration,” the court summarily rejected the franchisee’s claimed distinction, explaining that “an ‘expiration’ of an agreement is a more specific type of ‘termination.’” The court pointed to the fact that the franchise agreements provide that the non-compete provisions would apply after termination “for any reason,” and concluded that, “[c]learly, ‘expiration’ is one reason for the ‘termination’ of an agreement.” The court declined to “bend over backwards to distort the plain meaning of these everyday terms” to find an ambiguity which would allow it to construe the franchise agreement against the drafter.

Several years later, however, the court in *Hamden v. Total Car Franchising Corp.* found that the term “termination,” as used in the franchise agreement did “not encompass expiration.” The franchise agreement in *Hamden* contained a post-termination non-competition provision that prohibited the franchisee from competing with the franchisor “[f]or 2 years following the termination of” the franchise agreement. The franchisee filed a declaratory judgment action seeking a declaration that the restrictive covenant did not apply where the franchise agreement had expired.

The Fourth Circuit defined the issue as “whether termination encompasses the expiration of the Franchise Agreement at the end of its fifteen-year term.” Relying primarily on *Naturalawn*, the franchisor argued that the court could answer this question by a straightforward application of dictionary definitions and case law that find no difference between the terms.

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60 484 F. Supp. 2d 392 (D. Md. 2007).

61 *Id.* at 401.

62 *Id.*

63 *Id.* (emphasis in original).

64 *Id.*

65 *Id.*

66 548 F. App’x 842 (4th Cir. 2013).

67 *Id.* at 849.

68 *Id.* at 844.

69 *Id.* at 845.

70 *Id.* at 846.

71 The court explained that *Naturalawn* and other cases cited by the parties hold “limited persuasive value because not all contracts use the same terms in the same manner. Unlike the contract in *Naturalawn*, no covenant [that franchisee] attempts to enforce explicitly purports to apply upon termination.” *Id.* at 847.
“terminate” and “expire,” or the court could apply the “expansive definition” of “termination” that franchisor believed the franchise agreement presented as a whole.\textsuperscript{72} Although the court agreed with the \textit{NaturaLawn} court that in the “lexicological sense, termination would include expiration,” as the expiration is a “type of termination,”\textsuperscript{73} the court’s analysis did not end there.\textsuperscript{74}

The court went on to examine the franchise agreement as a whole, finding “support for the notion that termination correlates to an affirmative act,” and, thus, the terms “expiration” and “termination” as used in the franchise agreement at issue were “distinct.”\textsuperscript{75} The court examined the use of the terms “termination” and “expiration” in the franchise agreement and found, based upon the provisions in which “termination” and “expiration” appeared, that “termination” occurs automatically upon the happening of certain enumerated events, while “expiration” occurs upon the natural end of the term.\textsuperscript{76} The court explained that none of the events causing a termination of the agreement were the natural end of the term.\textsuperscript{77} Thus, the court concluded, the franchise agreement’s “failure to indicate that termination arises passively through expiration,” which it recognizes as a separate event, “indicates that expiration does not trigger the restrictive covenants.”\textsuperscript{78} The court therefore refused to enforce the restrictive covenants upon the expiration, or natural end, of the terms of the franchise agreements.\textsuperscript{79}

2. \textbf{What is a “Competitive Business”?}

Although it may seem obvious, a careful practitioner should define what most persons would assume are commonly known terms in non-competition provisions. For example, in \textit{Little Caesar Enterprises, Inc. v. Rooyakker},\textsuperscript{80} the appellate court found the trial court had erred by failing to define a “sandwich” to encompass a “grinder” (described on the franchisee’s menu as an “oven-baked sandwich”) when interpreting the franchise agreement and settlement agreement.\textsuperscript{81} The court explained that the dictionary definition of “sandwich” is “two or more slices

\textsuperscript{72} Id. at 846.

\textsuperscript{73} Id.

\textsuperscript{74} Id. at 847.

\textsuperscript{75} Id.

\textsuperscript{76} The court cited to \textit{Clinch Valley Physicians, Inc. v. Garcia}, 243 Va. 286, 286–89, 414 S.E.2d 599, 600–01 (1992), where the Supreme Court of Virginia found a non-competition provision inapplicable to renewal where the provision indicated is applicability to termination “for any reason whatsoever.”

\textsuperscript{77} Hamden, 548 F. App’x at 847.

\textsuperscript{78} Id.

\textsuperscript{79} Id. at 850–51.


\textsuperscript{81} Id. at *7.
of bread or the like with a layer of meat, fish, cheese, etc., between them,"\textsuperscript{82} and further explained that neither the franchise agreement nor the settlement agreement limits the word “sandwich” to specific types of sandwiches.\textsuperscript{83} The court therefore found that the trial court erred in finding that “while a grinder is ‘technically’ a sandwich, it was not contemplated in the provision limiting sales of sandwiches.”\textsuperscript{84}

A court was again asked to interpret the meaning of a “sandwich” in \textit{E&G Franchise Systems, Inc. v. Janik},\textsuperscript{85} where a franchisor moved for a preliminary injunction to preliminarily enjoin a former franchisee’s operation of a “competitive business.” The franchise agreement defined the term “competitive business” as “any quick service restaurant that derives more than 50% of its revenue from the sale of sandwiches.”\textsuperscript{86} The franchisor claimed the franchisee violated the non-compete by operating a restaurant that served sub sandwiches, wraps, paninis and salads.\textsuperscript{87} The franchise agreement did not define the term “sandwiches,” and the parties disputed whether wraps, paninis and sub sandwiches containing hot items constituted “sandwiches” under the non-compete provision.\textsuperscript{88} The franchisor relied on the dictionary definition of a “sandwich,” as “two or more slices of bread or a split role [sic] having a fill[l]ing in between.”\textsuperscript{89} The franchisor also argued that a “wrap” is a “kind of sandwich.”\textsuperscript{90}

The former franchisee, on the other hand, disputed the franchisor’s definition of “sandwich,” arguing that it should include only those sandwiches the former franchisee sold while operating the franchised restaurant.\textsuperscript{91} The former franchisee argued that at the time the parties entered into the franchise agreement, “the only sandwiches the parties could have intended to refer to were the only entrees” the franchise offered—“cold sub-sandwiches.”\textsuperscript{92} The court found the meaning of “sandwiches” as used in the non-complete to be a question of fact that could not be determined even on a preliminary basis based on the limited record before the court.\textsuperscript{93}

\begin{footnotes}
\item[82] Id.
\item[83] Id.
\item[84] Id.
\item[86] Id. at *2.
\item[87] Id. at *4.
\item[88] Id.
\item[89] Id. at *6.
\item[90] Id.
\item[91] Id.
\item[92] Id.
\item[93] Id. at *7.
\end{footnotes}
In *Bennigan’s Franchising Co. v. Swigonski*, the court was required to examine the meaning of “casual dining.” There, the court found a non-compete to be overly broad in scope of restricted activity, where it prohibited the former franchisees from “operating or having any involvement with ‘any casual dining or other restaurant business . . . that is in any way competitive with or similar to a Bennigan’s Restaurant.’” The court refused to enforce the non-compete primarily because the franchise agreement did not define the term “casual dining.” While the franchise agreement contained a list of restaurants that would apparently qualify as “casual dining,” the court explained, “there does not seem to be a common thread binding all the examples together.” The court denied the franchisor’s motion for preliminary injunction in large part because “the covenant prohibits the defendants from operating a ‘casual dining’ restaurant without defining the term or providing a means to determine its definition by applying recognized canons of construction.”

*Northglenn Gunther Toody’s, LLC v. Melody Lane, LLC,* dealt with a restrictive covenant contained in a shopping center ground lease, which plaintiff’s predecessor and the landlord executed in 1998. The lease permitted Gunther Toody’s to use its premises for a “diner-style, full-service restaurant with a liquor license.” The ground lease contained a restrictive covenant prohibiting the landlord from leasing or selling any portion of the shopping center “for usage as a diner similar in concept to the operation conducted from the Leased Premises by Tenant.” Gunther Toody’s and its predecessor operated a 1950’s-style diner from the premises. In 2016, the landlord executed a lease with a franchisee of the International House of Pancakes, which permitted the franchisee to operate a “a full-service sit-down restaurant serving breakfast food and related beverages as the primary menu item, which is identified as selling 40% or greater of gross sales towards breakfast food and related beverages.” Gunther Toody’s filed a lawsuit

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94 *Id.*


96 *Id.* at *3.

97 *Id.* at *3–4.

98 *Id.*

99 *Id.* at *4.


101 *Id.* at *2.

102 *Id.*

103 *Id.*

104 *Id.*
and, among other relief, sought an injunction prohibiting the landlord from leasing to IHOP.\textsuperscript{105} The court initially denied Gunther Toody’s motion for preliminary injunction, finding that Gunther Toody’s interpretation—that the landlord could not lease the premises to \textit{any} diner—would render superfluous the phrase “similar in concept” to the Gunther Toody’s restaurant at issue.\textsuperscript{106} The Tenth Circuit affirmed the denial of the motion for preliminary injunction, stating that Colorado law required the court to give effect to every relevant provision, and that by ignoring the language “similar in concept” to Gunther Toody’s would improperly broaden the restrictive covenant to preclude the operation of any “diner,” not just a “diner similar in concept to” Gunther Toody’s.\textsuperscript{107}

After construing the language of the restrictive covenant, the district court entered summary judgment in favor of the landlord.\textsuperscript{108} The court first adopted the definition of “diner” put forth by Gunther Toody’s experts, as “a table service restaurant with a broad array of breakfast, lunch, and dinner offerings, most of which are perceived as American cuisine.”\textsuperscript{109} The landlord did not contest whether IHOP was a diner.\textsuperscript{110} The district court rejected Gunther Toody’s argument that “diner similar in concept to” Gunther Toody’s meant essentially all diners, and found that Gunther Toody’s forfeited any counterargument against IHOP’s claim that no reasonable jury could find the IHOP restaurant to be a diner similar in concept to the Gunther Toody’s restaurant.\textsuperscript{111}

In \textit{Lawn Doctor, Inc. v. Rizzo},\textsuperscript{112} Lawn Doctor and a former franchisee entered into a consent injunction that prohibited the former franchisee from engaging in a “competitive business” as that term was defined in the franchise agreement.\textsuperscript{113} The franchise agreement defined the term “Competitive Business” as “[a]ny business which operates, or grants franchises or licenses to others to operate, a business for the establishment, care and conditioning of lawns or other vegetation or any related or ancillary services, including, but not limited to, trees, shrubbery and other plant life.”\textsuperscript{114} A dispute arose between the parties as to whether “irrigation services” fell within the definition of “Competitive Business” and, therefore, whether the defendants had violated

\textsuperscript{105} \textit{Id.} at *3.
\textsuperscript{106} 2016 WL 6569099, at *3 (D. Colo Nov. 4, 2016) \textit{aff’d}, 702 F. App’x 702 (10th Cir. 2017).
\textsuperscript{107} Northglenn Gunther Toody’s, LLC, 702 F. App’x at 707.
\textsuperscript{109} \textit{Id.} at *7.
\textsuperscript{110} \textit{Id.}
\textsuperscript{111} \textit{Id.} at *9.
\textsuperscript{112} No. 12–1430 (TJB), 2017 WL 4810000 (D.N.J. Oct. 25, 2017).
\textsuperscript{113} \textit{Id.} at *1.
\textsuperscript{114} \textit{Id.}
In ruling on Lawn Doctor’s motion for sanctions, the magistrate judge recounted the district court’s determination that “an irrigation services business is a Competitive Business prohibited by the parties’ settlement agreement.” In reaching this conclusion, the district court explained, “[i]rrigation services are not tangentially related to the ‘establishment, care and conditioning of lawns.’ Instead, they clearly fall within the plain and ordinary meaning of those terms,” even though irrigation services are not mentioned in the franchise agreement and the defendants never provided irrigation services when they were Lawn Doctor franchisees.

3. “Primarily” Engaged in a Competitive Business

Non-competition provisions regularly restrict former franchisees from being engaged in the operation of a business that is “primarily” engaged in certain activities “similar” to the franchised business. Problems commonly arise where the franchise agreement does not define what the parties meant by “primarily,” “similar,” or like terms, thereby leaving it up to the court to determine what those terms mean.

For example, while the non-competition provision in Little Caesar Enterprises, Inc. v. Rooyakker prohibited the former franchisee from being “primarily” engaged in the sale of “pizza, pasta, sandwiches, and/or related products,” the franchise agreement did not define the term “primarily.” Little Caesars sought injunctive relief and money damages resulting from the former franchisee’s alleged breaches of franchise agreements, a settlement agreement, and personal guarantees. Little Caesars alleged that the former franchisees had breached the non-compete, which prohibited them being engaged in “a quick or fast service restaurant primarily engaged in the sale of pizza, pasta, sandwiches, and/or related products.”

The franchise agreements’ failure to define the term “primarily” left it to the court to determine its meaning. The court first looked to the plain and ordinary meaning of “primarily,”

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115 Id.
116 Id. at *2.
117 Id.
119 Id. at *1.
120 Id.
121 Id. at *2.
122 Id. at *6 (emphasis added).
123 Id.
which it determined to be “essentially; chiefly,” by referring to the word’s dictionary definition.\textsuperscript{124} Given this plain and ordinary meaning, the court explained, the restricted items of pizza, pasta, sandwiches, and/or related products, “could not be the chief items sold at the restaurants.”\textsuperscript{125} This, the court explained, “provides an objective, not discretionary, standard of performance.”\textsuperscript{126}

The court next found that an ambiguity existed because the franchise agreements and settlement agreement did not instruct how sales of the offending products were to be measured to determine whether the former franchisee was “primarily” engaged in the sale of offending products.\textsuperscript{127} Were sales to be based on revenues received from sales of the offending items? Or based on the number of items sold? Or possibly both?\textsuperscript{128} The court again looked to the dictionary, and found that “primary” means “first in rank or importance.”\textsuperscript{129} The court, however, found that this meaning still did not provide any instruction as to whether the appropriate measure should be based on sales revenues, the number of items sold, or both.\textsuperscript{130} The court first rejected the trial court’s finding that the appropriate consideration was the “primary or dominant [menu] items available in the restaurants, without consideration of actual sales activity.”\textsuperscript{131} While the court explained that it “may supply the missing details for measuring sales by construction,”\textsuperscript{132} it found that unnecessary in this case, because regardless of which standard the court applied, the evidence showed that pizza, pasta and sandwich sales “were the primary or dominant items,” given that pizza sales alone comprised over fifty percent of gross sales.\textsuperscript{133}

Because the former franchisees’ pizza sales alone exceeded fifty percent of gross sales, the court was able to resolve the dispute without supplying the missing details required to measure sales, and Little Caesars prevailed without the court construing additional contract terms.\textsuperscript{134} However, not every dispute is as clear-cut as \textit{Rooyakker}. Therefore, in drafting non-competes, practitioners should anticipate closer calls than presented in \textit{Rooyakker} to avoid court construction, for example, where a prohibited menu item is just one of dozens on the menu, but comprises a significant (but less than 50%) portion of a former franchisee’s gross sales. To do

\textsuperscript{124} Id.
\textsuperscript{125} Id.
\textsuperscript{126} Id.
\textsuperscript{127} Id. at *7.
\textsuperscript{128} Id.
\textsuperscript{129} Id.
\textsuperscript{130} Id.
\textsuperscript{131} Id. (emphasis in original).
\textsuperscript{132} Id. (citing Nichols v. Seaks, 296 Mich. 154, 159, 295 N.W. 596, 598 (Mich. 1941) (“So long as the essentials are defined by the parties themselves, the law supplies the missing details by construction.”)).
\textsuperscript{134} Id.
this, practitioners should include objective standards of measurement courts should apply to
determine whether a franchisee has breached the non-compete. Possible standards of
measurement include (i) the number of prohibited menu items offered for sale in relation to
permitted menu items, (ii) the number of sales of prohibited menu items in relation to the number
of sales of permitted menu items, and (iii) the revenue generated from prohibited menu items
compared to the revenue generated from sales of permitted menu items.

4. Other Prohibited Activities

While all nearly non-competition provisions contain language prohibiting a former
franchisee from “competing” with the franchisor, engaging in a “competitive business,” or selling
certain enumerated “competitive” products or providing “competing services,” the absence of a
prohibition on specifically enumerated activities—such as leasing or subleasing real estate or
selling a former franchised business on an installment sales contract to a competitor—could
cause otherwise unnecessary litigation.

For example, in Gallagher’s NYC Steakhouse Franchising, Inc. v. 1020 15th Street, Inc., a franchisor sought the imposition of contempt sanctions against a former Gallagher’s franchisee who was subject to a preliminary injunction prohibiting him from “operating” a similar business; “directly or indirectly engaging in any other steakhouse restaurant business;” and “utilizing any device for the purpose of circumventing” or avoiding the injunction. While the franchisor admitted there was insufficient evidence to show that the former franchisee was directly or indirectly “operating” a business that violated the court’s order, the franchisor argued that the franchisee’s former employee was “working in concert” with the franchisee by operating from the former franchised premises a similar steak restaurant with a nearly identical menu as the former franchised restaurant. The franchisor also claimed the former franchisee was “indirectly engaged” in a steakhouse restaurant business by leasing his former franchised premises to his former chef, who operated a steak restaurant from the premises.

The court, however, disagreed. The court found no evidence that the former franchisee was acting in concert with his tenant, and concluded that “the mere leasing of property to a competitor does not violate the terms of the non-compete clause signed by the parties.” Importantly, the court noted that “Plaintiff could have included language in the Franchise Agreement prohibiting the franchisee from leasing property to a competitor, but did not do so.” The lesson here is that a franchisor should be sure to include all desired prohibited activities in a non-competition provision, and not rely on the standard catch-all prohibition of “direct or indirect” engagement in a competitive business.

136 Id. at *1–2.
137 Id. at *4.
138 Id. at *5.
139 Id. at *6.
140 Id.
In contrast, in *Victory Lane Quick Oil Change, Inc. v. Darwich*, the court held that a former franchisee was "connected with," had an "interest in," or "assist[ed] any person or Entity engaged in any Competitive Business," when it permitted a competing oil change business to operate at the former franchised premises, where the former franchisees remained the tenant under the lease because the landlord would not transfer the lease to the competitive business.

The *Rooyakker* decision, discussed in part above, is also instructive here. In *Rooyakker*, the court had to determine whether a former franchisee’s installment sales contract for the sale of its business entered into with a family member who purchased the business constituted a "loan" to "a quick or fast service restaurant" and, therefore, prohibited by the non-competition provision in the Little Caesar franchise agreement. Although the trial court found that the installment sales contract did not constitute a "loan," the appellate court disagreed. The appellate court explained that the word "loan" in the franchise agreement “is not defined in accordance with any "technical tax consequences of the transaction," nor was there evidence that the word "loan" has "any peculiar meaning for franchise transactions."

Given this, the appellate court explained that, in determining whether the arrangement constituted a prohibited loan, the trial court “should have applied the plain and ordinary meaning of the language. It should have looked to the substance of the sale of assets agreement, and not how it might be treated for tax purposes, in determining whether it was a ‘loan,’ directly or indirectly, within the meaning of the franchise agreement.” The appellate court examined the common meaning of the terms “loan” and “sale,” as well as the meaning of the phrase “installment sales contract,” and found that because the sale at issue required payments in installments, it “ha[d] characteristics of a loan, where interest is paid for the temporary use of money.” Thus, the court concluded that the trial court erred in finding that the former franchisee did not breach the non-competition provision by structing the transaction as it had.

5. **Best Practices for Drafting Non-Competes**

Based upon the cases above, the authors suggest the following best practices to avoid litigating an arguably ambiguous non-competition agreement, or one that may be found by a court to be overly broad in scope:

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142 Id.


144 Id. at *11.

145 Id. at *10.

146 Id.

147 Id. at *11.

148 Id.
• Make clear that the post-termination non-competition restrictions apply in the event of termination or expiration of the franchise agreement for any reason.

• If the non-compete restricts a franchisee from engaging in a business that is “primarily” engaged in the franchised business, define what is meant by “primarily” by referring to an objectively identifiable standard, such as gross revenues or number of menu items.

• Specifically define “similar” or “competing” businesses in the franchise agreement using detailed, objective standards.

• Do not leave it up to a court to define restricted products or activities. Define terms that may even have common meanings, such as "sandwich." For example, consider whether the term “sandwich” includes deli-style sandwiches, submarine sandwiches and grinders, hot and cold sandwiches, or wraps.

To avoid a court either refusing to enforce an ambiguous non-compete or supplying missing details, franchisors should carefully consider and precisely spell out the conduct they seek to prohibit, define key terms—even those with commonly-known meanings—and provide the court with detailed, objectively identifiable standards.

C. Renewal

Renewal provisions are critical for franchisees. Therefore, if the franchisor makes a unilateral decision not to renew a franchise agreement, franchisees often turn to the courts for relief. Most commonly, disputes arise when the renewal provision does not comport with state contract law, when default provisions that would prevent renewal are ambiguous, and when boilerplate language is not carefully reviewed to ensure its applicability to the circumstances of each franchisee.

1. Perpetual Contracts Can Be Disfavored

Drafters of franchise agreements must be cognizant of the nuances of contract law in the jurisdiction whose law applies to the agreement. For example, Missouri law disfavors perpetual contracts, and at least two courts held that under Missouri law, franchisors did not breach their franchise agreements by declining to renew franchise agreements with perpetual renewal clauses.149

The franchise agreements at issue in H & R Block Tax Services LLC v. Franklin150 allowed the franchisor to terminate for cause and the franchisee to terminate at the end of any term with 120 days written notice, but otherwise the franchise agreements would “automatically renew [] for

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150 691 F.3d 941.
successive five-year terms."\textsuperscript{151} H & R Block notified the franchisee of its intention not to renew the franchise agreements upon the expiration of a five-year renewal term, then sought a declaratory judgment that it could terminate the agreements.\textsuperscript{152} The parties moved for summary judgment, and the district court granted summary judgment in favor of the franchisee because the franchise agreements were enforceable under Missouri law.\textsuperscript{153} The district court then certified the issue of whether the franchise agreements were perpetually enforceable under Missouri law for interlocutory appeal.\textsuperscript{154}

The Eighth Circuit began its analysis by finding that Missouri substantive law applied to the franchise agreements and that under Missouri law, courts "will only construe a contract to impose an obligation in perpetuity when the language of the agreement compels that construction," such that the parties' intention that the 'contract's duration is for life . . . is clearly expressed in unequivocal terms."\textsuperscript{155} Acknowledging that the practical effect of the franchise agreements would be to create a perpetual contract, the appellate court identified the dispositive issue to be "whether the contracts' language unequivocally expresses the parties' intent that the agreements be perpetually enforceable."

H & R Block argued that the franchise agreements were terminable "because they do not include any language concerning duration, other than the five-year renewal provisions." The franchisee, on the other hand, claimed that the parties' intent to create perpetually enforceable contracts can be clearly implied from the terms of the franchise agreements, because they give the franchisee the right to terminate without cause, but do not afford the franchisor a similar right.\textsuperscript{157} In reversing the district court, the Eighth Circuit found the franchise agreements lacked express language that the parties intended to create a perpetual contract, such as the use of the word "perpetual."\textsuperscript{158} The court further found that the automatic renewal clause actually "contradicts an intention that the contract would last forever," because 'a contract that runs forever has no need for renewal.'\textsuperscript{159}

Virtually the same issue was presented in \textit{H & R Block Tax Services, LLC v. Strauss},\textsuperscript{160} where the question presented was whether the renewal provision in a franchise agreement stating

\textsuperscript{151} \textit{id.} at 943.

\textsuperscript{152} \textit{id.}

\textsuperscript{153} \textit{id.}

\textsuperscript{154} \textit{id.}

\textsuperscript{155} \textit{id.} at 944 (citing Paisley v. Lucas, 346 Mo. 827, 143 S.W.2d 262, 271 (1940)).

\textsuperscript{156} \textit{id.} at 943 (emphasis original).

\textsuperscript{157} \textit{id.} at 944–45.

\textsuperscript{158} \textit{id.} at 945.

\textsuperscript{159} \textit{id.} (internal citations omitted).

\textsuperscript{160} No. 1:15-CV-0085 (LEK/CFH), 2017 WL 395119 (N.D.N.Y. Jan. 27, 2017).
“this Agreement shall be automatically renewed for successive Renewal Terms” was enforceable under Missouri law. Citing Franklin and relying on the same reasoning for a substantially similar franchise agreement, the district court held the perpetual renewal clause to be unenforceable under Missouri law, and, therefore, H & R Block did not breach the franchise agreement by electing not to renew.161

2. **Ambiguous Default Provisions**

Renewal provisions in franchise agreements are routinely conditioned upon the franchisee not being in default of any terms in the franchise agreements. Issues can arise when certain defaults are not well defined. For example, the primary issue in *Sioux Falls Pizza Co., Inc. v. Little Caesar Enterprises, Inc.*,162 was whether the franchisor could elect not to renew the franchise agreements due to the franchisee’s alleged default.

The franchise agreements at issue required that, to be entitled to renewal, the franchisee must “not be in default of any provision of this Agreement, any amendment hereof or successor hereto, or any other agreement between Franchisee and Little Caesar or its affiliates, and . . . shall have substantially and timely complied with all the terms, conditions and obligations of such agreements during the terms thereof . . . .”163 The franchisor argued that the term “such agreements” in the renewal provision means “the franchise agreements, amendments thereto and any other ancillary agreement between” the parties because it refers to those agreements that are referenced earlier in the sentence.164 The franchisee, however, claimed that “such agreements” referred to “agreements other than the franchise agreements” because earlier in the sentence at issue, the franchise agreements used the defined term “Agreement” to refer to the franchise agreement.165

The district court found the “ordinary and plain meaning” of the term “such agreements” in the renewal provision referred to the agreements set forth in the immediately preceding clause, which included the franchise agreements, amendments thereto, and any other ancillary agreement between the parties.166 Because in prior litigation, a court had found that the franchisee breached the franchise agreements, the court in *Sioux Falls* held that the franchisee did not substantially and timely comply with the terms of the franchise agreements and, therefore, was not entitled to renewal.167

161 *Id.* at *8.


163 *Id.* at 1057.

164 *Id.* at 1060.

165 *Id.*

166 *Id.* at 1061.

167 *Id.* at 1062.
3. **Extension of Lease vs. New Lease**

Issues can arise when boilerplate provisions contained in a franchise agreement are not modified to fit the circumstances of each specific franchisee. For example, in *5 & Diner of North America, LLC v. Wadsworth Jordan Crossing, LLC*, the franchise agreement provided that its term would be automatically extended if a lease for the franchise location is “extended, renewed, or otherwise lengthened” during the term of the franchise agreement. In 1998, during the term of the franchise agreement, the franchisee sold the real estate from which the franchised business operated and entered into a twenty-year lease with the new owner. Years later, business had declined, and in 2015, the franchisee and a new owner entered into a lease amendment to accelerate the expiration of the lease close to three years, to 2018. According to the court, the landlord “terminated” the lease pursuant to the amendment.

After the lease expired, the franchisor brought an action for tortious interference with contract against the landlord, arguing that the 1998 lease “automatically extended” the franchise agreement to equal the term of the lease, and that the termination of the lease constituted tortious interference. The franchisor argued that the franchisee’s entering into the lease 1998 “automatically extended” the term of the franchise agreement. The landlord argued that the term would be extended only upon the extension or renewal of a lease, and that obtaining a new lease constitutes neither an extension nor a renewal. The court agreed with the landlord, explaining that the franchise agreement contemplated only an “extension” or “renewal” of an existing lease, and that the franchise agreement “says nothing about ‘initiating,’ ‘executing,’ commencing,’ or ‘entering into’ a lease.” Accordingly, because the franchise agreement had not been extended when the franchisee entered into the lease, it expired in 2015, and there was no contractual relationship with which the landlord could have interfered.


Based upon the cases above, the authors suggest the following best practices to avoid litigating an arguably ambiguous renewal provision, or one that may require a court’s

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169 *Id.* at *3.

170 *Id.* at *1.

171 *Id.*

172 *Id.*

173 *Id.*

174 *Id.* at *2.

175 *Id.*

176 *Id.* at *3.

177 *Id.* at *3.*
interpretation:

- Understand the nuances of state contract law governing the franchise agreement, especially if the agreement allows for perpetual renewal.

- Carefully review boilerplate language contained in franchise agreements to ensure the parties are not subject to unusual circumstances that could alter the intended effect of certain terms.

D. Termination

While every word of a franchise or dealer agreement can be fodder for disputes, the stakes are seldom higher—and the incentive to exploit arguable ambiguities greater—than when a party has invoked (or challenged the invocation of) termination provisions. With end-of-relationship consequences in the balance, and tensions or tempers high, termination cases reinforce the value of “clean” drafting and impeccable wording and phrasing.

1. Leaving the Triggers for Termination to Chance and Discretion

Termination fights can turn on the meaning of a single word, as demonstrated by In LC Franchisor, LLC v. Valley Beef, LLC. The franchise agreement at issue in that case defined neither “insolvent” nor “insolvency,” yet provided for immediate termination upon the occurrence of the franchisee’s insolvency. The omission of these definitions is particularly notable given the franchisee’s history, having emerged from bankruptcy to enter the franchise agreement at issue—with which the franchisee agreed to “periodically deliver to [franchisor] financial reports and information, including but not limited to, consolidated balance sheets and income statements.”

If past performance is any indicator or future success, the first three operating statements after entering the franchise agreement “showed a deficit” between “total assets” and “total liabilities.” Shortly thereafter, the franchisor sent a notice of “immediate termination of the Franchise Agreement,” contending that the franchisee was “insolvent.” The franchisee, of course, disputed the franchisor’s declaration of insolvency, and litigation ensued—as it does.

Neither the franchisor nor franchisee contended that the termination provision was ambiguous, yet they each disagreed over the meaning of “insolvency” and offered different definitions. The franchisor claimed that insolvency occurs when “liabilities exceed . . . assets”; the franchisee contended that “mere reliance on a balance sheet is improper, and that a debtor is insolvent if the sum of its debts is greater than all of its property, fairly valued” as a business


179 Id. at *6–7.

180 Id. at *1.

181 Id. at *3.

182 Id. at *4

183 Id. at *6–7
“prior to termination”—arguing, instead, that insolvency means “an inability to pay debts as they become due in the ordinary course of business.”\textsuperscript{184} The franchisee’s argument was not without its merit, as Missouri law (which expressly governed the franchise agreement) provided for “at least two definitions of ‘insolvent.’”\textsuperscript{185} The court, however, ultimately adopted the franchisor’s definition because a promissory note executed contemporaneously included as events of default both “becoming ‘insolvent’” and, separately, “being ‘unable’ or ‘fail[ing] generally to pay its . . . debts as they become due.’”\textsuperscript{186} Accepting the franchisee’s definition of “insolvent” as failure or inability to pay debts as they fall due would have rendered the separate “event of default” within the note both duplicative and meaningless. “Insolvent,” then, was held to mean “having debts greater than the entity’s property at fair value,” and the termination was valid.\textsuperscript{187}

The inclusion of a word can also fundamentally alter how a termination provision is interpreted and applied, injecting subjectivity and complicating the threshold for a proper termination. A recent episode in a multi-year saga of litigation and arbitration both illustrates this point and serves as a caution against custom-tailored provisions with mandatory arbitration, because judicial review of arbitration awards is so limited. The License Agreement at issue in Benihana, Inc. v. Benihana of Tokyo, LLC\textsuperscript{188} provided for termination in Article 13.1, as follows: “If this Agreement shall be terminated by [franchisor] and [franchisee] shall dispute [franchisor’s] right of termination, or the reasonableness thereof, the dispute shall be settled by arbitration . . . .”\textsuperscript{189} A divided arbitration panel of three interpreted this “reasonableness” qualifier as requiring a fact-specific, two-part inquiry to determine whether the franchisor could ever terminate the franchisee:

> Article 13.1 . . . require[s] a panel considering whether termination was justified to make two distinct inquiries:

> . . .

> (1) whether [franchisor] had a basis to terminate under the agreement; and, if so,

> (2) whether [franchisor’s] termination decision was “reasonable” (\textit{which the panel construed, based on its ordinary meaning, to mean “fair”}).

> . . .

> Thus, . . . \textit{no matter the magnitude of any breach}, [the franchisor’s] termination of the License Agreement \textit{must also be found reasonable by the arbitrators}, if [the franchisee], as here, contests the reasonableness of the termination.\textsuperscript{190}

After a 2-to-1 vote by the arbitration panel overturned [the franchisor’s] termination of the License

\textsuperscript{184} \textit{Id.} (emphasis added).

\textsuperscript{185} \textit{Id.}

\textsuperscript{186} \textit{Id.} at *9–10 (alteration in original).

\textsuperscript{187} \textit{Id.} at *9.

\textsuperscript{188} No. 15 Civ. 7428 (PAE), 2016 WL 3913599 (S.D.N.Y. July 15, 2016).

\textsuperscript{189} \textit{Id.} at *7 (emphasis added).

\textsuperscript{190} \textit{Id.} at *7 (emphasis added).
Agreement, the franchisor petitioned the U.S. District Court for the Southern District of New York to vacate it, in part.\footnote{Id. at *1 (emphasis added).}

The court concluded that the arbitration panel’s “construction” of Article 13.1, governing termination, was “beyond the scope of judicial review. Notwithstanding the following bases for termination advanced by the franchisor, the district court concluded it could not overturn the arbitration panel’s decision that the following were not “reasonable” bases on which a termination could be based:

i. Selling hamburgers, which were not an authorized menu item, repeatedly after notice of breach and demands to stop selling them under various names—even following an adverse court ruling that franchisee “appeared to be in breach . . . by selling hamburgers.”\footnote{Id. at *4.} Notwithstanding the dissenting arbitrator’s argument that “It is hard to conjure up a more serious breach of what is essentially a franchise restaurant . . . than the repeated, intentional and continuous sales of unapproved menu items”;\footnote{Id. at *15.}

ii. “Use, without notice to or approval by [franchisor], of various advertising, signs, and decorations”;\footnote{Id. at *4.}

iii. “Failing to give [franchisor] [franchisee’s] gross sales information and to spend 2% of gross sales on advertising, as the License Agreement required.”\footnote{Id.}

The divided panel concluded that franchisee’s breaches were “serious enough to be material but not serious enough to warrant termination of the License Agreement is internally contradictory.”\footnote{Id. at *9.} For example, the panel reasoned that “while the sale of hamburgers was “a continuing breach, . . . it only lasted four months and there was no evidence that it harmed the brand in any way.”\footnote{Id. at *15 (emphasis added).}

The district court was clear that “were this Court resolving this case as an original matter, it has no doubt . . . that given the severity, recurrence, and number of [franchisee’s] breaches, it would have upheld as reasonable [franchisor’s] decision to terminate the License Agreement.”\footnote{Id. at *15 (emphasis added).} Despite the “panel’s analysis” being “problematic or questionable in various respects,” and presenting a “genuinely close question giving “considerable cause,” the highly deferential and limited scope of judicial review precluded correction of the decision with which the court substantively disagreed.\footnote{Id. at *24; see also Benihana of Tokyo, LLC v. Angelo, Gordon & Co., 259 F. Supp. 3d 16 (S.D.N.Y. 2017).}
industry. However, special arrangements to reflect unique circumstances or account for a longstanding relationship can easily clash with form agreements or be challenging to reconcile with their content and structure. The result may be written text of a modified agreement that does not definitively reflect the understanding of either party’s business representatives. The dispute of Two Locks, Inc. v. Kellogg Sales Co., illustrates a disconnect between the written distribution agreement’s term and termination provisions (enforced by the manufacturer), against the competing understanding offered by the distributor. At issue were two provisions, which the U.S. District Court for the Eastern District of New York was required to reconcile:

i. Section 2, titled “Term of Agreement,” provided: “Subject to Section 12 of this Agreement, this Agreement shall become effective as of the date hereof and shall continue until December 31, 2010, and shall continue in effect until either party terminates this agreement by providing the other party with written notice of termination at least ninety (90) days prior to such termination. . . . After December 31, 2009, this Agreement may be terminated by either party upon ninety (90) days written notice effective on the date set forth in the notice, or until terminates in accordance with paragraph 12 herein.”

ii. Section 12, titled “Termination,” “This Agreement may be terminated by either party at any time upon ninety (90) days written notice to the other for good cause (defined as either party’s breach of this Agreement which is not cured within those times specified below) or a change in [Manufacturer’s] business that results in [Manufacturer’s] no longer using Independent distributors in this territory, with the date of termination to be set forth in the notice or by mutual agreement.”

The distributor claimed that Section 12 controlled the termination rights in Section 2, meaning that the Agreement could not be terminated—even on 90 days’ notice—without either “good cause” or a total cessation of the independent distributor model in the applicable territory, neither of which was contended. The court rejected this view, applying a number of maxims of New York contract law: i) “[a]n interpretation of a contract that has the effect of rendering at least one clause superfluous or meaningless is not preferred and will be avoided if possible”; and ii) “[w]here one interpretation is broader than another, courts should not apply the broader interpretation absent a clear manifestation of intent.” Although the court noted “that at first blush, both parties’ interpretations appear plausible,” it ultimately determined that the Agreement was not ambiguous, as a matter of law. The “Subject to Section 12” limitation was held to apply only to the first clause of Section 2, such that more limited means of termination applied through and “until December 31, 2010 (i.e., for cause or change of distribution model)—after which only a 90-day written notice period applied.”


200 Id. at 323.

201 Id. at 323.

202 Id. at 327–28.

203 Id. at 328 (citation and quotation omitted).

204 Id. at 329–31.
2. **Is an Expiration a Termination, or Something Else?**

Where rights, obligations, or timeframes arise or expire on the occurrence of some other event or contingency, those triggers can become the subject of debate, as occurred in the context of non-competition provisions (discussed in section II.B.1., supra).

While much of the dispute in *Sleepy’s LLC v. Select Comfort Wholesale Corporation* focused on the definition of what was to be supplied under the parties’ dealer agreement (also discussed in the section below in this paper), the parties similarly disagreed over the arguable distinction between the terms “termination” and “expiration.” Sleepy’s claimed that the Select Comfort defendants breached the non-disparagement provision in the franchise agreement by talking badly to consumers about the Select Comfort line and about Sleepy’s sales practices in general, and presented evidence of this from late 2006. The district court found that this claim failed because the non-disparagement provision existed only while the agreement was in effect. The agreement expired by its terms on September 30, 2006, and thus disparagements after this date could not be a breach. The district court relied on another provision of the dealer agreement, which provided the deal agreement could not be extended “after termination” without “an express written waiver of termination signed by the terminating party.”

The court of appeals agreed with Sleepy’s, however, that the terms “expiration” and “termination” were distinct in the agreement. Sleepy’s argued that “expiration” meant “arrival at the date contractually specified as the end of the contract’s term,” while “termination” meant “the act of a party, relying on a contractual justification, to bring the contract term to a premature end.” The court of appeals found that the dealer agreement used these terms in different ways, and relied in part on the provision defining the term that stated it was “Subject to earlier termination . . ., the term of this Agreement shall commence as of the Effective Date and will expire September 30, 2006. . . .” The court also relied on other provisions in the dealer agreement about termination and what gave a party the right to terminate. Due to the differences in the terms, the dealer agreement could have been extended in term based on the parties’ conduct since the

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205 779 F. 3d 191 (2d Cir. 2015).
206 *Id.* at 194.
207 *Id.* at 196–97.
208 *Id.*
209 *Id.*
210 *Id.* at 197–98.
211 *Id.*
212 *Id.* at 196–97 (emphasis in case).
213 *Id.* at 197–98.
agreement was never “terminated.” Accordingly, the disparagement claims were remanded.

The differences in opinion issued by the district court and court of appeals demonstrate that absent clear and unequivocal language, reasonable minds may disagree about the provisions of a contract that are dispositive of a dispute.


Seldom does a greater incentive to split hairs and engineer crafty interpretations exist than in the fight of a franchisee’s life: termination. And, rarely do the parties to a franchise agreement have so immediate a need for an adjudication, leading to filing of a lawsuit (including for injunctive relief) or other invocation of dispute resolution provisions. The following are best practices for termination provisions:

- What can be exploited, likely will be.

- Define, define, define. Disputes regarding meaning, intent, and interpretation are certainly foreseeable, so ensuring that the bases for and procedure to effect a termination are clear is critical. Standards can be objective instead of subjective, financial metrics can be formulas instead of concepts. Definitions should also be “layered,” so that undefined terms do not exist within definitions.

- Strive for consistency and beware of line edits. Consistent treatment of franchisees is never more important than in the context of termination, but this becomes challenging when variances exist in the system. Ideally, termination provisions should be both ironclad and carefully crafted, attributes that can rapidly deteriorate with piecemeal edits from counterparties that are the original author of a cohesive document. Conversely, memorialize rejection of changes or assurances of clarity in writing, as these may become key pieces of parol evidence.

Clarity in termination provisions leads to standardization and uniformity of treatment within a system, which are attributes that can only yield dividends in disputes, discovery, and disclosure.

E. **Transfers**

The best technical drafting can be foiled or superseded, even for the most fundamental of provisions and seemingly routine and noncontroversial phrasing within them. Drafters of franchise agreements (and particularly attorneys that advise on or litigate them) should be cognizant that words and phrasing are not drawn against a blank canvas, but may already have a meaning. Legal terms of art, typical in general contract drafting, can take on an unintended meaning in the franchising context due to state-specific case law or other authority (e.g., franchise or dealer relationship statutes).

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214 *Id.*

215 *Id.* at 198.
1. **Understand the Statutes and Standards by Which Conduct Will Be Judged, Before Acting**

*Fladeboe v. American Isuzu Motors Inc.*\(^{216}\) provides an example of this principle in practice so extreme that the parties’ contractual language, though consistent with a statutory regime, takes on a particularized and specialized standard all its own. In *Fladeboe*, the dealer agreement at issue provided that it could not be transferred without the vehicle manufacturer’s prior consent, “which consent shall not be *unreasonably withheld*.”\(^{217}\) The “unreasonably withheld” standard was parallel to language within statutory regulations, which had been construed in California cases to mean that consent is “reasonably” withheld:

> if it is supported by substantial evidence showing that the proposed assignee is materially deficient with respect to one or more appropriate, performance-related criteria. This test is more exacting than whether the manufacturer subjectively made the decision in good faith after considering appropriate criteria. It is an objective test that requires that the decision be supported by evidence. The test is less exacting than one which requires that the manufacturer demonstrate by a preponderance of the evidence that the proposed assignee is deficient.\(^{218}\)

This test is further guided by eight “non-exhaustive” criteria: “(1) whether the proposed dealer has adequate working capital; (2) the extent of prior experience of the proposed dealer; (3) whether the *proposed* dealer has been profitable in the past; (4) the location of the proposed dealer; (5) the prior sales performance of the proposed dealer; (6) the business acumen of the proposed dealer; (7) the suitability of combining the franchise in question with other franchises at the same location; and (8) whether the proposed dealer provides the manufacturer sufficient information regarding its qualifications.”\(^{219}\)

The dealer requesting transfer in *Fladeboe* dissolved before any transfer was authorized, and was directly involved and participated in the unauthorized transferee entity selling new vehicles, performing warranty work, and pre-delivery inspection claims that were both misrepresented to and concealed from the manufacturer.\(^{220}\) As applied to those facts, the “unreasonably withheld” standard was sufficiently flexible to allow the manufacturer to “reasonably” decline to permit a transfer in consideration of the “dealer’s honesty and good faith in its relations with the manufacturer,” which is “particularly important . . . when deciding whether to approve a transfer of the dealership to a person or entity owned or controlled by, or closely related to, the transferring dealer.”\(^{221}\) *Fladeboe* illustrates that whether negotiating an agreement, advising on a course of action, or litigating past conduct, the meaning of words and phrases on

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217 *Id.* at 49, 230.

218 *Id.* at 62, 240.

219 *Id.* at 62–63, 240–41.


221 *Id.* at 63, 241.
which cases can turn are often far beyond the “four corners.”

2. **Best Practices for Transfer Provisions**

Transfer provisions are nearly ubiquitous, as are disputes above them. The following are best practices when drafting, negotiating, and advising on this subject:

- Avoid attempts (or encouragement) to “reinvent the wheel” on transfer provisions. Efforts to do so will be in vain in jurisdictions having controlling statutes or strong common law, but may provide the parties with a false sense of security that their decisions or conduct are appropriate or compliant—only to be told otherwise by a court years later.

- Few words and phrases have so varied a legal meaning as those boilerplate concepts often appearing in transfer provisions, e.g., “reasonable.” The probability of coining an entirely new, and not-previously-litigated modifier in the context of transfer is highly remote, so understand both how the standard language is interpreted in the applicable jurisdiction—and how the deviations have been applied in practice, anywhere.

In the life cycle of a franchise, transfer is also a provision that can be invoked following a rocky relationship or amidst ongoing disputes about substantive performance, underscoring the need for a definitive process and clear pathway to an end-result that is neither the tipping point for or center point of litigation.

F. **Supply**

Having a clear agreement on what will be supplied in a distribution relationship is critical. Using undefined or ambiguous terms to define the supply can lead to disputes, confusion, and needless costs, as seen in *Sleepy’s LLC v. Select Comfort Wholesale Corp.*

Plaintiff Sleepy’s, LLC was a distributor for the Select Comfort defendants, pursuant to a Dealer Agreement for the sale of the “Personal Preference” line of Select Comfort’s Sleep Number beds. Select Comfort, however, sold its “Core” line of Sleep Number beds in company-owned stores. The beds differed in that the Personal Preference line had a wooden foundation and wired controls, while the Core line had a plastic polymer foundation and wireless remote controls. In the Dealer Agreement, Select Comfort agreed to provide to Sleepy’s “first quality merchandise . . . meeting all mutually agreed upon specifications.”

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222 779 F.3d 191 (2d Cir. 2015).
223 *Id.* at 193–94.
224 *Id.* at 194.
225 *Id.*
226 *Id.* at 194.
The parties’ relationship started falling apart after Sleepy’s sales of the beds were lower than expected, and Sleepy’s received reports that Select Comfort’s sales personnel were criticizing Sleepy’s and the Personal Preference line as being of lesser quality. Sleepy’s claimed that it conducted secret shopping and found evidence that Select Comfort’s personnel were indeed disparaging the Personal Preference line and Sleepy’s sales and warranty activity generally. Eventually, the parties’ agreement by its terms expired and the parties entered into a wind-up agreement.

Then, Sleepy’s sued for breach of the Dealer Agreement, claiming that Select Comfort failed to sell it “first quality merchandise”, among other things. The parties commenced several months of trial, after which Select Comfort moved for judgment on partial findings under Federal Rule of Civil Procedure 52(c), which the court granted. Sleepy’s appealed the trial court’s decision.

The parties disputed the meaning of “first quality” in the Dealer Agreement. Sleepy’s contended that this term meant that Select Comfort was required “to provide it with beds that were in no way inferior to the beds sold at Select Comfort stores”, providing evidence from the parties’ contract negotiation. Select Comfort contended that this term meant “new, unflawed products which are distinguished from defective or damaged goods.” The trial court found that the term “first quality” was ambiguous, agreed with Select Comfort’s definition, and held that Select Comfort did not breach the agreement to provide such products. The court of appeals found that it did not have to decide the meaning of the term “first quality” because under either interpretation, Select Comfort did not breach the agreement. The district court had also found that Sleepy’s did not show that the Personal Preference line was of lesser quality to the Core line, and the court of appeals found that ruling to be correct.

One would think what is meant by or required by “supply” would be clear from the context of the franchise or the franchise agreement, but Sleepy’s shows that this is not always the case.

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227 Id.
228 Id.
229 Id.
230 Id. at 194–95.
231 Id. at 195.
232 Id.
233 Id.
234 Id. at 195.
235 Id.
236 Id.
237 Id.
238 Id.
If a party is relying on the specific meaning of a term, that term should be defined as clearly as possible. The alternative is that courts are left with ambiguity that unintentionally detracts from the contract.

1. **Best Practices for Drafting Supply Provisions**

   While Select Comfort handily prevailed on this dispute over “first quality,” it did so after months of trial and an appeal over a term the trial court found to be ambiguous. To avoid such disputes:

   - Discourage “business” terms that do not have standardized or objective measurements, and appreciate that your factfinder—particularly outside of arbitration and barring a lucky draw—is unlikely to have any personal knowledge or background appreciation of industry parlance.

   - The term “first quality” seems like a term that could have a meaning in the particular industry, but relying on industry knowledge alone to create meaning is risky because industry meanings change and can be hard to support factually. Indeed, having to argue about the usage of terms within an industry likely means at least one battle has been won or lost (as a matter of perspective): ambiguity.

This case shows that even simple terms like “first quality” can lead to disputes. One might be able to back into the meaning of such a term based on the parties’ actions, but if a term is as critical (such as the ultimate meaning of “supply” was here), it is important to clearly and simply define the term.

G. **Offering/Menu Restrictions**

Parties have litigated the meaning of a single word to compel (or resist) compliance with franchisor’s insistence on standardization.

1. **For the Good of the “System”**

   Earlier this decade, Steak ‘N Shake implemented a “policy” that required its franchisees to “follow set menu and pricing (with the exception of breakfast items), and to offer all company promotions as published.”239 The Plaintiff, Stuller, resisted that policy as inconsistent with “long-standing custom, practice, policy, agreement, and representation, as the operator of five franchised locations, including—symbolically—the "longest-standing Steak ‘N Shake franchise" in the United States.240 Steak ‘N Shake countered, arguing that price, promotions, and menu are part of “the ‘System,’” as defined within the operative franchise agreement, so that it’s “right to revise ‘the System’ from time to time” and require Plaintiff, as a franchisee, to “comply with the entire System, as revised” included pricing and promotions.241

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240 Id.

241 Id. at 677–78.
Steak ’N Shake lost the battle in the Central District of Illinois, which also held that the franchise agreements were “ambiguous with respect to whether price was part of the ‘System.’”\textsuperscript{242} The agreements at issue defined “System” as:

a unique restaurant concept, including buildings of distinctive architectural design, decorative color scheme and trade dress, and . . . standardized methods of preparing and serving certain food products and beverages for on-premises and off-premises consumption.\textsuperscript{243}

The Court concluded that System did not “specifically address” whether Steak ’N Shake had the authority to “require uniform pricing and promotions” through “modified operational standards,” rejecting Steak ’N Shake’s reliance on recitals regarding the “importance of maintaining uniformity in every component of the operation of the System” and Steak ’N Shake’s right to “revise from time to time” the manual through which the “System is maintained.”\textsuperscript{244} Those contract provisions, which only referenced the “System,” merely begged the question of what the “System” encompassed and entailed: pricing and promotions (or not).\textsuperscript{245}

The Court’s finding of ambiguity opened the door for extrinsic evidence, which included:

i. Prior intent, in negotiating franchise agreements, that franchisee “continue to have the ability to determine its own prices”;

ii. The UFOC provided before executing the franchise agreements, which stated “[f]ranchisees are free to set selling prices different from prices on SNS-owned restaurant menus and several do so”; and

iii. Plaintiff set its own prices “[f]or 70 years,” and Steak ’N Shake previously printed “custom menus . . . reflect[ing] a 10% increase in the prices then-being charged.”\textsuperscript{246}

Once the door to extrinsic evidence was open (and illustrating the significance of such a ruling), the court concluded that “[t]he undisputed extrinsic evidence demonstrates that price and promotions were not part of the System. As such, SNS could not modify the System to require Plaintiff to following SNS pricing and promotions.”\textsuperscript{247}

2. **Best Practices for Controlling Menu and Pricing**

Few operational issues have so direct a financial impact on a franchise system than product or service offerings and pricing, which are traceable in the short term to revenues, expenses, and margin.

\textsuperscript{242} Id. at 689.

\textsuperscript{243} Id. at 389.

\textsuperscript{244} Id. at 689.

\textsuperscript{245} Id. at 676–77.

\textsuperscript{246} Id. at 682, 692–93.

\textsuperscript{247} Id. at 693.
Relying on explicit power and rights, rather than implied control, is highly preferable. These should, ideally, be embedded within the franchise agreement and the disclosures that preceded it.

Be cognizant of and stay current on governing law in this area. Restrictions on pricing implicate antitrust and other concerns, including the “rule of reason.”

Parties should be particularly wary of generalized language as a basis for exerting power or resisting control where that text was neither relied upon, nor corresponding right exercised, for a substantial period of time.

H. Net Sales

1. Net Sales Definitions In the Real Estate Context

The definition of “net sales” was the focus in _Goldmex, Inc., v. Glendale I Mall Associates, LLC_.248 While the case was not between the franchisee and franchisor, this type of definitional dispute is likely to come up in the franchise context and should be planned for when executing real estate leases. Here, the plaintiff was a La Salsa franchisee who leased space from defendant landlord and related parties.249 The lease allowed the franchisee to pay less rent if its net sales fell below a certain threshold.250 The franchisee found that its net sales fell under the threshold if its franchise royalties and marketing fees were subtracted.251 A dispute ensued when the franchisee notified the landlord that it was paying the lesser rent amount.252 The trial court ruled in favor of the franchisee, as did the court of appeals based on its interpretation of the term “net sales” and the franchisee being the only party to offer a percipient witness to the negotiation of the lease.253

The definition of Net Sales included the following carve outs:

The following shall be deducted or excluded, as the case may be, from Net Sales, provided such exclusions are specifically itemized: (a) refunds to customers to the extent that such refunds relate to (i) a prior inclusion of the same transaction or (ii) returns of merchandise purchased from other physical store locations of Tenant; (b) sales, use, excise, retailer’s, occupation or similar taxes imposed in a specific amount, or percentage upon, or determined by, the amount of sales; . . . (e) sales not in the ordinary course of Tenant’s business, of machinery or equipment which Tenant has the right to remove from the Leased Premises; . . . and (h) the

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249 _Id._ at *1.

250 _Id._

251 _Id._

252 _Id._

253 _Id._ at *5.
proceeds of the sale of any franchise to operate the business on the Premises and all fees, charges or charges [sic] from such franchise.254

The landlord argued that the carve out only applied to “sales transacted by [the franchisee]”—i.e., if the franchisee sold its franchise.255 The franchisee argued that the landlord’s representatives assured it that it could carve out the franchise fees that it paid to La Salsa from the Net Sales.256

The court found Net Sales to be ambiguous because it was missing certain words and concepts about who was receiving the fees.257 Plus, the clause used the word “any” in relation to “any franchise”, and so it could as easily mean fees for a franchise sold to the franchisee as it could mean fees for a franchise sold by the franchisee.258 The court also noted that the clause specifically allowed things like sales, use, and excise taxes to be deducted and found those similar in concept to franchise fees since both are determined as an amount or percentage of sales.259 The court went afield to another section of the lease—one that provided strict limits on the franchisee transferring its interest in the lease—and found that such strict limitations counseled against limiting the carve out from Net Sales to sales of the franchise by the franchisee.260

The franchisee also testified to his negotiations and discussions with the landlord’s representative.261 But, in an unexplained move, noted by the court, the landlord did not call that representative to testify. The landlord only called one of its directors, who was uninvolved in the actual negotiations with the franchisee, to testify about the meaning of net sales in the shopping center business generally.262 Ultimately, the court of appeals found the landlord’s expert testimony unconvincing in light of the franchisee’s testimony about his negotiations with the landlord.263

A definition of “net sales” is critical in many lease agreements, especially in the franchise context where the additional relationship of franchising impacts the landlord-tenant relationship. Writing the definition out in full is critical for clarity and to avoid future disputes. Here, where words and concepts were left out, the lack of clarity caused the possibility of more than one

254 Id. at *2.
255 Id. at *3.
256 Id. at *4.
257 Id. at *8.
258 Id.
259 Id.
260 Id. at *9.
261 Id. at *9, 11.
262 Id. at *11.
263 Id.
meaning and allowed the court to traverse throughout the lease to settle upon a meaning in the dispute. Parties will want to avoid this consequence and take the time and the care to create and document a clear definition of net sales.

2. **Net Sales Definitions in Franchise Agreements**

It is also critical to take the time to properly edit definitions of high impact terms, like net sales in franchise agreements, when working with form definitions. In *Coyote Portable Storage, LLC v. PODS Enterprises, Inc.*, the parties dispute also focused in part on the meaning of the phrase “net sales,” but in the context of their franchise agreements.\(^{264}\) Plaintiff franchisees sued their franchisor, PODS Enterprises, Inc., for the return of royalties they paid on cross-country moves, among other claims.\(^{265}\) The trial court granted summary judgment for the franchisees, and the court of appeal affirmed based on the interpretation of the ambiguous term “net sales” and the parties’ original intent in the face of a changing business model that only later contemplated cross-country moves.\(^{266}\)

The franchisees claimed that the phrase “net sales” *excluded* cross-country revenues (moves between franchise territories), while the franchisor claimed cross-country revenues were included and added to the total revenue.\(^{267}\) The court of appeals called the definitions of “net sales” a “law-school class on bad drafting.”\(^{268}\) “Net sales” was defined as follows:

"Net sales" - The aggregate amount of sales, revenues, fees, charges and other consideration actually received for services and products sold in connection with operations conducted by the Franchised Business including income derived from sales at or away from the Franchised Business but excluding: (a) all federal, state and municipal sales or service taxes collected from customers and paid to the appropriate authority; (b) all insurance billed to and collected from customers and paid to the appropriate insurance company; (c) the amount of all customer refunds and adjustments and pre-approved, in writing, promotional discounts; (d) any amounts written off as bad debt expense; (e) revenue from the sale of Containers as part of a long distance move program organized and managed by us; and (f) any other sale of Containers, Lifts or other assets that we have approved in advance between you and other franchisees or us. The royalties and MAF ["Marketing and Advertising Fund" fees] shall be calculated on the "Net Sales," which is the total revenue as shown on the "Sales by Item Summary- Complete Summary," excluding sales tax and insurance as explained above, [**9**] less discounts, credit memos or adjustments and bad debt expense, and monies received as part of the cross country move program, which are distributed

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264 618 F. App’x 525 (11th Cir. 2015).
265 *Id.* at 527–28.
266 *Id.* at 528, 537.
267 *Id.* at 528–29.
268 *Id.* at 528.
separately on a monthly basis and not included in this summary.\textsuperscript{269}

The court found the definition was ambiguous as it included an incomplete and unclear fragment in the first sentence and contained two definitions of net sales in the same paragraph (when comparing the first sentence and the second sentence).\textsuperscript{270} The court relied on extrinsic evidence to determine the parties' intent, including documentary evidence, parties' construction of agreement, and common sense.\textsuperscript{271} Testimony from both sides showed that the representatives who negotiated the agreement intended to exclude cross-country revenues from net sales.\textsuperscript{272} The clause was confusing because it was edited from its normal form—normally the “and” (emphasized above) instead would have read “plus,” to indicate that it was not excluded, but the parties changed that “plus” to “and” to indicate that the cross-country revenues were excluded here.\textsuperscript{273} Even though the drafting was bad, the clear intentions of the drafters prevailed.\textsuperscript{274} The court also examined the parties' construction of the contract before the dispute and found that PODS did not charge cross-country royalties until a year after the agreements and then used a smaller royalty rate than what PODS now claimed the agreements provided.\textsuperscript{275} Also, the court found that the franchisees' interpretation made common sense because cross-country moves were originally a small part of PODS' business and not charging for that revenue was not surprising.\textsuperscript{276}

Here, the court looked to both the parties' original intent and the revised language to determine the meaning of net sales.\textsuperscript{277} The matter was complicated because the parties edited a form definition in a manner that ultimately turned out to be unclear. The case shows that the history of a system and how the parties used terms at an earlier point can impact later interpretation of the contract definitions. To avoid this dispute, the parties would have been better served by not limiting themselves to editing the original definition of net sales—as it was set up in a way to show what was included instead of what was excluded—and instead starting anew to define the meaning of net sales to show that certain items were excluded from the definition.

3. **Best Practices for Drafting Net Sales Definitions**

The phrase “net sales” can come up in various factual situations, but it is usually a critical term and one that can have significant carve-outs.

- Use complete sentences with all the nouns and verbs—not long lists and

\textsuperscript{269} Id. at 529 (emphasis added).

\textsuperscript{270} Id. at 528–29.

\textsuperscript{271} Id.

\textsuperscript{272} Id. at 530.

\textsuperscript{273} Id.

\textsuperscript{274} Id.

\textsuperscript{275} Id. at 531.

\textsuperscript{276} Id. at 532.

\textsuperscript{277} Id. at 528–32.
fragments of phrases—to describe contractual obligations. In *Goldmex*, if the landlord had taken the time to clearly state who was receiving the fees and what fees were received, the carve out or lack thereof could have been created without dispute.

- Be cautious in using forms of definition, especially when editing the definition for a new use. And consider drafting the definition from scratch when using the term in another manner. In *Coyote Portable Storage*, the franchisor ran into trouble because it edited its usual and already long list of what was included and excluded from “net sales.” A dispute may have been avoided if it instead clearly wrote a new definition.

The term “net sales” is a critical definition in franchise agreements, and care should be taken to define it as the parties intended, instead of relying on form definitions or tweaks to form definitions. The next section also shows another area of high-impact terms—marketing and advertising—that should be defined with specificity and care.

I. **Marketing and Advertising**

After developing and investing in a brand, franchisors want to protect the concept they have developed in order to preserve their reasonable expectations of being able to monetize the goodwill and value created. Franchise agreements can accomplish these protections through various means, including restrictive covenants, limitations on the use of intellectual property, and other contractual commitments.

1. **Specific Controls Over Generalities**

The case of *T. G. I. Friday’s, Inc. v. International Restaurant Group, Inc.*, demonstrates the criticality of clear drafting. As the title suggests, the franchisee in *T. G. I. Fridays, Inc.* obtained a “restaurant license” to operate such a restaurant in Jackson, Mississippi. A year after opening this restaurant, the franchisee asked to open a second restaurant in Baton Rouge, Louisiana—but was declined. In the entrepreneurial spirit, and three months later, the franchisee formed a new entity and opened a restaurant named “Ever Lovin’ Saturdays,” which the Fifth Circuit commented was “strikingly similar” to a Friday’s restaurant from its . . . motif to its menus” and “an obvious copy of the trade dress of Friday’s.” The franchisor, unsurprisingly, called foul and attempted to rely on its agreement as prohibiting just such a tactic, through the following provisions:

14. **OTHER TRADENAMES AND MARKS**

A. [Franchisee] acknowledges (1) that [Franchisor] has a vital interest in the names and marks, ‘Tuesday’s’, ‘Wednesday’s’, ‘Thursday’s’, and ‘Sunday’s’ (the ‘other marks’) and expects to develop interest in businesses

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278 569 F.2d 895, 898 (5th Cir. 1978).

279 *Id.* at 897.

280 *Id.* at 897–98.

281 *Id.*
operated under the other marks;
B. [Franchisee] covenants and warrants that during the term of this agreement and subsequent to its termination [Franchisee] . . . shall not utilize the names of the days of the week singly or in combination with other words in connection with the operation of a business.282

The franchisor argued that the prohibition on the “names of the days of the week” expressly precluded, by contract, franchisee’s operation of a restaurant containing the word “Saturday.” Both the District Court and Fifth Circuit disagreed—finding that “the words ‘the names of the days of the week’ are uncertain of meaning and susceptible to dual interpretation.”283 Read independently, 14B’s “names of the days of the week” includes all seven days of the week, but—when viewed in context of 14A that lists only four specific days of the week (and, curiously, not Friday’s).284 This ambiguity could have been pretermitted by numerous drafting alternatives (e.g., by including “all seven” days of the week in 14B), but this case provides an important lesson in the uncertainty that results once a Court concludes that an ambiguity exists, or otherwise resorts to attempting to infer the parties (uncertain) intent from a written agreement.

2. Over-Stating Can Mean Negation

Drafting with awareness of the rules of contract construction, particularly as applied by a specific jurisdiction, is particularly important because they may render words in a document meaningless when read the in the context of the agreement as a whole. Lokhandwala v. KFC Corp.,285 provides just such an example, where a Kentucky Fried Chicken franchise agreement was, predictably, subject to Kentucky law and its instruction that courts “give effect to as much of the contract as possible without rendering portions of it superfluous.”286

The franchisee sued Kentucky Fried Chicken, contending that the franchisor was “unreasonably attempting to block him from telling customers that his KFC franchises offer Halal chicken,” with Halal being a preparation conforming to Islamic laws and customs.287 The franchisee relied on the introductory phrasing to specific subjection regarding advertising and promotions:

During the License Term, the Franchisee will strictly comply with all reasonable standards, specifications, processes, procedures, requirements, and instructions of KFC regarding the operation of the business which now exist or may be established from time to time, and the Franchisee [*14] will take such action and precautions as necessary to assure that:

\[ \ldots \]

282 Id. at 898.
283 Id.
284 Id.
286 Id. at *5.
287 Id. at *2.
(h) only signs and menuboards, advertising and promotional material, equipment, . . . and other supplies which meet KFC's standards and specifications (as established from time to time) are used at the Outlet or in connection with its business.  

Despite the overarching “reasonableness” requirement as to Kentucky Fried Chicken’s actions, the court disregarded the word “reasonableness” because many of the subsections—unlike subsection (h)—also included the words “reasonable” or “reasonably.” So, the court disregarded the “reasonable” within the lead-in language, and only imposed a reasonableness standard on the (eight) sections that expressly included the language within them. Otherwise, the court reasoned, the eight uses of “reasonable” or “reasonably” within the subsections would be “superfluous.” Not only do individual words matter, but having too many of the same word can mean that some of the instances of the words have no meaning at all.

3. **Best Practices for Marketing & Advertising**

Marketing and advertising practices directly impact branding and, with it, one of the most valuable assets in franchising: intellectual property. The following drafting strategies mitigate litigation (and interpretation) risk:

- By requiring pre-approval of all marketing and advertising messaging through a specific procedure that does not originate from the holder of intellectual property, the weight of longstanding practices (that were never formally authorized) can be mitigated.
- Minimize subjectivity and vagueness, in favor of clear standards that lead to finality in the exercise of discretion, rather than creating an issue for review by a neutral adjudicator.

Teams that monitor and protect intellectual property should also be mindful of the contractual provisions that guard those rights, not only for purposes of enforcement, but also for reasons of being able to demonstrate routine protection of marks.

J. **Indemnity and Attorneys’ Fees**

Indemnity and attorneys’ fee provisions can be tricky in wording, but common contract tenets apply to interpret these provisions, such as reading the provision and the contract as a whole. While broad phrases like “any and all claims” are often in such provisions, these phrases may be defined and narrowed by what comes after this phrasing and specify what a party is actually being indemnified or reimbursed for. The cases below shows that, once again, words matter.

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288 *Id.* at *9, 13–14 (emphasis in original).

289 *Id.* at *14.

290 *Id.* at *14.
1. **Defining Scope of Indemnity Is Not Limited to the Phrase “All Claims”**

In *L.A. Insurance Agency Franchising, LLC v. Montes*, the court determined the effect of an indemnity clause by giving meaning to all parts of the clause. Here, defendant Claudia Montes and her franchises (“Montes”) asserted various counterclaims and defenses against plaintiff L.A. Insurance Agency Franchising, LLC, including that the franchise agreements were unenforceable because there were no mutual obligations between the parties. Montes argued that the indemnity provisions in the franchise agreements were an example of this because L.A. Insurance was completely exempt from any liability. L.A. Insurance moved for summary judgment on these claims.

The court analyzed the indemnity clause to determine the merit of Montes’ claims. The provision read:

> Franchisee is responsible for all losses or damages from contractual liabilities to third persons from the possession, ownership and operation of the Franchise Business and all claims or demands for damages to property or for injury . . . of persons, directly or indirectly, arising out of, or in connection with, possession, ownership or operation of the Franchise Business or the actions or omissions of Franchisee. Franchisee must defend, indemnify and hold harmless the Franchisor . . . against any and all claims . . . which arise out of, in connection with, or as a result of possession, ownership or operation of the Franchise Business or the acts or omissions of Franchisee . . .

Montes focused on the breadth of clauses like “any and all claims” and “which arise out of, in connection with, or as a result of.” But the court found this reliance was misplaced and the real question on mutuality was “‘arising out of, in connection with, or as a result of’ what?” The court found that reading the full words of the indemnity provision showed that the provision did not exempt L.A. Insurance from all liability. Rather, it was indemnified only if the claim arose out of the possession, ownership or operation of the Franchise Business. The court noted that Montes’ reading of the clause—that the indemnity was for any claim in connection with Montes’ agencies—wrongly asked the court to write language out of the provision, which narrowed it.

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292 *Id.* at *2.

293 *Id.*

294 *Id.*

295 *Id.* at *3 (emphasis in case).

296 *Id.* (emphasis in case).

297 *Id.* at *3.

298 *Id.* at *3–4.

299 *Id.* at *3.*
Accordingly, the court found the indemnity provision did not show the agreements were void for lack of mutuality and dismissed counterclaims and defenses based on this argument.\(^{300}\)

The court’s interpretation of the indemnity provision here shows that all parts of the provision must be read in order to give it meaning. Parties cannot take certain phrases like “any and all” out of the context of the whole because the limiting phrases matter.

2. **Attorneys’ Fees Provisions Can Be Limited in Scope Too**

The attorneys’ fee provision was interpreted in *Gallagher’s NYC Steakhouse Franchising, Inc. v. NY Steakhouse of Tampa, Inc.*\(^{301}\) Here, plaintiff Gallagher’s NYC Steakhouse Franchising, Inc.’s motion for summary judgment was granted against defendant NY Steakhouse of Tampa, Inc. and related parties, and the award included attorneys’ fees.\(^{302}\) On the motion for attorney’s fees, plaintiff sought over $50,000 in fees and costs, but defendants argued that some of these fees were incurred before litigation and thus could not be sought under the franchise agreement’s language.\(^{303}\)

The court noted New York law that stated “‘[b]ecause promises in a contract to indemnify the other party’s attorney’s fees run against the grain of the accepted policy that parties are responsible for their own attorneys’ fees, . . . courts applying New York law should not infer a party’s intention to provide counsel fees as damages for breach of contract unless the intention to do so is unmistakably clear from the language of the contract.”\(^{304}\) Accordingly, the court looked to the language of the attorneys’ fee provision in the parties’ franchise agreement to determine if there was clear intention to provide the fees.\(^{305}\) The provision stated that plaintiff could recover: “‘reasonable attorneys’ fees, experts’ fees, court costs, and all other expenses of litigation, if [Gallagher’s] prevail[s] in any action instituted against [Tampa Gallagher’s] to secure or protect [Gallagher’s] rights under this Agreement . . . .’”\(^{306}\)

Because the provision stated that the fees recovered were “expenses of litigation”, pre-litigation expenses were indeed not recoverable, and included plaintiff’s expenses in terminating the franchise agreement and entering into a limited term franchise agreement with defendants in this case.\(^{307}\) Plaintiff was awarded about $40,000 of its $50,000 request.\(^{308}\)

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\(^{300}\) *Id.* at *4.

\(^{301}\) No. 11 Civ. 1456 (THK), 2011 WL 6935295 (S.D.N.Y. Dec. 29, 2011).

\(^{302}\) *Id.* at *1, 3.

\(^{303}\) *Id.* at *3–250.

\(^{304}\) *Id.* at *4 (citation omitted).

\(^{305}\) *Id.* at *4.

\(^{306}\) *Id.* (emphasis in case).

\(^{307}\) *Id.*

\(^{308}\) *Id.* at *5.*
This case also illustrates the principle that more specific language can limit what would be an otherwise broad contractual provision. Without the latter phrase “all other expenses of litigation,” the clause could have been broad enough to include pre-litigation expenses.\textsuperscript{309} But the addition of this later phrase limited the prior words in the attorneys’ fee provision to limit it to items incurred during litigation.

3. **Best Practices in Drafting Indemnity and Attorneys’ Fees Provisions**

Drafting indemnity and attorneys’ fee provisions can require more attention because the American Rule of fee recovery does not allow a presumption of recovery of fees. Interpretation of these provisions can be critical because they may be a party’s only way to recover fees and certain costs.

- Limiting phrases are as or more important than the general broad language of fee recovery.
- Do not presume broad fee recovery in indemnity and attorney’s fee provisions, and carefully read and draft for what could be later construed as a limiting phrase, depending on what the parties desire for recovery options.

In drafting indemnity and attorneys’ fee provisions, parties should think through how they will be applied in varying factual scenarios to determine if the provisions are drafted to mean what the parties intend, before a dispute. As the cases above show, parties cannot presume broad application of the provision and the specific language in the provision may limit it.

**IV. DRAFTING CONSIDERATIONS, LITIGATION OPPORTUNITIES, & LESSONS LEARNED**

The compendium of cases within this paper underscores the importance of phrases, words, structure—and even punctuation. While some arguments and ambiguities in these disputes may have appeared opportunistic or contrived, the outcomes of judicial and arbitral decisions were hardly predictable, and often surprising. In addition to the context-specific best practices,

i. **Know the Governing Law and Dispute Forum** – Differences in the law governing an agreement (and inevitable disputes over it) can be dispositive, or at the very least generate costly uncertainty. Uniformity in text will not equate to standardization in interpretation and application. And, just as important as the law to be applied is the forum in which it is applied. Arbitration has benefits and drawbacks, but be cognizant of the highly limited redress and recourse available from courts—particularly where no

\textsuperscript{309} This calls to mind the different but related concept of *ejusdem generis* which provides “[w]here general words follow specific words in a statutory enumeration, the general words are construed are construed to embrace only objects similar in nature to those objects enumerated by the preceding specific words.” *Circuit City v. Adams*, 532 U.S. 105, 114-15 (2001). Essentially in *ejusdem generis* the general words and concepts—that follow the specific words—are limited by those preceding specific words. In *Gallagher’s NYC Steakhouse Franchising, Inc.*, the concept of *ejusdem generis* did not arise, but rather the opposite of this canon occurred. The restricting phrase “and all other expenses of litigation,” which followed a listing of words describing the recoverable expenses, actually limited the application of the preceding listing of words.
precedent exists for a custom-tailored phrase that has never been tested and for which no guideposts (or guardrails) exist.

ii. **Look Beyond the Four Corners** – Where the text of an agreement leads to an undesirable or unwanted outcome, search for an anchor for an alternative argument: within relationship statutes; within other statutes and regulations, irrespective of whether related to franchising; in past communications between the parties (or, better still, by the counterparty), in a course of conduct/dealing.

iii. **Beware of Rules of Construction Traps** – So long as the rules of construction encourage giving effect to every word, there can be no “distinction without a difference” in contract drafting. *All* words must have a meaning, so an inadvertent inconsistency in phrasing (or redundancy) may have the unintentional effect of creating a discrepancy that must be resolved by distinguishing two (or more) phraseologies that should, instead, be identical.

iv. **Leave Nothing to Chance** – The best safeguard against an ambiguity is to eliminate it through a definition that is both specific and detailed. Relying on “obvious” or standard meanings or use of generalities may leave open an avenue for debate that could have been foreclosed with just a few additional sentences.
**BIOGRAPHIES**

Eric D. Stolze is a Senior Associate in the Complex Litigation & Arbitration Practice Group in the Atlanta office of Paul Hastings LLP. His practice focuses on representing corporate clients in high value and high stakes disputes, with an emphasis on franchise dispute litigation and mitigating risk from business conflicts, both inside and external to organizations.

Elizabeth M. Weldon is a partner at Snell & Wilmer L.L.P. in Costa Mesa, California. Elizabeth concentrates her practice on business litigation and franchise litigation. She is a Certified Specialist, Franchise & Distribution Law, by the State Bar of California Board of Legal Specialization and represents franchisors in matters including breach of contract, trademark and trade name infringement, business competition torts and franchise law claims. She is currently a member of the governing committee of the ABA Forum on Franchising. She graduated with a J.D. from the William & Mary School of Law in 2001. She is the immediate past president of the board of directors of Girls Inc. of Orange County, a non-profit organization serving over 4,000 girls each year.

Michael J. Boxerman is a partner at Marcus & Boxerman in Chicago. Michael’s practice focuses on the representation of multi-unit franchisees and franchisors in a wide range of franchise, real estate, business and corporate matters, and in dispute resolution through litigation, arbitration and mediation.